Book: Introduction to Business (Lumen)

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Licensing

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

CHAPTER OVERVIEW

1: Course Contents

1.1: About This Course

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

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

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

Course Improvements

This new edition of Waymaker Introduction to Business includes improvements and enhancements including:

- Fully revised Module 5: Legal Environment and Module 8: Entrepreneurship with new updated content.
- Added a new module, Module 17: Using Technology to Manage Business Information.
- Added practice opportunities to every learning outcome for students to enrich their learning.

We believe in making continuous improvements to our courses in order to enhance and facilitate student learning. This newest version of the course includes data-driven improvements to assessment questions and text content in order to better illustrate, clarify, and evaluate concepts.

Acknowledgments

This book has benefited from the contributions of many people, including Daniel Hossa, Lelah Jones Olender, David Clark, Kathleen Jackson, Alaina Ray, Caitland Holland, Luke Edwards, Shawna Hunt, Joshua Hirschfeld, Barry Hardy, Aaron Marcinkevich, Anni Mabasa, Anthony Avram, Nate Moore, John Rolon, Michelle Cain, Teri Huff, Tammi Lampe, Abigail M, Magdi Alkaifi, Renny Y. and Kathryn Grace.

Contributors and Attributions

1.2: Course Contents at a Glance

The following list shows a summary of the topics covered in this course.

Module 1: Role of Business

- What Is Business?
- For-Profit vs. Nonprofit
- Factors of Production
- Functional Areas
- Stakeholders
- External Forces

Module 2: Economic Environment

- What Is Economics?
- Economic Systems
- Demand
- Supply
- Equilibrium
- Health of the Economy
- Economic Stages

Module 3: Global Environment

- Globalization
- Measuring Global Trade
- Global Business Strategies
- Global Trade Forces
- Global Trade Agreements and Organizations
- Ethical Challenges in the Global Environment

Module 4: Financial Markets and System

- Money
- Role of Banks
- Financial Markets and Business

Module 5: Legal Environment

- The Meaning and Purpose of Law
- Statutory and Common Law
- Tort Law
- Intellectual Property
- Warranties
- Contracts
- Consumer Protection and Antitrust Laws

Module 6: Business Ethics and Corporate Social Responsibility

- Ethical and Legal Behavior
- Business Ethics
- Ethical Challenges

- Corporate Social Responsibility

Module 7: Business Ownership

- Choosing an Organizational Type
- Sole Proprietorships
- Partnerships
- Corporations
- Hybrid Forms of Ownership
- Franchises
- Mergers and Acquisitions

Module 8: Entrepreneurship

- Small Business
- Entrepreneurs
- Advantages, Disadvantages, and Considerations
- Steps to Starting a Business
- Business Plans

Module 9: Management

- Managers
- Management Theory
- Planning
- Organizing
- Leading
- Controlling

Module 10: Motivating Employees

- The Hawthorne Effect
- Need-Based Theories
- Process-Based Theories
- Theory X, Theory Y, and Theory Z
- Strategies for Motivating Employees

Module 11: Teamwork and Communication

- Teams
- Team Development and Success
- Effective Communication and Barriers
- Communication Channels, Flows, and Networks
- Electronic Communication

Module 12: Managing Processes

- Operations Management
- Production Processes
- Production Planning
- New Technologies
- Supply Chain Management and Logistics
- Quality Assurance

Module 13: Marketing Function

- Role of Customers
- Segmentation and Targeting
- Marketing Mix Introduction

Module 14: Marketing Mix

- Product
- Promotion
- Place
- Price

Module 15: Human Resource Management

- Human Resource Management
- Human Resources and Laws
- Recruitment and Hiring
- Training, Development, and Rewards
- Termination
- HR Challenges

Module 16: Accounting and Finance

- Accounting in Business
- Key Financial Statements
- The Break-Even Point
- Financial Ratios
- Ethical Practices in Accounting

Module 17: Using Technology to Manage Business Information

- Technological Changes in Business
- How Businesses Use Information
- Information Networks
- Current Issues in IT

Contributors and Attributions

1.3: Learning Outcomes

The content, assignments, and assessments for Introduction to Business are aligned to the following learning outcomes. For a complete list of topics covered in the course, see the Detailed Learning Outcomes.

Module 1: Role of Business

Discuss the role of business in society, the primary functions within a business, and external forces that affect business activities

- Explain the concept of business
- Distinguish between for-profit and nonprofit businesses
- List and explain the four factors of production required to sustain a business
- Identify the primary functional areas within a business and describe their contribution to the organization
- Identify business stakeholders and describe their relationship with business organizations
- Identify the external forces that shape the business environment

Module 2: Economic Environment

Explain fundamental economic principles and describe how they shape the business environment

- Define economics and explain the difference between macroeconomics and microeconomics
- Identify the forces that drive supply and demand within an economic system
- Illustrate the relationship between supply and demand using supply and demand curves
- Compare and contrast different economic systems (capitalist, planned, and mixed)
- Describe the methods economists use to evaluate the health of an economy, such as GDP, unemployment rate, and CPI
- Explain the effect that the four stages of an economy (expansion, peak, contraction and trough) have on business operations
- Identify and explain the four stages of an economy (expansion, peak, contraction, and trough), and describe their impact on business operations

Module 3: Global Environment

Describe the characteristics, opportunities, and challenges of the global business environment

- Explain why nations and U.S. firms engage in global business
- Describe how nations measure global trade
- Evaluate common strategies used to reach global markets
- Identify and describe forces that affect global trade
- Describe global trade agreements and economic organizations that regulate and promote global trade
- Describe ethical challenges that businesses face in a global environment

Module 4: Financial Markets and Systems

Explain the institutions and markets that comprise the financial system, and explain how they impact the economy and the money supply

- Explain what money is and what makes it useful
- Explain the role of banks in the U.S. monetary system
- Describe common ways in which businesses obtain financial capital (money) to fund operations

Module 5: Legal Environment

Summarize the role of the legal system in governing and shaping the climate for business

- Explain the meaning and purpose of law
- Differentiate between statutory and common law
- Define tort law, and explain the role of product liability in tort law
- Explain the purpose and characteristics of intellectual property law
- Describe warranties
- List and describe the elements of a legally enforceable contract, and explain the consequences of breach of contract
- Summarize consumer protection and antitrust laws

Module 6: Business Ethics and Corporate Social Responsibility

Explain the importance of business ethics and corporate social responsibility

- Differentiate between ethical and legal behavior
- Explain the concept of business ethics, and outline the steps companies take to encourage ethical behavior
- Identify common ethical challenges faced by organizations
- Explain the concept of corporate social responsibility (CSR)

Module 7: Business Ownership

Distinguish among the forms of business ownership

- List and explain the important factors in choosing an organizational type
- Discuss the advantages and disadvantages of sole proprietorships
- Discuss the advantages and disadvantages of partnerships
- Discuss the advantages and disadvantages of corporations
- Discuss the advantages and disadvantages of hybrid forms of business ownership
- Discuss the advantages and disadvantages of franchises
- Describe the two types of mergers and acquisitions

Module 8: Entrepreneurship

Discuss the role of entrepreneurship in small business

- Discuss the contributions of small business to the U.S. economy
- Identify the common traits of successful entrepreneurs
- Discuss the advantages, disadvantages, and important considerations of starting a small business
- Describe the steps to starting a business
- List and describe the key components of a business plan

Module 9: Management

Describe the primary functions, responsibilities, and skills of effective leadership and management

- Describe the three levels of management and the key skills needed by managers
- Summarize the development of management theory and the key functions of management today
- Identify the types of planning and decision making managers engage in, and explain how these help organizations reach their goals
- Describe the organizing function of management and common types of organizational structure
- Describe common management and leadership styles, and identify the circumstances under which they are most effective
- Explain why control is an essential part of effective management, and outline the steps of the control process

Module 10: Motivating Employees

Explain common motivational theories and apply them to business

- Describe the Hawthorne effect, and explain its significance in management
- Explain need-based theories of worker motivation

- Explain process-based theories of motivation
- Differentiate between Theory X, Theory Y, and Theory Z managers
- Explain how managers can use job characteristics and goal-setting theory to motivate employees

Module 11: Teamwork and Communication

Explain the importance of teamwork and effective communication in a business environment

- Differentiate between groups and teams, and describe the characteristics of different types of teams
- Explain the stages of team development and the factors that contribute to team success
- Explain the importance of, and barriers to, effective communication within an organization
- Describe typical communication flows, channels, and networks within an organization, and explain when different channels are appropriate
- Describe the ethical issues, risks, and challenges associated with electronic communication in business

Module 12: Managing Processes

Explain how operations management contributes to organizational success

- Define operations management in manufacturing and production businesses
- Describe four major types of facility layouts: process, product, cellular, and fixed position
- Identify existing and emerging technologies that are changing the way goods are produced and delivered
- Define operations management in service businesses
- Explain the scheduling tools (Gantt and PERT) used to increase operations efficiency
- Explain the importance of logistics and supply-chain management
- Identify the techniques that are available to ensure high-quality goods and services (Six Sigma, TQM, SPC) and describe the costs of poor quality

Module 13: Marketing Function

Explain the key components of the marketing function

- Explain the role of customers in marketing
- Explain the role of segmentation and targeting in marketing
- Explain the marketing mix

Module 14: Marketing Mix

Explain how organizations use the marketing mix to market to their target customers

- Explain common product marketing strategies and how organizations use them
- Explain common pricing strategies and how organizations use them
- Explain common product distribution strategies and how organizations use them
- Explain how organizations use integrated marketing communication (IMC) to support their marketing strategies

Module 15: Human Resource Management

Recognize the role of human resource management in planning, recruiting, and managing a workforce

- Explain how the functions of human resource management contribute to business success
- Summarize and discuss key laws affecting human resource management
- Discuss how organizations can effectively recruit and hire employees
- Discuss effective approaches to training, developing, and rewarding employees
- Describe the different HR management options for employee termination
- Discuss the challenges facing today’s HR managers

Module 16: Accounting and Finance

Recognize sound accounting practices, and use financial statements and accounting principles to make informed judgments about an organization's financial health

- Define accounting, and explain its role as a form of business communication
- Identify key financial statements and their components, and explain the primary use of each type of statement
- Calculate the break-even point, where profit will be equal to $0, using information from financial statements
- Use financial statements to calculate basic financial ratios to measure the profitability and health of a business
- Discuss the importance of ethical practices in accounting and the implications of unethical behavior

Module 17: Using Technology to Manage Business Information

Recognize the roles of data and information technology in supporting business operations

- Discuss the role of technology in business
- Discuss ways in which information is used in business
- Compare the ways that businesses can manage information
- Identify security, privacy, and ethical issues affected by information technology

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CHAPTER OVERVIEW

2: Faculty Resources

2.1: Request Access

To preserve academic integrity and prevent students from gaining unauthorized access to faculty resources, we verify each request manually.

Click here to fill out the request form, and we'll get you on your way.

Overview of Faculty Resources

This is a community course developed by an Achieving the Dream grantee. They have either curated or created a collection of faculty resources for this course. Since the resources are openly licensed, you may use them as is or adapt them to your needs.

Now Available

- Discussions
- Assignments
- Cases

Share Your Favorite Resources

If you have sample resources you would like to share with other faculty teaching this course, please send them with an explanatory message and learning outcome alignment to share@lumenlearning.com.

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2.2: I Need Help

Need more information about this course? Have questions about faculty resources? Can't find what you're looking for? Experiencing technical difficulties?

We're here to help! Take advantage of the following Lumen customer-support resources:

- Check out one of Lumen's Faculty User Guides here.
- Submit a support ticket here and tell us what you need.
- Talk and screen-share with a live human during Lumen's OER office hours. See available times here.

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CHAPTER OVERVIEW

3: Faculty Resources

3.1: Faculty Resources Overview

We’ve seen overwhelming demand for high quality, openly-licensed course materials, including supplemental resources to enrich teaching and learning and to make life easier for instructors. To support this need, we’ve developed and curated faculty resources to use with this course.

Free and Open Supplemental Materials

On the following pages, you will find supplemental resources that are freely available to use with the interactive learning materials for this course. Since these resources are openly licensed, you may use them as is or adapt them to your needs.

Additional Faculty Resources

Additional supplemental resources, learning tools, and support services are available to faculty who adopt Waymaker, OHM, or Candela courses with paid support from Lumen Learning. For many courses, these include some combination of summative assessments, answer keys, solutions manuals, or other materials shared only with authorized instructors in order to protect academic integrity.

Click here to learn more about additional instructor tools and resources available to faculty who adopt Lumen-supported courseware. Information about pricing and payment options is available on this page. Lumen’s low-cost support fees replace the cost of expensive textbooks and may be paid by students or by the institution directly.

Continuously Improving Learning Materials

Are you interested in collaborating with us to make these course materials better? We use learning data to identify where content improvements are needed, and then we invite faculty and subject matter experts to work with us developing continuous improvements aimed at increasing learning.

Learn more from this blog post, or sign up here to join our continuous improvement mailing list and stay up to date about upcoming OER hackathons and other continuous improvement activities.

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3.2: Pacing

The Introduction to Business textbook contains sixteen modules—one module per week for a sixteen-week semester. If you need to modify the pace and cover the material more quickly, the following modules work well together:

- **Module 3: Global Environment** and **Module 6: Business Ethics and Social Responsibility**
- **Module 4: Financial Markets and Systems** and **Module 16: Accounting and Finance**
- **Module 5: Legal Environment** and **Module 7: Business Ownership**

We recommend NOT doubling up the following modules, because they are long and especially challenging. Students will need more time for mastery and completion of assignments.

- **Module 2: Economic Environment**
- **Module 13: Marketing Function**
- **Module 14: Marketing Mix**

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3.3: PDF

Lumen makes significant investments to ensure our digital courseware is accessible, allowing students to learn using superior interactivity, multimedia, and a variety of accommodations for individuals with varying abilities.

PDFs offer an inferior learning experience compared to the richness and interactivity in our digital courseware. A PDF version of the textbook is available as a print alternative. The PDF does not include interactive content such as simulations, videos, and quizzes and is not vetted for accessibility. For these reasons, **we do not recommend using the textbook in the PDF form**. The offline version should be used as a print backup rather than as the primary textbook.

You can download the PDF using the following link:

- PDF (87.2 MB)

To share these files with your students, copy and paste the text and download link above into a page or announcement in your learning management system (Blackboard, Canvas, etc.).

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3.4: PowerPoints

This course includes PowerPoint slide decks organized by chapter and aligned to course content. The decks also include practice questions and class discussion/activity prompts, which you may use, edit, or remove according to your classroom needs.

Since the slides are openly licensed, you are welcome to retain, reuse, revise, remix, and redistribute them. They are also accessible. If you do revise them, make sure to follow these guidelines for creating accessible PowerPoints.

Download individual decks, below:

- Module 1: Role of Business
- Module 2: Economic Environment
- Module 3: Global Environment
- Module 4: Financial Markets and System
- Module 5: Legal Environment
- Module 6: Business Ethics and Corporate Social Responsibility
- Module 7: Business Ownership
- Module 8: Entrepreneurship
- Module 9: Management
- Module 10: Motivating Employees
- Module 11: Teamwork and Communication
- Module 12: Managing Processes
- Module 13: Marketing Function
- Module 14: Marketing Mix
- Module 15: Human Resource Management
- Module 16: Accounting and Finance
- Module 17: Using Technology to Manage Business Information

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3.5: In-Class Activities

A set of in-class activities is available to support face-to-face and hybrid classes. These are not already built into the assignment tool of your learning management system (Canvas, Blackboard, etc.), but they can be downloaded for use or previewed, below:

- In-Class Activities

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3.6: Assignments

The assignments in this course are openly licensed, and are available as-is, or can be modified to suit your students' needs. Answer keys are available to faculty who adopt Waymaker, OHM, or Candela courses with paid support from Lumen Learning. This approach helps us protect the academic integrity of these materials by ensuring they are shared only with authorized and institution-affiliated faculty and staff.

If you import this course into your learning management system (Blackboard, Canvas, etc.), the assignments will automatically be loaded into the assignment tool.

Salty Pawz Assignments and Discussions

Half of the written assignments and discussions (32 in total) are based on a case study, whose focus is a fictional dog-treats business called "Salty Pawz." Many of these assignments take the form of asking students to give Wanda, the company's inexperienced owner, advice about how she can run her business more effectively. Lighthearted in tone, the Salty Pawz case study and associated assignments create a common framework for applying knowledge and skills developed through the course, encouraging students to demonstrate mastery of the content through real-world tasks and work products.

Alternate Assignments and Discussions

The other half of the written assignments and discussions (32 in total) use a variety of approaches, depending on the subject and learning outcome being assessed; many ask students to go beyond course content to form connections between research topics and what they've learned in class.

Using Assignments

We recommend assigning *one discussion OR one assignment per chapter*, rather than all of them. Some instructors prefer to stick with the Salty Pawz theme throughout the course; others like to use some of the alternates along the way. You can view any assignments or discussions below or throughout the course.

Assignments and Discussions with Module Alignment

Module Alignment	Salty Pawz Assignments	Salty Pawz Discussions	Alternate Assignments	Alternate Discussions
Module 1: Role of Business	Assignment: What Does a Business Look Like?	Discussion: The Stakeholders of Salty Pawz	Assignment: What Is Killing Our Business?	Discussion: External Factors = Internal Pressure
Module 2: Economic Environment	Assignment: Supply and Demand for Salty Pawz	Discussion: Supply and Demand at Salty Pawz	Assignment: Price Inelasticity of Demand	Discussion: Supply and Demand in Your Life
Module 3: Global Environment	Assignment: Taking Salty Pawz to the Global Market	Discussion: Sending Salty Pawz Global	Assignment: We Do It Better Here	Discussion: Made in America
Module 4: Financial Markets and System	Assignment: Show Wanda the Money	Discussion: Why Wanda Cares About the Federal Reserve—or Does She?	Assignment: The Most Powerful Person in the World	Discussion: Do You Have Change for a $20?

Module Alignment	Salty Pawz Assignments	Salty Pawz Discussions	Alternate Assignments	Alternate Discussions
Module 5: Legal Environment	Assignment: Your Dog Treats Made Fluffy Sick!	Discussion: They Don't Sue Dog-Treat Companies, Do They?	Assignment: Who Is Suing Whom?	Discussion: The Product-Liability Debate
Module 6: Business Ethics and Corporate Social Responsibility	Assignment: What They Don't Know Won't Hurt Me	Discussion: It's Not Stealing if You Pay For It, Is It?	Assignment: Corporate Social Responsibility	Discussion: Are They Simply Guidelines?
Module 7: Business Ownership	Assignment: Wanda's Business-Ownership Options	Discussion: Business Structure Does Matter	Assignment: Franchising—an Alternative to Start-up	Discussion: Entrepreneurs and Business Ownership
Module 8: Entrepreneurship	Assignment: Dear Wanda's Mom	Discussion: Wanda's Entrepreneurial Spirit	Assignment: Today's Hottest Entrepreneurs	Discussion: Am I an Entrepreneur?
Module 9: Management	Assignment: One Owner, Many Hats	Discussion: How Does Wanda Manage?	Assignment: Are Leaders Born or Made?	Discussion: How Great Leaders Inspire Action
Module 10: Motivating Employees	Assignment: Motivating with Dog Treats?	Discussion: Why Isn't Jamie More Motivated?	Assignment: What's Empowerment Got to Do with It?	Discussion: Motivate Me!
Module 11: Teamwork and Communication	Assignment: Teamwork at Salty Pawz	Discussion: What You Heard Was Not What I Meant	Assignment: Multicultural Virtual Work Teams	Discussion: The Ultimate Cost of Poor Communication
Module 12: Managing Processes	Assignment: From Kitchen Baker to Operations Manager	Discussion: More Than Just Baking Treats	Assignment: The Malcolm Baldridge Award	Discussion: How Things Are Made
Module 13: Marketing Function	Assignment: Customers and Marketing at Salty Pawz	Discussion: Customer Value Perception	Assignment: Hit Your Target	Discussion: Black Friday and Cyber Monday
Module 14: Marketing Mix	Assignment: The Four Ps of Gourmet Dog Treats	Discussion: The Four Ps of the Competition	Assignment: I Can See the Four Ps of Marketing	Discussion: Marketing Mix
Module 15: Human Resource Management	Assignment: Wanda's Hiring Approach, or How to Be Sued in One Easy Lesson	Discussion: People Won't Work for Dog Treats!	Assignment: Career Choices	Discussion: Are Interviews a Waste of Time?
Module 16: Accounting and Finance	Assignment: Bison Are Biting into Wanda's Break-Even Point	Discussion: Cooking More Than Dog Treats	Assignment: Claire's Cuttery	Discussion: CPAs and Financial Crisis
Module 17: Using Technology to Manage Business Information	Assignment: Policy at Salty Pawz	Discussion: Wanda on the Web		

Open Pedagogy Assignments and Alignment

Assignment	Module
Functional Areas of Business	Module 1: Role of Business
Business Ethics and Corporate Social Responsibility	Module 6: Business Ethics and Corporate Responsibility

Assignment	Module
Formal and Informal Communication	Module 11: Teamwork and Communication
The Marketing Mix	Module 13: Marketing Function

Rubrics for Written Assignments and Discussion Posts

For faculty using the assignments or discussions included here, there are also sample rubrics to assist you in grading. Instructors may download and modify these guidelines or use their own.

Grading Rubric for Discussion Posts

Written Assignment Rubric

Guidelines for Written Assignments

For faculty using the assignments included here, there is also a set of guidelines regarding length, formatting, and other mechanical submission requirements. Instructors may download and modify these guidelines or use their own.

- Guidelines for Written Assignments

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3.7: Question Banks

The machine-graded assessments in this course are organized by module and are aligned to specific learning outcomes. Waymaker courses assess students in three locations: Show What You Know (ungraded pretests at the beginning of each module), Self-Checks (short, ungraded practice tests), and end-of-module quizzes (graded).

Authorized faculty may edit and delete quiz questions and also add new ones using the quiz editing tool inside their Waymaker course(s). To learn more about editing the assessments in Waymaker, visit the Waymaker Faculty User Guide AFTER the course package has been imported to your learning management system (Blackboard, Canvas, etc.).

Optional Download

The Show What You Know and Self-Check questions are also available as a separate file that can be downloaded and imported into the assessment tool in your LMS. This format and extra step are needed ONLY if you want to make your own customized quiz, midterm, or final exam that combines quiz questions from multiple modules.

There are 17 question banks with a total of 929 multiple choice questions.

We provide quiz banks as QTI files, a standard format that allows you to import questions, build, and customize quizzes in most learning management systems (Canvas, Blackboard, etc.). **These files cannot be opened outside of an LMS.**

According to Lumen company policy, we do not provide quizzes in written (e.g. MS Word) form, in order to preserve the academic integrity of our quiz banks on behalf of everyone using our materials. We adopted this policy after observing how easy it is for quiz banks in written formats to find their way onto websites that promote academic cheating.

Click the name of your LMS to prompt the download of the file.

- Canvas
- Blackboard
- D2L
- Moodle

Once you've downloaded the file, visit the Quiz Imports page and click through to the directions for your LMS.

Midterm and Final Exams

A comprehensive set of short-answer questions has been provided for midterm and final exams. Two questions per chapter are included so that faculty can create two different exams without repeating questions. You can download the question set as a Microsoft Word document, below:

- Midterm and Final Exam Questions

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3.8: I Need Help

Need more information about this course? Have questions about faculty resources? Can't find what you're looking for? Experiencing technical difficulties?

We're here to help! Take advantage of the following Lumen customer-support resources:

- Check out one of Lumen's Faculty User Guides here.
- Submit a support ticket here and tell us what you need.
- Talk and screen-share with a live human during Lumen's OER office hours. See available times here.

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CHAPTER OVERVIEW

4: Student Resources- Salty Pawz Case-Study Information

4.1: Salty Pawz- A Case Study in Business

Throughout the course, you will interact with Wanda, the founder and owner of Salty Pawz.

Salty Pawz a small business that specializes in preparing and selling high-quality gourmet dog treats. Like many entrepreneurs, Wanda has a great deal of experience and expertise in the specific products she produces, but she knows little about the broader business environment. As a student of business, you will find that Wanda will need your help and ask your advice throughout this course. The information contained in this case study is taken from Wanda's business operations, and you'll need this in order to apply the concepts and theories in this course—and to help her.

You can read the case study information on the following pages or download it as a Microsoft Word document.

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4.2: Salty Pawz Background

Several years ago, Wanda went to the local animal shelter looking for a new dog, and when she arrived, the most pathetic-looking bulldog-boxer mix she had ever seen greeted her. The puppy had terrible skin problems, had lost almost all of his fur, and his skin was pink from scratching. The poor thing looked like a naked mole rat, but Wanda fell in love with him on the spot. She promptly filled out the paperwork, named him Cosmo, and took him to the vet. Her vet was cautiously optimistic about the dog's prospects for recovery but advised Wanda that, in addition to medication, Wanda would have to be very careful about what she fed him. As a result, Wanda began to research dog food and was horrified at the low quality of the foods and treats available. She looked into healthier alternatives and, after some experimentation, developed several recipes that Cosmo could tolerate. As her friends watched the evolution of Cosmo from sickly pup to happy dog, they began to ask Wanda to bake those treats for their dogs, as well. Soon, friends of friends were calling her for her creations, and before she knew it, Wanda was in the gourmet dog-treat business.

As a result of this blossoming interest in what she was doing, Wanda has been successfully baking and selling dog treats out of her home for the past several years, using the product name "Salty Pawz." The demand for her custom dog treats has grown to the point that she has a couple of friends who help her on a regular basis. Several months ago, she began selling her treats on Etsy.com. Since then, her online orders have started to outpace her capacity. This month, her brother-in-law set up a website for Salty Pawz. At first she was excited that more people would have access to her products, but she didn't anticipate how many orders it would generate.

She has been talking to entrepreneurs in her hometown to get advice about taking her operation "to the next level." She has questions and concerns about almost every aspect of business—finances, business structure, marketing, production, and overall strategy: Does she even want to grow Salty Pawz further? And if so, how would she grow it successfully?

General Information About Salty Pawz

- The business was established in 2010 as a sole proprietorship. Wanda has been claiming all of the income and expenses for her business on a Schedule C of her personal income tax return. She uses a CPA to prepare her taxes but maintains the daily bookkeeping herself. Salty Pawz has shown a profit since 2011.
- Salty Pawz currently operates out of Wanda's home in North Carolina; her kitchen has been certified by the local health department to operate as a commercial kitchen.
- She does not currently need a business license because all of her product is shipped, and no customers come to her home.
- Salty Pawz does have a Federal Employer Identification number for tax withholding purposes, a NC Sales Tax identification number, and is registered with the NC Employment Security Commission for the purposes of reporting NC Unemployment Insurance Tax.

- Two of Wanda's friends help her on a part-time basis, primarily at night and on weekends after their regular jobs. She pays them in dog treats and is not currently paying salaries or wages.
- Wanda's brother-in-law manages her website, posting information about her products and keeping the information on the company current. He doesn't charge her anything, but she feels badly asking him to do too much work for free.
- Wanda spends most nights answering emails and inquiries through Etsy and her website while her friends bake and package the treats. She is working fifteen-hour days, seven days a week, and she knows she can't maintain this pace much longer. She is very reluctant to change how she is doing business because she doesn't want to risk the success she has had so far.
- She is using the local "Pack & Ship" to get her dog treats to her customers, but sometimes she finds herself running there more than once a day. She is trying to figure out a better way to handle shipping but hasn't come up with a solution.

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- Salty Pawz Background. **Authored by**: Linda Williams and Lumen Learning. **License**: *CC BY: Attribution*

4.3: Salty Pawz Marketing

Products

Wanda sells three varieties of dog treats: Chicken Cuties, Bison Bites, and Lamb Lovies. Each treat comes in a plastic pouch containing 12 treats. She has the following assortments available:

- Party Pooch = 4 each of 3 flavors
- Chicken Cuties= 12 Chicken
- Bison Bites = 12 Bison
- Lamb Lovies = 12 Lamb

Salty Pawz Commitment to Healthy Dogs

Since the very beginning, Wanda has been committed to providing a healthy alternative to mass-produced dog treats. Consequently, she has been very careful about sourcing her ingredients. For the Chicken Cuties she uses free-range chickens that are fed no artificial growth hormones or antibiotics. It took her a while, but she was able to find several ranchers who raise lamb and bison with non-GMO grains. She does not add preservatives, dyes, or fillers to her treats.

Pricing

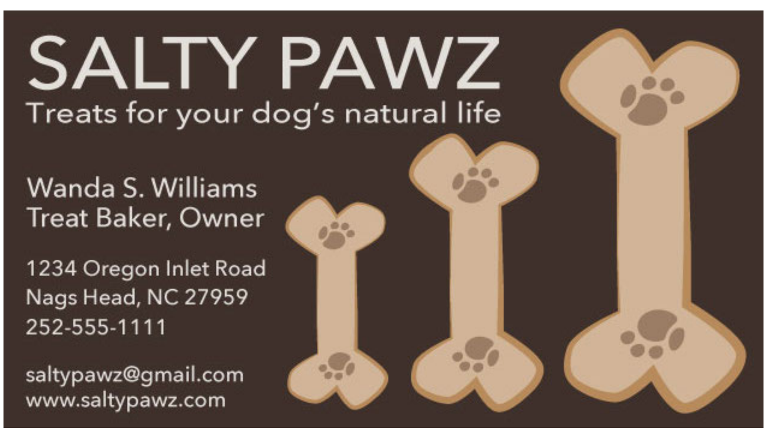
Wanda has priced her treats according to what would be considered the high end of the market. She determined her price based on her costs and what she wants to earn every month. Although she pays attention to what other businesses are charging, she has never conducted any research to determine how she stacks up against the competition. She is selling as many treats as she and her friends can make, so pricing is not something she is concerned about at this time.

Place

Salty Pawz products are sold via the Internet, and all of Wanda's business is conducted through some form of e-commerce. Her treats are listed on Etsy, where they are one of a large variety of treats available. Her brother-in-law recently launched her website using Weebly, and she is still getting used to managing the site. In reality, when she gets a sale through her website, she is sending the customers to Etsy to complete the purchase. When she explained this to Jim, he asked her, "Aren't you afraid that when your customers get to Etsy they will find someone else's treats and buy them instead?" Wanda just scratched her head.

Promotion

Salty Pawz does not have marketing materials and does no promotions or advertising. Wanda thinks it might be a good idea, but currently she relies on word-of-mouth to advertise her business. She has business cards she purchased from an online service and encloses one with each order. Jamie dropped some off at the local veterinarian's office a few months ago, but no one has checked to see if they are still there.



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4.4: Salty Pawz Financial Information

Sales + Revenue

For the last six months, Wanda's sales have broken down as shown below. She has also provided you with her cost for each variety of treat.

Sales and Revenue Breakdown

Product	% of Sales	Sales Price	COGS	Contribution	Profit Margin	Weighted Profit Margin
Party Pooch	45%	$20.00	$10.40	$9.60	48.00%	21.60%
Chicken Cuties	18%	$15.00	$7.80	$7.20	48.00%	8.64%
Bison Bites	5%	$21.00	$10.80	$10.20	48.57%	2.43%
Lamb Lovies	32%	$24.00	$12.60	$11.40	47.50%	15.20%
Total Sales % (Must equal 100%)	**100%**			**Average Profit Margin**	**47.87%**	

Cost of Goods Sold

Wanda's COGS include the packaging, labeling, the ingredients, and the time it takes to make the treats. Since she can bake them in big batches, her labor cost per unit is very low.

When Wanda ships her products, she charges just what it costs her. Shipping is done on a cost recovery basis and currently she doesn't consider it in her income/expenses.

Price and Cost of Goods Sold by Unit

Product Unit	Sales Price	COGS
Chicken Cuties	$1.25	$0.65
Bison Bites	$1.75	$0.90
Lamb Lovies	$2.00	$1.05

Monthly Expenses

Currently Wanda's monthly expenses are:

Salty Paws Monthly Expenses

Expense	Amount
Rent	$0.00
Electricity	$0.00
Telephone	$100.00
Water/Sewer	$0.00
Internet	$60.00
Website	$175.00
Salaries	$0.00
Owner's Draw	$1000.00
Office Supplies	$50.00

Expense	Amount
Loan Payment	$0.00
Insurance	$85.00
Other	$0.00
Total Overhead	**$1,470.00**

Sales Mix

Currently Wanda’s customers purchase her products at the following ratios:

Product Purchase Ratios

Product	% of Sales
Party Pooch	45%
Chicken Cuties	18%
Bison Bites	5%
Lamb Lovies	32%
Total % of Sales	**100%**

Break Even Calculation

Average Sales per customer: $20.00

Total overhead (as in table above): $1,470.00

Average profit margin (as in table above): 47.87%

BREAKEVEN = Total Overhead divided by Average Profit Margin

$$\begin{align*} \text{Salty Paws Breakeven} &= \dfrac{\$1,470.00}{47.87\%} \\ \\ &= \dfrac{\$1,470.00}{\dfrac{47.87}{100}} \\ \\ &= \dfrac{\$1,470.00}{47.87} X 100 \\ \\ & =\$3,070.91 \end{align*}$$

Based on her current monthly expenses and sales mix, this is what Wanda has to sell in order to break-even:

Product Breakeven in Dollars and Units

	BREAKEVEN	Party Pooch	Chicken Cuties	Bison Bites	Lamb Lovies
Monthly In Dollars	$3,070.91	$1,381.91	$552.76	$153.55	$982.69
In Units		69	37	7	41

Forecasting Supply and Demand

Wanda is at capacity for production out of her kitchen, so she believes that she is at the maximum income she can generate with her current structure. If Wanda changes her pricing structure, the following quantities demanded and quantities supplied will result.

Chicken Cuties
Response in Supply & Demand to Price Changes

Price ($)	**Demand (Q)**	**Supply (Q)**
$0.75	1000	500
$1.00	900	650
$1.25	800	800
$1.50	700	1000
$1.75	600	1400

Price ($)	**Demand (Q)**	**Supply (Q)**
$2.00	500	1500

Bison Bites
Response in Supply & Demand to Price Changes

Price ($)	Demand (Q)	Supply (Q)
$1.00	1200	500
$1.25	1100	600
$1.50	900	700
$1.75	800	900
$2.00	700	1000
$2.25	400	1400

Lamb Lovies
Response in Supply & Demand to Price Changes

Price ($)	Demand (Q)	Supply (Q)
$1.75	1500	800
$2.00	1400	900
$2.25	1200	1000
$2.50	1000	1200
$2.75	800	1400
$3.00	700	1600

Party Pooch
Response in Supply & Demand to Price Changes

Price ($)	Demand (Q)	Supply (Q)
$16.00	1400	600
$18.00	1200	700
$20.00	1100	800
$22.00	1000	1000
$24.00	900	1200
$26.00	800	1400

Income Information

Here is a summary of Wanda’s Salty Pawz income information for the past 6 months.

Salty Paws 6 Month Income Statement

Income:	
Party Pooch	$ 40,500.00
Chicken Cuties	$ 16,200.00
Bison Bites	$ 4,515.00

Lamb Lovies	$ 28,800.00
Total Income	**$ 90,015.00**
Cost of Good Sold:	
Party Pooch	$ 21,060.00
Chicken Cuties	$ 8,424.00
Bison Bites	$ 4,515.00
Canine Craving	$ 15,120.00
Total Cost of Sales	**$ 49,119.00**
GROSS PROFIT	**$ 40,896.00**
Operating Expenses:	
Rent	$ –
Electricity	$ –
Telephone	$ 600.00
Water /Sewer	$ –
Internet	$ 360.00
Website	$ 1,050.00
Salaries	$ –
Owner’s Draw	$ 6,000.00
Office Supplies	$ 300.00
Loan Payment	$ –
Insurance	$ 510.00
Other	$ –
Total Expenses	**$ 8,820.00**
NET INCOME BEFORE TAXES	**$ 32,076.00**

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CHAPTER OVERVIEW

5: Module 1- Role of Business

5.1: Why It Matters- Role of Business

Why discuss the role of business in society?

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

As you embark on your study of business, you may be thinking that so much of what you will learn in school isn't applicable to your career or future—you may not be planning on going into business, for instance, you may want to be an academic, a therapist, a chef, a media specialist—surely you don't need to know about business then. Here's a challenge that may change your mind.

Figure 5.1.1: Soup Cycle. (Travis, flickr.com *CC BY: Attribution)*

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

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

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

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5.2: Introduction to What Is Business?

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

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

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5.3: Getting Down to Business

Learning Objectives

- Define the term business
- Distinguish between profit, loss, and value
- Distinguish between goods and services

Today's Business Environment

Figure 5.3.1: RadioShack Closing.

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

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

Although the environment in which businesses operate is always changing, the accelerated pace of change presents special challenges and opportunities for businesses today. Think about this: in the 1950's the average lifespan of a Fortune 500 corporation (the largest businesses we know) was over 60 years. Today, the life expectancy of a Fortune 500 corporation is less than 20 years.

Figure 5.3.2: Open pill bottle Meds.

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

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

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

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

Defining Business

So, what is this thing we call "business"? A **business** is any activity that provides goods or services to consumers for the purpose of making a profit. Examples of **goods** provided by a business are tangible items such as cars, televisions, or soda. A **service** is an action or work performed for monetary compensation. Services include things such as haircuts, hotel stays, or roller-coaster rides.

Business can generate profits from the sale of goods and/or services, and profits are the financial reward that comes from taking the risk of running or owning a business. More specifically, **profit** is the amount of revenue or income that a business owner retains after paying all the expenses associated with the operation of the business. If the expenses of the business exceed the revenue or income generated from operations, then the business will suffer a **loss**. Businesses that suffer extraordinary losses during a short period of time, or slowly see their profits decline, may end up closing or filing for bankruptcy**.**

Clearly the goal of most businesses is to generate a profit by increasing revenue while holding expenses in check, and one of the best ways they do this is by providing their customers with value. When businesses talk about **value**, they are referring to the relationship between the price a customer pays for the good or service and the perceived benefits the customer receives in exchange for his or her time and money.

Value has become such a key component of today's business model that if you go to almost any fast-food restaurant you'll find a "value meal" or "value menu" advertised. Such businesses are sending the message to their customers that they'll receive the most "bang for the buck" or the highest value in terms of quantity obtained in exchange for money spent. It's a business model based on the belief that if you give your customers value, the profit will follow. While all businesses seek to increase their revenue, what a business actually does with those funds can vary and depends on whether it's a for-profit or nonprofit organization.

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5.4: Introduction to For-Profit vs. Nonprofit

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

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

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5.5: Profits and Purpose

Learning Objectives

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

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

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

Profit and Non-Profit Lemonade Stands

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

Figure 5.5.1:Molly's For-Profit Lemonade Stand

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

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

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

Figure 5.5.2: Emma's Nonprofit Lemonade Stand

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

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

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

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

? Practice Questions

https://assessments.lumenlearning.co...essments/14249

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

For-Profit vs. Not-for-Profit/Nonprofit

For-Profit

- Incurs expenses for operations
- Provides goods and services to customers
- Generates revenues from sales
- **Owned by individuals, partners, or shareholders**
- Profit is used to pay owners, partners, or shareholders
- Pays salaries to employees and managers
- **Profits are subject to taxation by local, state, and federal authorities**

Not-for-Profit/Nonprofit

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

> **? Practice Question**
>
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5.6: Introduction to Factors of Production

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

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

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5.7: Factors of Production

> **Learning Objectives**
>
> - List the four factors of production
> - Explain the four factors of production

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

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

- Natural resources (land)
- Labor (human capital)
- Capital (machinery, factories, equipment)
- Entrepreneurship (somebody who recognizes a profit opportunity)

Natural Resources

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

A key feature of natural resources is that people can't make them. They also tend to be limited. New natural resources—or new ways of extracting them (such as fracking, for example)—can be discovered, though. These natural resources can be renewable, such as forests, or nonrenewable, such as oil or natural gas. It's also possible to invent new uses for natural resources (using wind to generate electricity, for example). Resources that are cultivated or made with human effort can't be considered *natural* resources, which is why crops aren't natural resources.

Labor

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

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

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

Capital

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

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

Entrepreneurship

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

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

Dr. Mary J. McGlasson. *CC BY-NC-ND: Attribution-NonCommercial-NoDerivatives*

You can view the transcript for “Episode 3: Resources” (opens in new window).

? Practice Question

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✓ Baking a Cake

Let’s take a look at an example: baking a cake. What factors go into the production of a cake?

Table 5.7.1: Factors of Production

Natural Resource	Wind is harnessed to produce electricity that powers the electric mixer and oven.
Labor	The baker’s labor combined with the creativity and skills needed to actually bake and decorate it
Capital	Ovens, cake pans, flour, sugar, butter, and other ingredients used to make the cake

Entrepreneurship	An individual who starts the bakery or runs a home-based business baking and selling cakes to customers

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

Practice Question

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5.8: Introduction to Functional Areas

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

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

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5.9: Functional Areas of Business

Learning Objectives

- Identify the primary functional areas within a business
- Identify key people and explain the activities within each functional area

Figure 5.9.1: Worker Bees.

Just as different functions in the human body are performed and regulated by different organs, different functions within a business are performed and controlled by different parts of the business.

One of the reasons for separating business operations into functional areas is to allow each to operate within its area of expertise, thus building efficiency and effectiveness across the business as a whole. Functional areas in a business vary according to the nature of the market and the size of the business. For example, manufacturing companies like Nike and Apple have significant Research and Development (R&D) departments in order to stay in the lead in their respective business segments. On the other hand, retail companies may have no R&D functional area per se, but will be heavily invested in Operations areas surrounding Supply Chain Management.

In general, the key functional areas of a business are the following:

- Management
- Operations
- Marketing/Sales
- Finance
- Research and Development

Each of these functional areas are represented in the following organization chart.

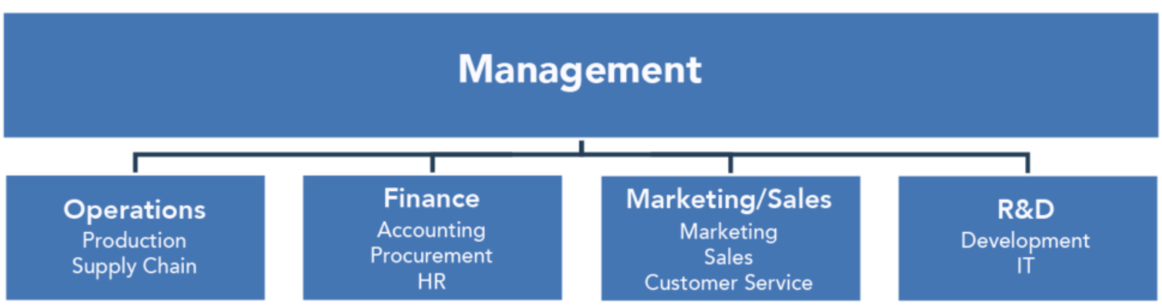

Figure 5.9.2: Copy and Paste Caption here.

Management

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

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

Operations

Operations is where inputs, or factors of production, are converted to outputs, which are goods and services. Operations is the heart of a business providing goods and services in a quantity and of a quality that meets the needs of the customers. Operations control the supply chain, including procurement and logistics.

Marketing/Sales

Marketing consists of all that a company does to identify customers' needs and design products and services that meet those needs. The marketing function also includes promoting goods and services, determining how the goods and services will be delivered, and developing a pricing strategy to capture market share while remaining competitive. In today's technology-driven business environment, marketing is also responsible for building and overseeing a company's Internet presence (e.g., the company website, blogs, social media campaigns, etc. Today, social media marketing is one of the fastest growing sectors within the marketing function.

The goal of **Sales** is to close the revenue the company needs in order to operate profitably, especially in B2B businesses. Again, depending on the nature of the market and the company size, Sales functional areas can vary in structure and approach: inside/outside representation, vertical/horizontal focus, direct, etc. Sales works to exploit the leads created by Marketing and activities generated by the sales force itself.

Finance

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

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

Key People Within Functional Areas

Here is an example of the functional areas of a large technology manufacturing corporation and the key functions and people within.

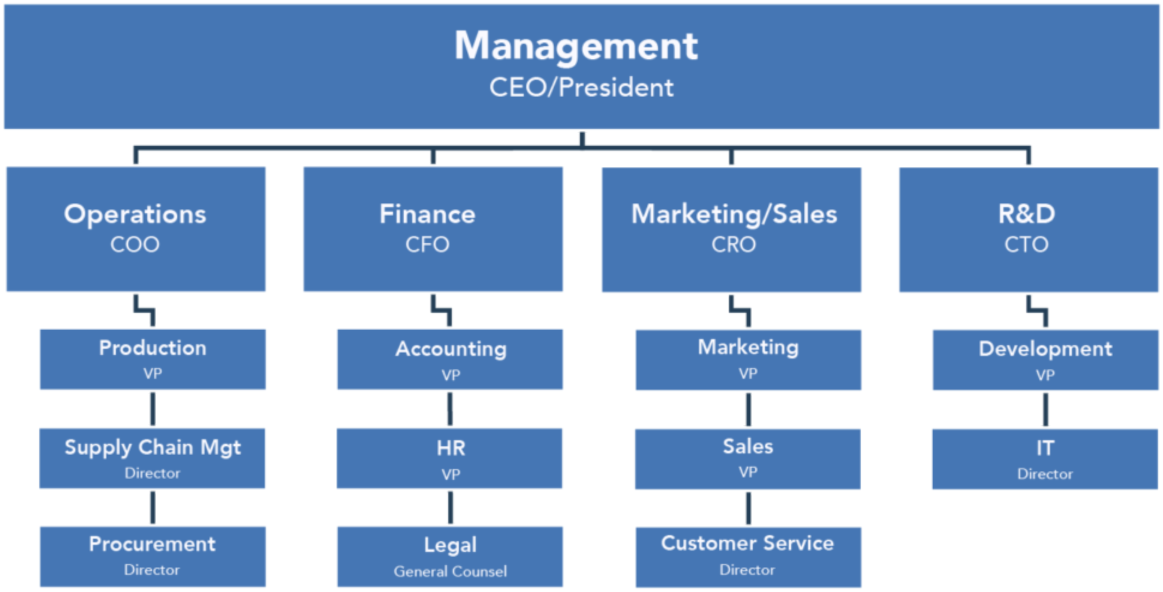

Figure 5.9.3: Key people within functional areas.

The **Management** functional area in most large corporations is led by the Chief Executive Officer (CEO). Depending on company size, there may be a President in position as well.

The **Operations** functional area is managed by the Chief Operations Officer (COO). In this example, Operations consists of Production, led by a Vice President (VP), a Supply Chain department, and a Procurement area with Director-level people in charge.

The **Finance** functional area is led by the Chief Financial Officer (CFO), who is one of the most important "C-level" executives. In addition to running Finance and Accounting, the CFO is responsible for reporting company results to the financial community. Finance also contains Human Resources (HR) in many companies and the Legal department as well. It is common for the CFO to have VPs of HR, Accounting, and Legal as direct reports. HR contains functions like employee training, compensation and benefits, and recruiting. Accounting has multiple functions such as Accounts Payable, Receivable, record-keeping and cash flow. The Legal department is responsible for contracts, copyrights, and various negotiations on behalf of the company.

The **Marketing/Sales** functional area is managed by the Chief Revenue Officer (CRO), which is a relatively new addition to C-level executives. The CRO may have a Sales VP and Marketing VP as direct reports, but in some cases the CRO may act as VP of Sales or Marketing. This functional area may also contain Customer Service (and Support) with a Director-level manager in charge. Marketing has specialized functions such as communications (press releases), social media, data science analysis and product marketing. Customer Service is usually responsible for Customer Relationship Management (CRM) and problem resolution and support.

Finally, the **Research and Development** functional area is the lifeblood of manufacturing businesses. R&D is staffed with scientists, thought-leaders, subject-matter experts and industry analysts striving to provide the organization with knowledge and ideas to keep up and ahead of the competition. R&D is led by the Chief Technology Officer (CTO), who manages a Development VP or similar title depending on what technology products are being produced: semiconductors, athletic footwear, software systems, or dental appliances. In many organizations, the Information Technology area (IT), responsible for providing internal technology tools to the company's employees, is housed in the R&D organization.

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5.10: Introduction to Stakeholders

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

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

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5.11: What Is a Stakeholder?

Learning Objectives

- Define internal and external stakeholder
- Describe stakeholders' relationship with business organizations

Figure 5.11.1: Andrew's Stone.

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

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

Internal Stakeholders

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

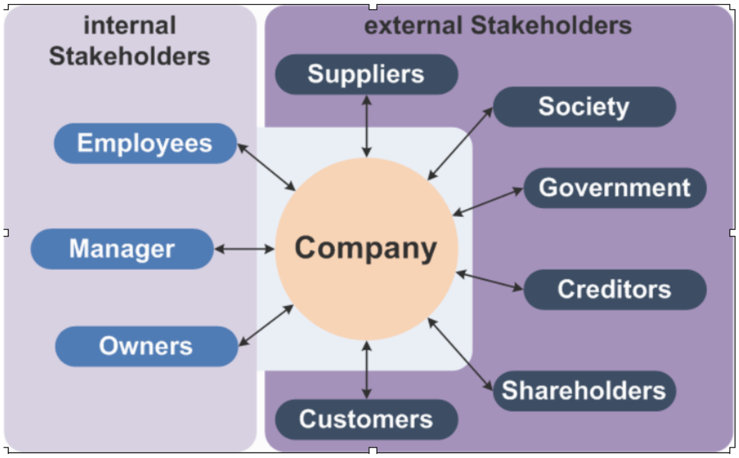

Figure 5.11.2: The picture shows the typical stakeholders of a company. The stakeholders are divided into internal and external stakeholders.

External Stakeholders

External stakeholders are groups outside a business or people who don't work inside the business but are affected in some way by the decisions and actions of the business. Examples of external stakeholders are customers, suppliers, creditors, the local community, society, and the government. **Customers** want the business to produce quality products at reasonable prices.

Shareholders have an interest in business operations since they are counting on the business to remain profitable and provide a return on their investment in the business. **Creditors** that supply financial capital, raw materials, and services to the business want to be paid on time and in full**. Federal, state, and local governments** need businesses to thrive in order to pay taxes that support government services such as education, police, and fire protection. The **local community** has a stake in the business because it provides jobs, which generate economic activity within the community. **Society** as a whole (as well as the local community) is concerned about the impact that business operations have on the environment in terms of noise, air, and water pollution. Society also has an interest in the business with regard to the safety of the goods and services produced by the business. **Suppliers** need the business to continue to buy their products in order to maintain their own profitability and long-term financial health.

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5.12: Introduction to External Forces

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

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

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5.13: External Forces That Shape Business Activities

Learning Objectives

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

Figure 5.13.1: Charging Bull 2014 New York City.

Businesses do not operate in a vacuum, and they are influenced by forces beyond their control. How they respond—and *howquickly* they respond—to these external forces can make the difference between success and failure, especially in today's fast-paced business climate.

We can organize the external forces that affect business into the following six categories:

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

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

Economic Environment

The economic environment of business has changed dramatically in recent years. After decades of growth and dominance, the US economy is now challenged by the developing economies of other nations, which are jockeying to be number one. Since the financial crisis in 2008, the US economy and businesses have struggled to recover from the greatest economic crisis since the Great Depression of the 1930s. Long-established companies have closed their doors, costing workers their jobs, retirement savings, and even their homes. Thus far the US economy has proven resilient, and since the Great Recession in 2008, the stock market has more than recovered, home prices have reached an all-time high, and unemployment is at a record low. Despite this progress, there are still challenges to be faced in the economic environment. Wages have not grown in step with overall economic growth, the US workforce has shrunk, there are less buyers in the real estate market, and wealth inequality has continued to increase. These economic conditions have all had a direct impact on businesses, regardless of size.

Legal Environment

Figure 5.13.2: Tide Pods Laundry Detergent Capsules.

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

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

Competitive Environment

Figure 5.13.3: Hardware Store Sign.

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

Technological Environment

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

Social Environment

Figure 5.13.4: Stand with Standing Rock protests in San Francisco resisting the construction of the Dakota Access Pipeline by Energy Transfer Partners. Standing Rock activists claim that the construction of the pipeline would be environmentally irresponsible and endanger indigenous sources of water.

The social environment of business encompasses the values, attitudes, beliefs, wants, and desires of the consuming public. The **demographics** that describe the American population by gender, age, ethnicity, location, occupation, education and income are constantly evolving. The American population is steadily becoming more ethnically diverse: The US Census Bureau estimates that the Hispanic and Asian populations in the United States will double by 2050. At the same time, Americans are aging, and with the current median above thirty-six years of age, it will not be long before the majority of Americans are ready to retire.

In addition to ethnic diversity and age, the social environment brings forces such as **Corporate Social Responsibility (CSR)**, which means that more and more consumers are demanding that businesses be “good corporate citizens” by supporting charitable causes and contributing to local communities, adhering to ethical standards in their treatment of workers and others, and adopting environmentally responsible practices. Combine these factors with the whirlwind of changing fads, trends, and “hot topics,” and you have some idea of why the social environment can present the greatest challenge to business.

Global Environment

From a business perspective, it is a small world, and it’s only getting smaller. **Free trade** among nations has allowed goods and services to flow across international borders more efficiently and cheaply. Formal trade agreements among nations have forged unprecedented links and interdependencies among economies.

Look at the items on your desk, and you may see items from China, Mexico, Canada, or Japan. It’s possible that you drive a car that was made in the United States but was produced in a plant owned by a Japanese company. The growth of the Chinese economy has brought a flood of affordable goods into the United States and, along with those cheaper prices, created a reliance on foreign goods and materials. Now, when the Chinese economy slows down, the US economy is affected. When the price of foreign oil increases or decreases, businesses in the United States feel the impact. So, it’s not just the local economy or even the national economy that businesses must track—they must also keep an eye on the world economy in order to anticipate and adapt to changes that will impact their products and services.

Figure 5.13.5: Business and its environment.

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5.14: Putting It Together- Role of Business

Synthesis

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

Figure 5.14.1: Question Marks.

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

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

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

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

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

Summary

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

What Is Business?

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

For-Profit vs. Non-Profit

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

Factors of Production

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

Functional Areas

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

Stakeholders

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

External Forces

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

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5.15: Discussion- The Stakeholders of Salty Pawz

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda becomes frustrated with the amount of time she is spending running Salty Pawz and decides that she would be better off getting a "real job" as a dog groomer at ShamPooch. She will no longer be answering emails at midnight and running back and forth to Pack & Ship; however, closing Salty Pawz will have an impact beyond Wanda's daily life.

For Discussion

If Wanda closes Salty Pawz, what will the impact be on **both** internal and external stakeholders of the business? Select ONE INTERNAL and ONE EXTERNAL stakeholder as the basis for your discussion post. Put yourself in the place of that stakeholder and consider what the impact of Wanda's decision would be on your life.

In addition to your analysis of the external and internal stakeholders in the first part of this response, *you also need to answer the following questions*: In your opinion, how much responsibility does an entrepreneur like Wanda *really* have to the stakeholders of the business? Do the interests of stakeholders outweigh the interest of the entrepreneur?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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5.16: Discussion- External Factors = Internal Pressure

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

1. Select **one** of the external factors discussed in the text that influences business.
2. Choose a company that is being significantly influenced by the factor you selected. For example, there has been a great deal of consumer concern about the use of GMOs in food, and Monsanto has been on the receiving end of a great deal of criticism. See the article "Monsanto in the middle of upcoming congressional fight over GMO labeling"

Now that you have a company and an external factor (Monsanto and GMOs, for example), the next step is to research your company's activities during the past six to twelve months, as they relate to this external factor. You will want to start at the company's Web site. Find out what the company owners and managers are doing/saying about the issue. Consider the stakeholders, as well, and look for information on how they are influencing company reaction/action.

For Discussion

Using the research you performed in the preparation steps, craft your initial discussion posting. In this initial post you will:

- Provide a brief background on the company and the external factor you selected.
- Explain how this **external** factor is currently influencing the **internal** functional areas of the business/company. In other words, what short-term changes, actions, or decisions are needing to be made within the functional, internal areas of the company as a result of the external factor?
- How do you think the company will address this external factor over the long term?
    - For example, if you selected the Ronald McDonald House and the external factor of corporate citizenship, you might surmise that the slow economy and high unemployment will put additional pressure on McDonald's to provide more assistance to families and people in need. However, in a slow economy people are less likely to make donations. They are being asked to do more but may have less to do it with. In the long term, if donations do not increase and demand remains high, the company may have to look for other means besides donations to support their mission. Marketing may need to increase, and the finance department may start to look for ways to cut costs.

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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5.17: Assignment- What Does a Business Look Like?

Scenario

Wanda has never thought of herself as running a business, although it certainly seems to have turned out that way. Originally she really just wanted to give her friends and family an alternative to cheap, low-nutrition dog treats. When you explain to Wanda that she has created a business with stakeholders and all of the internal workings and structure of a business, she just stares at you blankly. So, you tell her to just hang on and you will explain this in more detail.

Your Task

Using a visual or graphical representation, show Wanda what her business looks like from the inside and the outside. Include forces in the external environment and internal functional areas, as well as both internal and external stakeholders. In other words, what components of a business have come together with Wanda's work?

Like any graphical representation, there needs to be an explanation of what the graphic represents! Along with the graphic that you create, provide Wanda with a written description of the following:

- The components of her external environment
- Internal functional areas and their purpose
- Internal and external stakeholders in Wanda's business

Grading Rubric

Table 5.17.1 : Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Visual/graphical representation of a business	0 points	11 points	16 points	20 points	20%
Thorough, accurate representation of external environment	0 points	5.5 points	8 points	10 points	10%
Thorough, accurate representation of internal functional areas and purpose	0 points	5.5 points	8 points	10 points	10%
Thorough, accurate representation of stakeholders	0 points	5.5 points	8 points	10 points	10%
Explains how business elements interrelate within context of Salty Pawz business	0 points	16.5 points	24 points	30 points	30%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Articulation of response (citations, grammar, spelling, syntax, or organization that negative impact readability and articulation of main ideas)	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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5.18: Assignment- What Is Killing Our Business?

Preparation

Quickly think of a brand you used to buy or a store where you used to shop that no longer exists. Do any of these names ring a bell?: Blockbuster, Radio Shack, Wachovia Bank, Circuit City? Businesses like these fade from memory soon after they close as the business environment replaces them with bigger, better, or newer products, goods, or services.

What is it that causes formerly “top” businesses to fail? While every business and its circumstances are unique, the cause of failure can usually be traced to big changes in the external or internal environment.

Your Task

1. Research a business that financial analysts predict will be **gone** in the very near future. You may choose one of the following companies or research another company that business analysts think is on its way out. Note: If you select a company that is not on this list, you must provide the source for your research.
    - J.C. Penney
    - Sprint/Nextel
    - The Container Store
    - New York & Company (Retail Clothing)
    - Jamba Juice
    - Elizabeth Arden (Cosmetics)
    - Sears
    - Aeropostale
    - Rosetta Stone
    - PacSun
2. Based on what you find, determine whether the business is declining on account of an an **external factor** (i.e., shift in demographics, competition, consumer demand) or an **internal factor** (i.e., poor management, poor quality, lack of cost control). It may be a combination of *both*, in which case you should include this insight in your paper. Either way, be sure to explain in detail how this factor has negatively impacted the business.
3. If you discover an external factor, was there anything the company could have done to adapt? If you discover an internal factor, why do you think the company didn’t address it before it got so serious?

Be sure to include properly formatted APA citations of your research.

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5.19: Assignment- Functional Areas of Business

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 the learning outcomes of Introduction to Business 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 Objectives

- Identify the primary functional areas within a business

In the first module of the course, we introduce the functional areas within a business and we refer to these concepts throughout the course. For this assignment, you are going to create a short video of less than two minutes explaining these primary functional areas using a business of your choice.

Using your cell phone or any other recording device, create a short video. 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 learn about these functional areas in a business setting. In your video, you'll want to practice using the concepts (in bold listed below).

The five functional areas of business are management, operations, marketing/sales, finance, and research and development.

Choose a business and describe one of the five functional areas in your own words. You could select a company that you currently work for or one that you worked for in the past. You could also choose a company that you hope to work for someday.
If you need some questions to guide your response, here is a short list.

- Which company did you choose? Why did you select this company?
- Why does this functional area seem important to you?
- Which two functional areas did you select? In your own words describe what these functional areas do to support the success of the business you selected.
- What are the responsibilities of the people who work in the area you selected? For instance, if you choose to focus on Operations, what are some of the jobs those people do for the company? You can read their company bio or details on their website.

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 focus on companies they are interested in either as employees or as consumers.

In our analysis of student performance, we found that students struggle with this learning outcome, so having a focus on each of these areas may help them with the summative quizzes. We recommend utilizing this assignment as a formative assessment where you can use the misunderstanding and errors of students as learning experiences about these concepts.

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CHAPTER OVERVIEW

6: Module 1 Readings - Role of Business

6.1: Reading- Getting Down to Business

The Business World Today

Now 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) have had a huge effect on 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. Plus—and this is a big plus—businesses today are facing the lingering effects of what many economists believe is the worst financial crisis since the Great Depression.

The economic turmoil began in the housing and mortgage industries as a result of troubled subprime mortgages and 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, yet businesses and individuals were still denied access to needed credit. Without money or credit, consumer confidence in the economy dropped and consumers cut back their spending. Businesses responded by producing fewer products, and their sales and profits dropped. Unemployment rose as troubled companies shed the most jobs in five years, and 760,000 Americans marched to the unemployment lines. 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. Things have turned around for some businesses, 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 remain low. These conditions make it all the more important that we understand business and the challenges and opportunities it affords.

Defining Business

So, what is this thing we call "business"? We can apply a broad approach that defines a **business** is any activity that provides goods or services to consumers for the purpose of making a profit. When Steve Jobs and Steve Wozniak created Apple Computer in Jobs's family garage, they started a business. The product was the Apple I, and the company's founders hoped to sell their computers to customers for more than it cost to make and market them. If they were successful (which they were), they'd make a **profit**. Later in this outcome we will add another type of organization to our definition of business: a **nonprofit business**, which provides goods or services to consumers but whose primary goal is not profit.

Before we go on, let's make a couple of important distinctions concerning the terms in our definitions. Whereas Apple produces and sells **goods** (iPhone, iPod, Mac), many businesses provide **services**. Your bank is a service company, as is your Internet provider. 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).

As you go through this course, you'll explore the exciting world of business. We'll introduce you to the various activities business people engage in—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.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered above. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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6.2: Reading- Making a Profit

For-Profit Businesses

An organization that aims to earn profit through its operations and is concerned with its own interests and not those of the public (non-profit) is known as a for-profit corporation.

Structure

A for-profit cooperation is usually an organization operating in the private sector that sets goals which eventually help the organization itself. This kind of a company often makes shares of ownership available to the general public. The purchasers of those shares then become the company's shareholders; shareholders have bought a portion of ownership of the corporation by giving away a certain amount of money (differentiating from company to company) or assets of a particular value. Such organizations are usually not aided by the government, as they are working for private financial gains, unlike a non-profit organization, which exists to serve a mission. The nature of a for-profit corporation is such that it is required to pay applicable taxes and register with the state. Any donation they receive will also be subject to the tax policies of the concerned country. As these organizations are all corporations and have a separate identity from their owners the owners are not in their personal capacity required to satisfy any debts which the company might owe to anyone.

Aims

Unlike non-profit organizations, the policies of these organizations are usually profit oriented. Managers (corporate employees) here have a profit-oriented mindset and aim at maximizing the revenue of the firm, which in turn contributes to the profits of the shareholders/owners. Their aim can be accompanied by a goal of serving the society; however, that usually happens only in cases of specific corporations (B-corporations, which we'll learn about later).

Non-Profit Businesses

Some organizations are not established solely for the purpose of making and retaining profit; however, they 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 non-profits. Let's take a look at some of the characteristics of the non-profit organization.

A non-profit business, often referred to as an NPO (non-profit organization), is an organization that uses its surplus revenues to further achieve its purpose or mission, rather than distributing its surplus income to the organization's directors (or equivalents) as profit or dividends. This is known as the distribution constraint. The decision to adopt a non-profit legal structure is one that will often have taxation implications, particularly where the non-profit seeks income tax exemption, charitable status and so on.

Types of NPOs

The non-profit landscape is highly varied, although many people have come to associate NPOs with charitable organizations. Although charities do comprise an often high profile or visible aspect of the sector, there are many other types of non-profits. Overall, they tend to be either member-serving or community-serving. Member-serving organizations include mutual societies, cooperatives, trade unions, credit unions, industry associations, sports clubs, retired serviceman's clubs and peak bodies—organizations that benefit a particular group of people—the members of the organization. Typically, community-serving organizations are focused on providing services to the community in general, either globally or locally: organizations delivering human services programs or projects, aid and development programs, medical research, education and health services, and so on. It could be argued many non-profits sit across both camps, at least in terms of the impact they make. For example, the grassroots support group that provides a lifeline to those with a particular condition or disease could be deemed to be serving both its members (by directly supporting them) and the broader community (through the provision of a helping service for fellow citizens).

Although NPOs are permitted to generate surplus revenues, they must be retained by the organization for its self-preservation, expansion, or plans. NPOs have controlling members or a board of directors. Many have paid staff including management, whereas others employ unpaid volunteers and even executives who work with or without compensation (occasionally nominal). In some countries, where there is a token fee, in general it is used to meet legal requirements for establishing a contract between the executive and the organization.

Designation as a non-profit does not mean that the organization does not intend to make a profit, but rather that the organization has no “owners” and that the funds realized in the operation of the organization will not be used to benefit any owners. The extent to which an NPO can generate surplus revenues may be constrained or use of surplus revenues may be restricted.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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6.3: Reading- Factors of Production- Inputs and Outputs

Factors of Production: Inputs and Outputs

All businesses, both for-profit and non-profit, require fundamental resources in order to operate. In other words, resources are the *inputs* used to produce *outputs.* These factors or resources include the following:

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

Goods and services are produced using the factors of production available to the economy.

Land and Natural Resources

There are two essential characteristics of natural resources. The first is that they are found in nature—that no human effort has been used to make or alter them. The second is that they can be used for the production of goods and services. That requires knowledge; we must know how to use the things we find in nature before they become resources.

Consider oil. Oil in the ground is a natural resource because it is found (not manufactured) and can be used to produce goods and services. However, 250 years ago oil was a nuisance, not a natural resource. Pennsylvania farmers in the eighteenth century who found oil oozing up through their soil were dismayed, not delighted. No one knew what could be done with the oil. It was not until the mid-nineteenth century that a method was found for refining oil into kerosene that could be used to generate energy, transforming oil into a natural resource. Oil is now used to make all sorts of things, including clothing, drugs, gasoline, and plastic. It became a natural resource because people discovered and implemented a way to use it.

Defining something as a natural resource only if it can be used to produce goods and services does not mean that a tree has value only for its wood or that a mountain has value only for its minerals. If people gain utility from the existence of a beautiful wilderness area, then that wilderness provides a service. The wilderness is thus a natural resource.

The natural resources available to us can be expanded in three ways. One is the discovery of new natural resources, such as the discovery of a deposit of ore containing titanium. The second is the discovery of new uses for resources, as happened when new techniques allowed oil to be put to productive use or sand to be used in manufacturing computer chips. The third is the discovery of new ways to extract natural resources in order to use them. New methods of discovering and mapping oil deposits have increased the world's supply of this important natural resource.

Labor

Labor is human effort that can be applied to production. People who work to repair tires, pilot airplanes, teach children, or enforce laws are all part of the economy's labor. People who would like to work but have not found employment—who are unemployed—are also considered part of the labor available to the economy.

In some contexts, it is useful to distinguish two forms of labor. The first is the human equivalent of a natural resource. It is the natural ability an untrained, uneducated person brings to a particular production process. But most workers bring far more. The skills a worker has as a result of education, training, or experience that can be used in production are called human capital. Students who are attending a college or university are acquiring human capital. Workers who are gaining skills through experience or through training are acquiring human capital. Children who are learning to read are acquiring human capital.

The amount of labor available to an economy can be increased in two ways. One is to increase the total quantity of labor, either by increasing the number of people available to work or by increasing the average number of hours of work per week. The other is to increase the amount of human capital possessed by workers.

Capital

Long ago, when the first human beings walked the earth, they produced food by picking leaves or fruit off a plant or by catching an animal and eating it. We know that very early on, however, they began shaping stones into tools, apparently for use in butchering animals. Those tools were the first capital because they were produced for use in producing other goods—food and clothing.

Modern versions of the first stone tools include saws, meat cleavers, hooks, and grinders; all are used in butchering animals. Tools such as hammers, screwdrivers, and wrenches are also capital. Transportation equipment, such as cars and trucks, is capital.

Facilities such as roads, bridges, ports, and airports are capital. Buildings, too, are capital; they help us to produce goods and services.

Capital does not consist solely of physical objects. The score for a new symphony is capital because it will be used to produce concerts. Computer software used by business firms or government agencies to produce goods and services is capital. Capital may thus include physical goods and intellectual discoveries. Any resource is capital if it satisfies the following two criteria:

- The resource must have been produced.
- The resource can be used to produce other goods and services.

One thing that is not considered capital is money. A firm cannot use money directly to produce other goods, so money does not satisfy the second criterion for capital. Firms can, however, use money to acquire capital. Money is a form of financial capital. Financial capital includes money and other "paper" assets (such as stocks and bonds) that represent claims on future payments. These financial assets are not capital, but they can be used directly or indirectly to purchase factors of production or goods and services.

The Entrepreneur

Two things play a crucial role in putting the other three factors of production to work. The first is technology, the knowledge that can be applied to the production of goods and services. The second is an individual who plays a key role in a market economy: the entrepreneur. An entrepreneur is a person who, operating within the context of an economy, seeks to earn profits by finding new ways to organize factors of production. The interplay of entrepreneurs and technology affects all our lives. Entrepreneurs put new technologies to work every day, changing the way factors of production are used. Farmers and factory workers, engineers and electricians, technicians and teachers all work differently than they did just a few years ago, using new technologies introduced by entrepreneurs. The music you enjoy, the books you read, the athletic equipment with which you play are produced differently than they were five years ago. The text you are reading was written and manufactured using technologies that did not exist ten years ago. We can dispute whether all the changes have made our lives better. What we cannot dispute is that they have made our lives different.

Here is an example of the factors of production used to produce a shirt:

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

Looking deeper into how inputs and outputs interact to create the goods and services consumers demand allows us to begin to think of activities within business in terms of **cycles.** Consider how the factors of production (resources) flow from a business to your home.

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6.4: Reading- The Flow of Inputs and Outputs

The Flow of Inputs and Outputs

Many of the factors of production (or resources) are provided to businesses by households. For example, households provide businesses with labor (as workers), land and buildings (as landlords), and capital (as investors). In turn, businesses pay households for these resources by providing them with income, such as wages, rent, and interest. The resources obtained from households are then used by businesses to produce goods and services, which are sold to the same households that provide businesses with revenue. The revenue obtained by businesses is then used to buy additional resources, and the cycle continues. This circular flow is described below in Figure 1, which illustrates the dual roles of households and businesses:

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

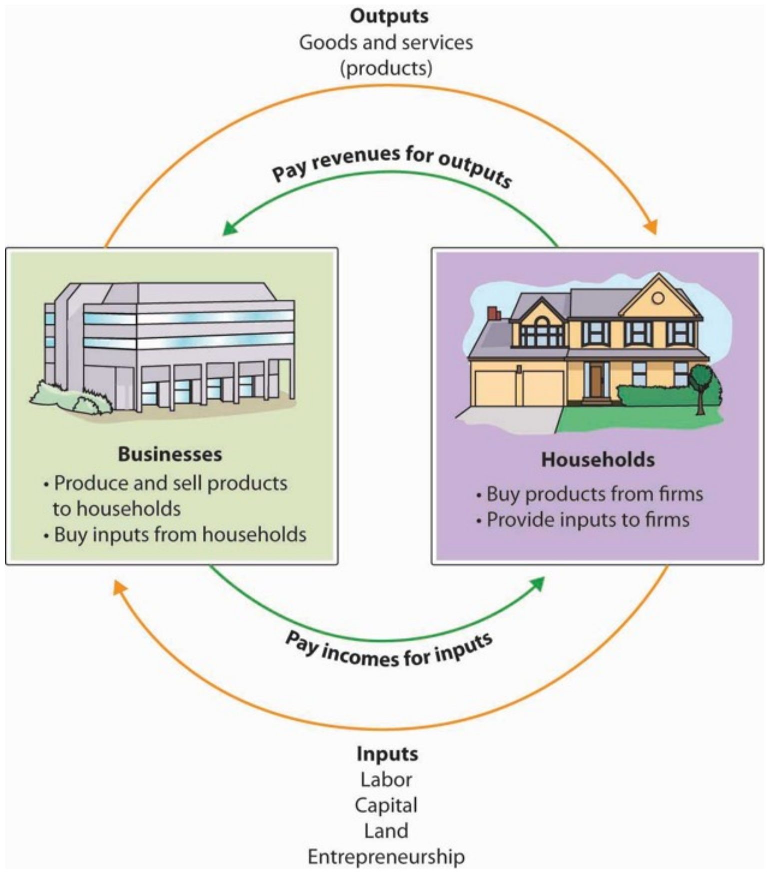

Figure 6.4.1: The Circular Flow of Inputs and Outputs.

The Questions Economists Ask

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

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

The answers to these questions depend on a country's economic system—the means by which a society (households, businesses, and government) makes decisions about allocating resources to produce products and about distributing those products. The degree to which individuals and business owners, as opposed to the government, enjoy freedom in making these decisions varies according to the type of economic system. We will explore the various types of economic systems and how each system answers these questions in a module on economics and economic systems.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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6.5: Reading- Functional Areas of Business

Functional Areas of Business

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

Management

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

Operations

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

Marketing

Marketing consists of everything that a company does to identify customers' needs and 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, timely financial information, and accountants provide it. Accountants measure, summarize, and communicate financial and managerial information and advise other managers on financial matters. There are two fields of accounting. *Financial accountants* prepare financial statements to help users, both inside and outside the organization, assess the financial strength of the company. *Managerial accountants* prepare information, such as reports on the cost of materials used in the production process, for internal use only.

Finance

Finance involves planning for, obtaining, and managing a company's funds. Finance managers address such questions as the following: How much money does the company need? How and where will it get the necessary money? How and when will it pay the money back? What should it do with its funds? What investments should be made in plant and equipment? How much should be spent on research and development? How should excess funds be invested? Good financial management is particularly important when a company is first formed, because new business owners usually need to borrow money to get started.

KEY TAKEAWAYS

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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6.6: Reading- Business Stakeholders

What Is a Stakeholder?

A stakeholder is an individual or group that has a legitimate interest in a company. A corporate stakeholder is an individual or group who can affect or be affected by the actions of a business. The stakeholder concept was first used in a 1963 internal memorandum at the Stanford Research Institute. It defined stakeholders as “those groups without whose support the organization would cease to exist.”

In the last decades of the twentieth century, the word “stakeholder” has become more commonly used to refer to a person or group that has a legitimate interest in a project or entity. In discussing the decision-making process for institutions—including large business corporations, government agencies, and non-profit organizations—the concept has been broadened to include everyone with an interest (or “stake”) in what the entity does.

Internal Stakeholders

Internal stakeholders are groups within a business or people who work directly within the business, such as employees, owners, and investors. Employees want to earn high wages and keep their jobs. Owners are interested in maximizing the profit the business makes. Investors are concerned about earning income from their investment.

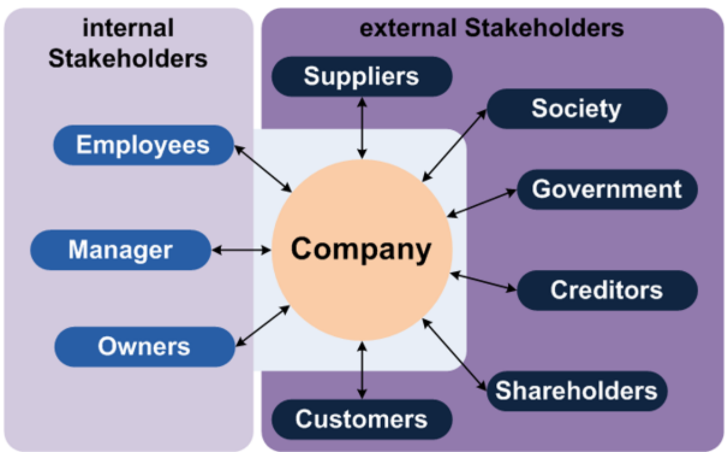

Figure 6.6.1: The picture shows the typical stakeholders of a company. The stakeholders are divided in internal and external stakeholders.

External Stakeholders

External stakeholders are groups outside a business or people who are not directly working within the business but are affected in some way from the decisions of the business, such as customers, suppliers, creditors, community, trade unions, and the government. The government wants the business to pay taxes, employ more people, follow laws, and truthfully report its financial conditions. Customers want the business to produce quality products at reasonable prices. Suppliers want the business to continue to buy their products. Creditors want to be repaid on time and in full. The community has a stake in the business as employers of local people.

KEY TAKEAWAYS

- A corporate stakeholder is a person or group who can affect or be affected by the actions of a business.
- Internal stakeholders are groups within a business or people who work directly within the business, such as employees, owners, and investors.
- External stakeholders are groups outside a business or people who are not directly working within the business but are affected in some way from the decisions of the business, such as customers, suppliers, creditors, community, trade unions, and the government.

GLOSSARY

corporate stakeholder:
A corporate stakeholder is that which can affect or be affected by the actions of the business as a whole.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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6.7: Reading- External Forces

External Forces That Influence Business Activities

Apple and other businesses don't operate in a vacuum: they're influenced by a number of external factors. These include the economy, government, consumer trends, and public pressure to act as good corporate citizens. The figure below sums up the relationship among the participants in a business, its functional areas, and the external forces that influence its activities.

Figure \(\PageIndex{1}\): Business and its environment.

Participants in a business must respond to the conditions created by a variety of external forces. Economic factors include things like strong economic growth cycles or recessions, consumer confidence and other economic indicators, interest rates and the strength of financial markets. Government actions such as policies, regulation, tax code and legislation all impact businesses as well as their internal and external stakeholders. In order to serve customers effectively, it is essential to monitor consumer trends such as consumer spending, fads, fashions and buying behavior. Demonstrating strong corporate citizenship through ethical business practices helps ensure goodwill and a culture of trust among all stakeholders and society at large.

The fast food industry provides a great example of how all these factors come together to affect business. A strong *economy* means people have more money to eat out at places where food standards are monitored by a *government* agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by *consumer trends* (eating fried foods might be okay one year and out the next). Finally, a number of decisions made by the industry result from its *desire to be a good corporate citizen*. For example, several fast-food chains have responded to environmental concerns by eliminating Styrofoam containers.[1] Addressing public health concerns about obesity in the U.S., many fast food restaurants have added healthier alternatives to their menus. As you move through this text, you'll learn more about these external influences on business.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. David Baron, "Facing-Off in Public," *Stanford Business*, April 15, 2006. ↵

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CHAPTER OVERVIEW

7: Module 2- Economic Environment

7.1: Why It Matters- Economic Environment

Why learn about fundamental economic principles?

Figure 7.1.1: Ice cream flavors at ice cream shop.

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

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

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

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

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

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7.2: Introduction to What Is Economics?

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

This section introduces the fundamental assumption of economics: scarcity—that is, the resources we need are limited—and the associated implications. Economics is, simply stated, the study of choice given the assumption of scarcity. A second key concept introduced is that of opportunity cost, or the next best alternative.

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7.3: Understanding Economics and Scarcity

Learning Objectives

- Explain scarcity

Try It

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

You can view the transcript for "Episode 2: Scarcity and Choice" (opens in new window).

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

1. Economics is the study of how humans make choices under conditions of scarcity.
2. Scarcity exists when human wants for goods and services exceed the available supply.
3. People make decisions in their own self-interest, weighing benefits and costs.

Scarcity

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

Figure 7.3.1: Kansas Summer Wheat and Storm Panorama.

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

Economics

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

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

Question 1: What classes are you taking this term?

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

Question 2: Where do you live?

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

Problems of Scarcity

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

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

? Practice Question

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7.4: The Concept of Opportunity Cost

Learning Objectives

- Explain opportunity cost

Figure 7.4.1: Two Doors.

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

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

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

Individual Decisions

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

Practice Question

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Societal Decisions

Figure 7.4.2: Pastel background_detail

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

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

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

? Practice Question

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? Try It

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

You can view the transcript for “Episode 8: Opportunity Cost” (opens in new window).

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7.5: Division of Labor and Specialization

Learning Objectives

- Explain division of labor and specialization

Figure 7.5.1: Assembly Line

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

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

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

Figure 7.5.1: Card of old pins

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

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

Practice Question

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Why the Division of Labor Increases Production

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

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

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

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

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

Practice Question

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Trade and Markets

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

Practice Question

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7.6: Microeconomics and Macroeconomics

Learning Objectives

- Distinguish between macroeconomics and microeconomics

Try It

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

You can view the transcript for “Episode 4: Micro vs Macro” (opens in new window).

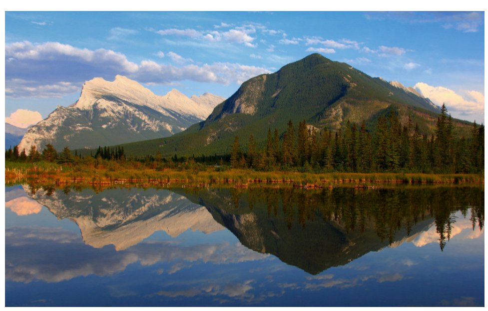

Figure 7.6.1: Vermilion Lake.

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

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

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

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

Microeconomics

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

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

Macroeconomics

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

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

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

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

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

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

? Practice Questions

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7.7: Introduction to Economic Systems

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

In a society, the economic system answers three fundamental questions:

1. What do we produce?
2. How do we produce it?
3. For whom do we produce it?

Practically speaking, this translates as who owns the factors of production and who decides what and how much to produce and associated pricing. This module introduces the three major economic systems: command, market, and mixed.

We'll also discuss the characteristics and management implications of each system, such as the role of government or a ruler/ruling party. This section also highlights factors that interfere with the conceptually ideal free market system. Although a free and competitive market is the economic ideal in terms of efficiency, it may not be the ideal in terms of representing a society's values.

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7.8: Economic Systems

Learning Objectives

- Distinguish between market, planned, and mixed economies

Legoland, Billund, Denmark: Picture of a Planned Economy?

Figure 7.8.1: Legoland, Billund, Denmark: Picture of a Planned Economy?

Consider how complex a modern economy is. It includes all production of goods and services, all buying and selling, all employment. The economic life of every individual is interrelated, at least to a small extent, with the economic lives of thousands or even millions of other individuals.

Who organizes and coordinates this system? Who ensures that, for example, the number of televisions a society produces is the same as the amount it needs and wants? Who ensures that the right number of employees works in the electronics industry? Who makes sure that televisions are produced in the best way possible? How does it all get done? The answer to these important questions depends on the kind of economic system a society uses.

The following Crash Course video provides additional information about the broad economic choices that countries make when they decide between planned and market economies.

You can view the transcript for "Economic Systems and Macroeconomics: Crash Course Economics #3" (opens in new window).

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

Market Economies

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

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

Free Markets

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

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

? Practice Questions

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Planned (or Command) Economies

Figure 7.8.1: Sphinx.

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

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

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

Most economies in the real world are mixed; they combine elements of command and market systems. The U.S. economy is positioned toward the market-oriented end of the spectrum. Many countries in Europe and Latin America, while primarily market-oriented, have a greater degree of government involvement in economic decisions than in the U.S. economy. China and Russia, while they are closer now to having a market-oriented system than several decades ago, remain closer to the command-economy end of the spectrum.

? Practice Question

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To recap, economic systems determine the following:

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

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

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

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

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

Even in generally free market economies, governments will

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

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

Contributors and Attributions

7.9: Introduction to Demand

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

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

Contributors and Attributions

7.10: The Law of Demand

Learning Objectives

- Explain the law of demand
- Explain a demand curve

Try It

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

You can view the transcript for "Episode 11 – Demand" (opens in new window).

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

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

Ceteris paribus means "other things being equal."

Demand for Goods and Services

Figure 7.10.1: A gas pump at a gas station

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

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

An example from the market for gasoline can be shown in the form of a table or a graph. A table that shows the quantity demanded at each price, such as Table 7.10.1, is called a **demand schedule**. Price in this case is measured in dollars per gallon of gasoline. The quantity demanded is measured in millions of gallons over some time period (for example, per day or per year) and over some geographic area (like a state or a country).

Table 7.10.1. Price and Quantity Demanded of Gasoline

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

A **demand curve** shows the relationship between price and quantity demanded on a graph like Figure 1, below, with quantity on the horizontal axis and the price per gallon on the vertical axis. *Note that this is an exception to the normal rule in mathematics that the independent variable (x) goes on the horizontal axis and the dependent variable (y) goes on the vertical. Economics is different from math!* Note also that each point on the demand curve comes from one row in Table 7.10.1. For example, the upper most point on the demand curve corresponds to the last row in Table 7.10.1, while the lower most point corresponds to the first row.

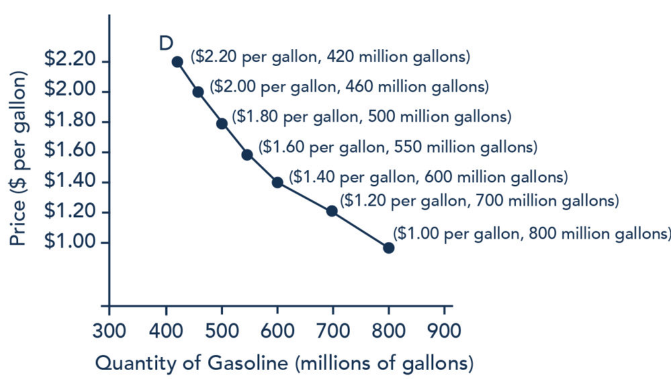

Figure 7.10.2: **A Demand Curve for Gasoline** (derived from the data in Table 1)

The demand schedule (Table 7.10.1) shows that as price rises, quantity demanded decreases, and vice versa. These points can then be graphed, and the line connecting them is the demand curve (shown by line D in the graph, above). The downward slope of the demand curve again illustrates the law of demand—the inverse relationship between prices and quantity demanded.

The demand schedule shown by Table 7.10.1 and the demand curve shown by the graph in Figure 7.10.1 are two ways of describing the same relationship between price and quantity demanded.

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

? Practice Questions

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? Demand vs. Quantity Demanded

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

Change in Demand vs. Change in Quantity Demanded

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

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

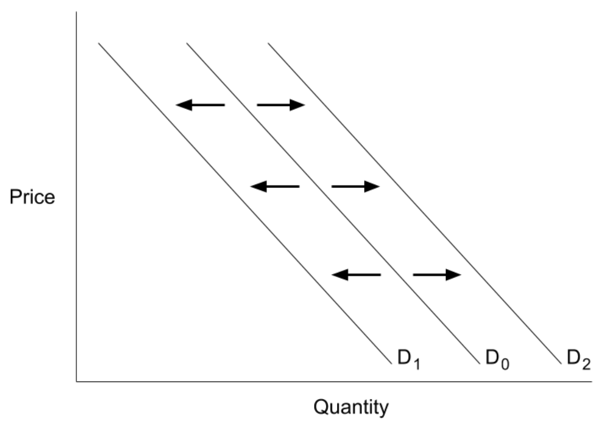

Figure 7.10.2: **Change in Demand.** A change in demand means that the entire demand curve shifts either left or right. The initial demand curve D_0 shifts to become either D_1 or D_2. This could be caused by a shift in tastes, changes in population, changes in income, prices of substitute or complement goods, or changes future expectations.

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

Figure 7.10.3: **hange in Quantity Demanded.** A change in the quantity demanded refers to movement along the existing demand curve, D_0. This is a change in price, which is caused by a shift in the *supply* curve.

Contributors and Attributions

7.11: Factors Affecting Demand

Learning Objectives

- Explain the factors that can change demand

Figure 7.11.1: Get targeted leads to shopify stores.

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

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

Ceteris Paribus Assumption

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

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

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

Practice Questions

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Effect of Income on Demand

Let’s use income as an example of how factors other than price affect demand. Figure 1 shows the initial demand for automobiles as D_0. At point Q, for example, if the price is $20,000 per car, the quantity of cars demanded is 18 million. D_0 also shows how the quantity of cars demanded would change as a result of a higher or lower price. For example, if the price of a car rose to $22,000, the quantity demanded would decrease to 17 million, at point R.

Figure 1. Shifts in Demand: A Car Example

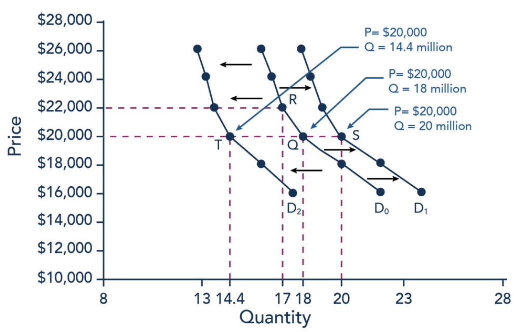

Figure 7.11.2: Copy and Paste Caption here. (Copyright; author via source)

The original demand curve D_0, like every demand curve, is based on the *ceteris paribus* assumption that no other economically relevant factors change. Now imagine that the economy expands in a way that raises the incomes of many people, making cars more affordable. How will this affect demand? How can we show this graphically?

Return to Figure 7.11.2. The price of cars is still $20,000, but with higher incomes, the quantity demanded has now increased to 20 million cars, shown at point S. As a result of the higher income levels, the demand curve shifts to the right to the new demand curve D_1, indicating an increase in demand. Table 7.11.1, below, shows clearly that this increased demand would occur at every price, not just the original one.

Table 7.11.1. Price and Demand Shifts: A Car Example

Price	Decrease to D_2	Original Quantity Demanded D_0	Increase to D_1
$16,000	17.6 million	22.0 million	24.0 million

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

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

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

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

Other Factors That Shift Demand Curves

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

Changing Tastes or Preferences

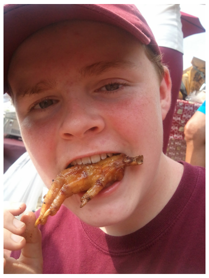

Figure 7.11.3: Grilled Chicken Feet.

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

Changes in the Composition of the Population

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

Changes in the Prices of Related Goods

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

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

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

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

? PRactice Questions

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Summary

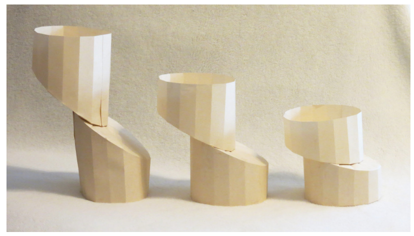

Figure 7.11.4: Diagonal shift test folds.

Six factors that can shift demand curves are summarized in Figure 2, below. The direction of the arrows indicates whether the demand curve shifts represent an increase in demand or a decrease in demand. Notice that a change in the price of the good or service itself is not listed among the factors that can shift a demand curve. A change in the price of a good or service causes a movement along a specific demand curve, and it typically leads to some change in the quantity demanded, but it does not shift the demand curve.

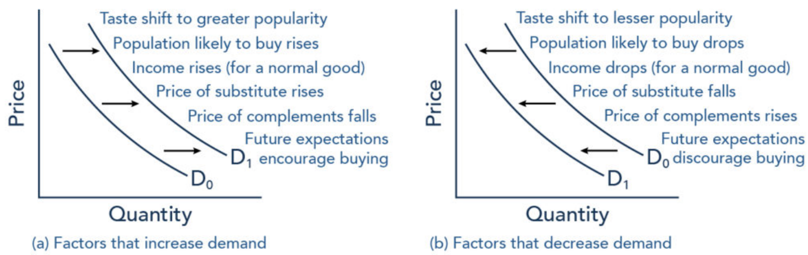

Figure 7.11.5: **Factors That Shift Demand Curves** (a) A list of factors that can cause an increase in demand from D_0 to D_1. (b) The same factors, if their direction is reversed, can cause a decrease in demand from D_0 to D_1.

? Practice Questions

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Shift in Demand Due to Income Increase

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

Step 1. Draw the graph of a demand curve for a normal good like pizza. Pick a price (like P_0). Identify the corresponding Q_0. An example is shown in Figure 7.11.7.

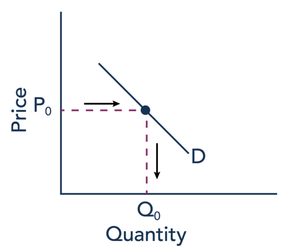

Figure 7.11.67: Copy and Paste Caption here. (Copyright; author via source)

Step 2. Suppose income increases. As a result of the change, are consumers going to buy more or less pizza? The answer is more. Draw a dotted horizontal line from the chosen price, through the original quantity demanded, to the new point with the new Q_1. Draw a dotted vertical line down to the horizontal axis and label the new Q_1. An example is provided in Figure 7.11.8.

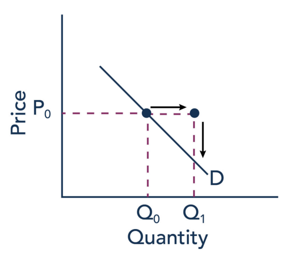

Figure 7.11.7: **Demand Curve with Income Increase.** With an increase in income, consumers will purchase larger quantities, pushing demand to the right.

Step 3. Now, shift the curve through the new point. You will see that an increase in income causes an upward (or rightward) shift in the demand curve, so that at any price, the quantities demanded will be higher, as shown in Figure 7.11.9

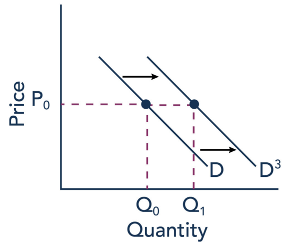

Figure 7.11.8: **Demand Curve Shifted Right.** With an increase in income, consumers will purchase larger quantities, pushing demand to the right, and causing the demand curve to shift right.

You can view the transcript for “Episode 12: Change in Demand vs Change in Quantity Demanded” (opens in new window).

Simulation: Demand for Food Trucks

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

A link to an interactive elements can be found at the bottom of this page.

Contributors and Attributions

7.12: Introduction to Supply

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

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

Contributors and Attributions

7.13: The Law of Supply

Learning Objectives

- Explain the law of supply
- Explain a supply curve

Try It

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

You can view the transcript for “Episode 13: Supply” (opens in new window).

Supply of Goods and Services

When economists talk about **supply**, they mean the amount of some good or service a producer is willing to supply at each price. Price is what the producer receives for selling one unit of a good or service. A rise in price almost always leads to an increase in the quantity supplied of that good or service, while a fall in price will decrease the quantity supplied. When the price of gasoline rises, for example, it encourages profit-seeking firms to take several actions: expand exploration for oil reserves; drill for more oil; invest in more pipelines and oil tankers to bring the oil to plants where it can be refined into gasoline; build new oil refineries; purchase additional pipelines and trucks to ship the gasoline to gas stations; and open more gas stations or keep existing gas stations open longer hours.

Economists call this positive relationship between price and quantity supplied—that a higher price leads to a higher quantity supplied and a lower price leads to a lower quantity supplied—the **law of supply**. The law of supply, like the law of demand, assumes that all other variables that affect supply are held equal (*ceteris paribus*).

Supply vs. Quantity Supplied

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

Figure 1, below, illustrates the law of supply, again using the market for gasoline as an example. Like demand, supply can be illustrated using a table or a graph. A **supply schedule** is a table—like Table 1, below—that shows the quantity supplied at a range of different prices. Again, price is measured in dollars per gallon of gasoline, and quantity demanded is measured in millions of gallons. A **supply curve** is a graphic illustration of the relationship between price, shown on the vertical axis, and quantity, shown on the horizontal axis. You can see from this curve (Figure 1) that as the price rises, quantity supplied also increases and vice versa. The supply schedule and the supply curve are just two different ways of showing the same information. Notice that the horizontal and vertical axes on the graph for the supply curve are the same as for the demand curve.

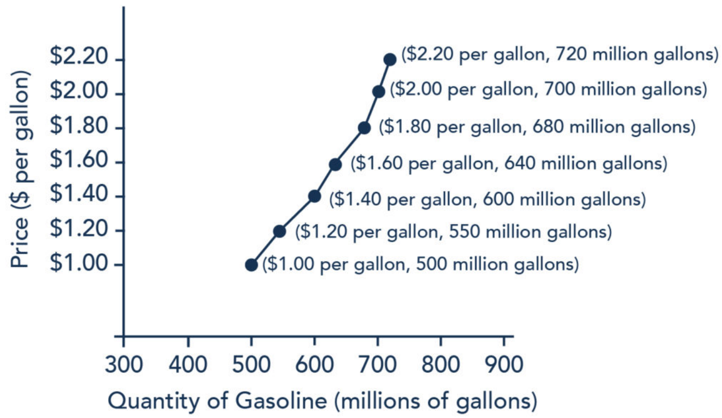

Figure 7.13.1: **A Supply Curve for Gasoline**

Table 7.13.1. Price and Supply of Gasoline

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

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

Practice Questions

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Learning Objectives

[glossary-page][glossary-term]law of supply: [/glossary-term]
[glossary-definition]the common relationship that a higher price leads to a higher quantity supplied of a certain good or service and a lower price leads to a higher quantity supplied, while all other variables are held constant[/glossary-definition][glossary-

term]quantity supplied: [/glossary-term][glossary-definition]the total number of units of a good or service producers are willing to supply at a given price[/glossary-definition][glossary-term]supply: [/glossary-term][glossary-definition]the relationship between the price of a certain good or service and the quantity of that good or service producers are willing to offer for sale [/glossary-definition][glossary-term]supply curve: [/glossary-term][glossary-definition]a graphic representation of the relationship between price and quantity supplied of a certain good or service, with price on the vertical axis and quantity on the horizontal axis [/glossary-definition][glossary-term]supply schedule: [/glossary-term][glossary-definition]a table that shows the quantity demanded for a certain good or service at a range of prices[/glossary-definition][/glossary-page]

Contributors and Attributions

7.14: Factors Affecting Supply

Learning Objectives

- Explain the factors that can change supply

How Production Costs Affect Supply

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

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

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

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

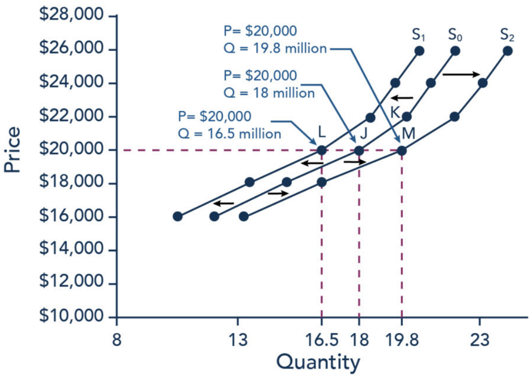

Figure 7.14.1: **Shifts in Supply: A Car Example**

Consider the supply for cars, shown by curve S_0 in Figure 7.14.1, below. Point J indicates that if the price is $20,000, the quantity supplied will be 18 million cars. If the price rises to $22,000 per car, *ceteris paribus*, the quantity supplied will rise to 20 million cars, as point K on the S_0 curve shows. The same information can be shown in table form, as in Table 7.14.1.

Table 7.14.1. Price and Shifts in Supply: A Car Example

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

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

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

Other Factors That Affect Supply

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

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

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

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

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

? Practice Questions

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Summary

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

Figure 7.14.2, below, summarizes factors that change the supply of goods and services. Notice that a change in the price of the product itself is not among the factors that shift the supply curve. Although a change in price of a good or service typically causes a change in quantity supplied or a movement along the supply curve for that specific good or service, it does not cause the supply curve itself to shift.

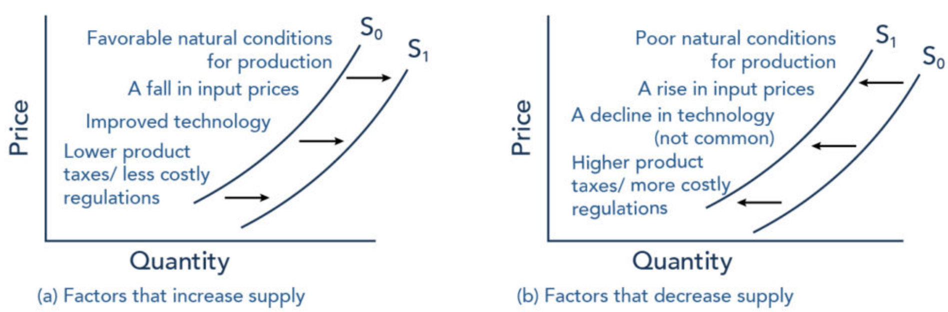

Figure 7.14.2: **Factors That Shift Supply Curves.** (a) A list of factors that can cause an increase in supply from S_0 to S_1. (b) The same factors, if their direction is reversed, can cause a decrease in supply from S_0 to S_1.

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

? Practice Question

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

Step 1. Draw a graph of a supply curve for pizza. Pick a quantity (like Q_0). If you draw a vertical line up from Q_0 to the supply curve, you will see the price the firm chooses. An example is shown in Figure 7.14.3.

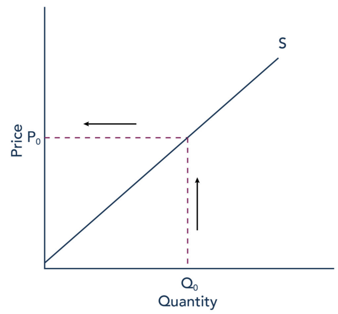


Figure 7.14.3: **Supply Curve**. The supply curve can be used to show the minimum price a firm will accept to produce a given quantity of output.

Step 2. Why did the firm choose that price and not some other? One way to think about this is that the price is composed of two parts. The first part is the average cost of production: in this case, the cost of the pizza ingredients (dough, sauce, cheese, pepperoni, and so on), the cost of the pizza oven, the rent on the shop, and the wages of the workers. The second part is the firm's desired profit, which is determined, among other factors, by the profit margins in that particular business. If you add these two parts together, you get the price the firm wishes to charge. The quantity Q_0 and associated price P_0 give you one point on the firm's supply curve, as shown in Figure 7.14.4.

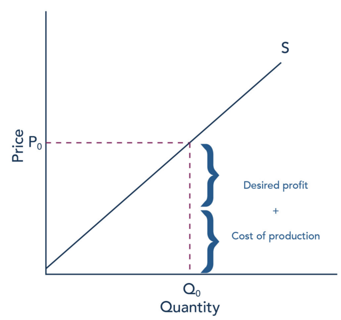


Figure 7.14.4: **Setting Prices**. The cost of production and the desired profit equal the price a firm will set for a product.

Step 3. Now, suppose that the cost of production goes up. Perhaps cheese has become more expensive by $0.75 per pizza. If that is true, the firm will want to raise its price by the amount of the increase in cost ($0.75). Draw this point on the supply curve directly above the initial point on the curve, but $0.75 higher, as shown in Figure 7.14.5.

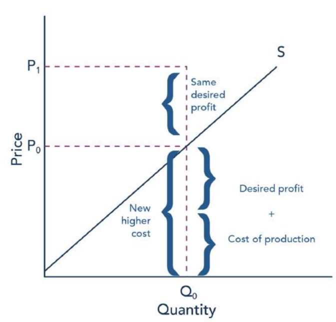


Figure 7.14.5: **Increasing Costs Lead to Increasing Price.** Because the cost of production plus the desired profit equal the price a firm will set for a product, if the cost of production increases, the price for the product will also need to increase.

Step 4. Shift the supply curve through this point. You will see that an increase in cost causes a leftward shift of the supply curve so that at any price, the quantities supplied will be smaller, as shown in Figure 7.14.6.

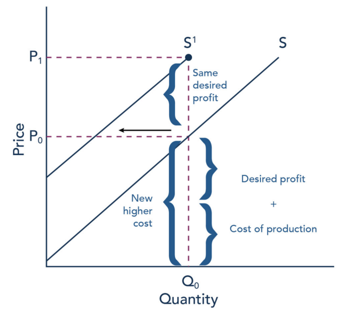
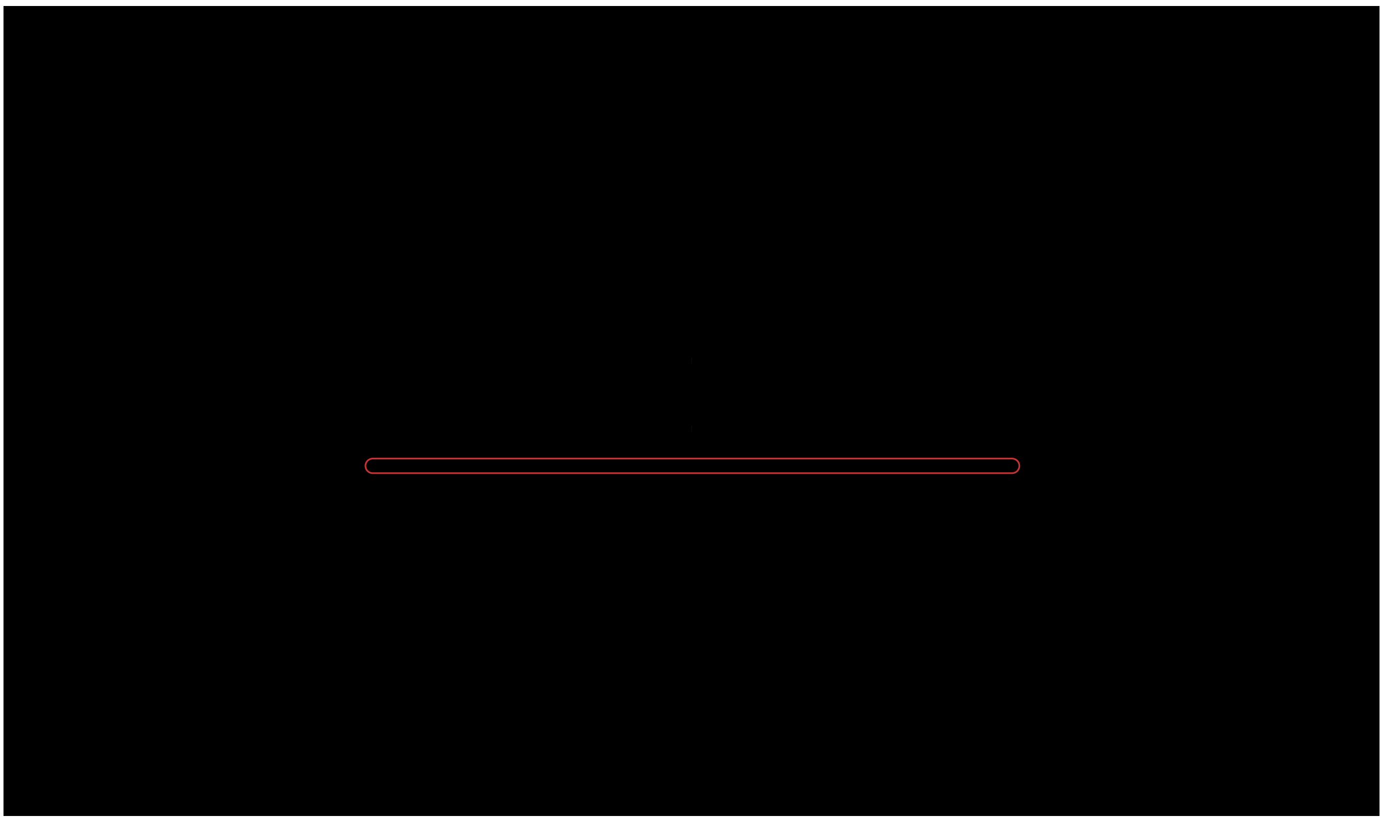


Figure 7.14.6: **Supply Curve Shifted Left**. When the cost of production increases, the supply curve shifts leftward to a new price level.

Simulation: Supply of Food Trucks

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



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7.15: Introduction to Equilibrium

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

In this section, we'll put the two fundamental pieces of the economic puzzle—supply and demand—together and see how the two laws interact in market situations. This section also introduces the concept of equilibrium—a stable market condition—and illustrates situations where the market is out of equilibrium, resulting in either a short-term surplus or shortage situation, and the resulting market pressure toward equilibrium. Finally, this section provides opportunities to work through scenarios where market factors result in shifts in both supply and demand.

Contributors and Attributions

7.16: Surpluses and Shortages

Learning Objectives

- Explain surpluses and shortages

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

Because the graphs for demand and supply curves both have price on the vertical axis and quantity on the horizontal axis, the demand curve and supply curve for a particular good or service can appear on the same graph. Together, demand and supply determine the price and the quantity that will be bought and sold in a market. These relationships are shown as the demand and supply curves in Figure $7.16.1$, which is based on the data in Table 1, below.

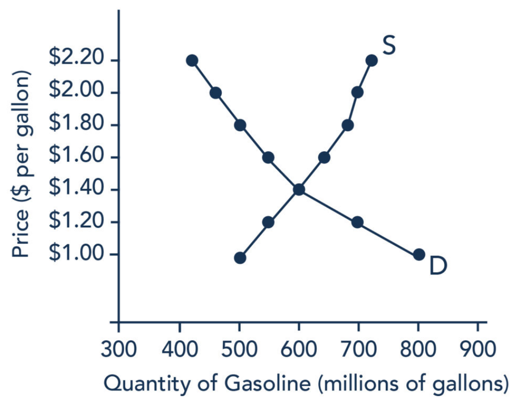

Figure $7.16.1$: **The supply and demand curves for gasoline.**

Table $7.16.1$. Price, Quantity Demanded, and Quantity Supplied

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

If you look at either Figure $7.16.1$ or Table $7.16.1$, you’ll see that at most prices the amount that consumers want to buy (which we call the quantity demanded) is different from the amount that producers want to sell (which we call the quantity supplied). What does it mean when the quantity demanded and the quantity supplied aren’t the same? The answer is: a surplus or a shortage.

Surplus or Excess Supply

Let’s consider one scenario in which the amount that producers want to sell doesn’t match the amount that consumers want to buy. Consider our gasoline market example. Imagine that the price of a gallon of gasoline were $1.80 per gallon. This price is illustrated by the dashed horizontal line at the price of $1.80 per gallon in Figure $7.16.2$, below.

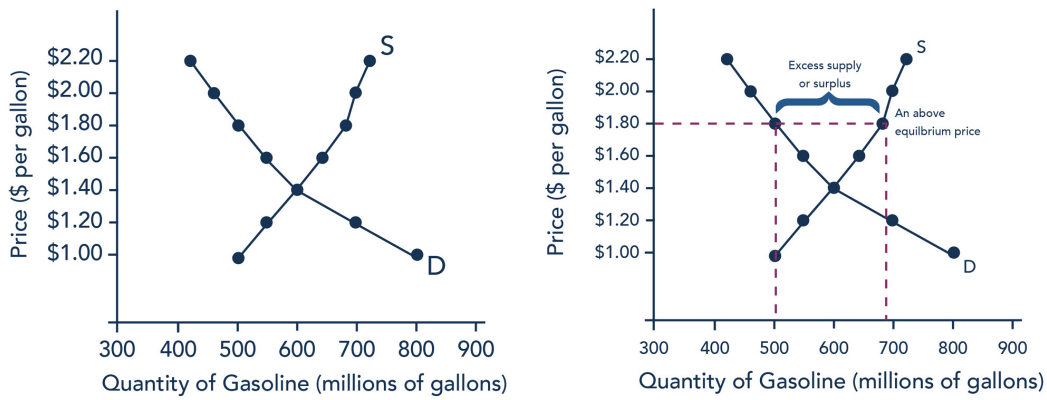

Figure 7.16.1: **A price above equilibrium creates a surplus.**

At this price, the quantity demanded is 500 gallons, and the quantity of gasoline supplied is 680 gallons. You can also find these numbers in Table 1, above. Now, compare the quantity demanded and quantity supplied at this price. Quantity supplied (680) is greater than quantity demanded (500). Or, to put it in words, the amount that producers want to sell is greater than the amount that consumers want to buy. We call this a situation of **excess supply** (since Qs > Qd) or a **surplus**. Note that whenever we compare supply and demand, it's in the context of a specific price—in this case, $1.80 per gallon.

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

How far will the price fall? Whenever there is a surplus, the price will drop until the surplus goes away. When the surplus is eliminated, the quantity supplied just equals the quantity demanded—that is, the amount that producers want to sell exactly equals the amount that consumers want to buy. We call this **equilibrium**, which means "balance." In this case, the equilibrium occurs at a price of $1.40 per gallon and at a quantity of 600 gallons. You can see this in Figure 2 (and Figure 1) where the supply and demand curves cross. You can also find it in Table 1 (the numbers in bold).

Practice Questions

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Shortage or Excess Demand

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

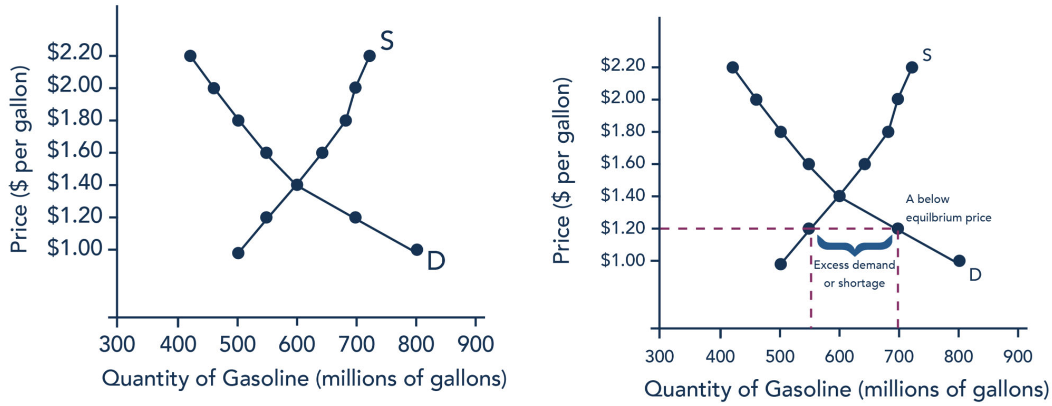

Figure 7.16.3: A price below equilibrium creates a shortage.

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

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

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

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

Contributors and Attributions

7.17: Equilibrium, Price, and Quantity

Learning Objectives

- Explain equilibrium price and quantity

Equilibrium: Where Supply and Demand Intersect

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

If you have only the demand and supply schedules, and no graph, you can find the equilibrium by looking for the price level on the tables where the quantity demanded and the quantity supplied are equal (again, the numbers in **bold** in Table 1 indicate this point).

Finding Equilibrium with Algebra

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

$$Qd = 16 - 2P \tag{7.17.1}$$

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

$$Qs = 2 + 5P \tag{7.17.2}$$

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

$$Qd = Qs \tag{7.17.3}$$

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

$$Qd = Qs \tag{7.17.4}$$

,

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

$$\begin{aligned} Qd &= Qs \\ 16 - 2P &= 2 + 5P \end{aligned} \tag{7.17.5}$$

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

$$\begin{aligned} 16 - 2P &= 2 + 5P \\ -2 + 2P &= -2 + 5P \\ 14 &= 7P \end{aligned} \tag{7.17.6}$$

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

$$\frac{14}{7} = \frac{7P}{7} \tag{7.17.7}$$

$$2 = P \tag{7.17.8}$$

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

$$Qd = 16 - 2P \tag{7.17.9}$$

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

$$\begin{aligned} Qd &= 16 - 2(2) \\ Qd &= 16 - 4 \\ Qd &= 12 \end{aligned} \tag{7.17.10}$$

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

$$\begin{aligned} Qs &= 16+5P \\ Qs &= 2+5(2) \\ Qs &= 2+10 \\ Qs &= 12 \end{aligned} \tag{7.17.11}$$

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

$$Qd = Qs \tag{7.17.12}$$

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

? Try It

Watch this video for a closer look at market equilibrium:

You can view the transcript for "Episode 14: Market Equilibrium" (opens in new window).

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

Equilibrium **and Economic Efficiency**

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

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

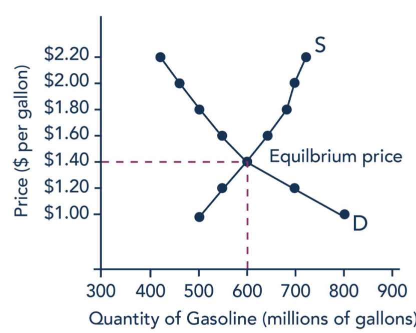

Figure 7.17.1: **Demand and Supply for Gasoline: Equilibrium.** At this equilibrium point, the market is efficient because the optimal amount of gasoline is being produced and consumed.Efficiency in the demand and supply model has the same basic meaning: the economy is getting as much benefit as possible from its scarce resources, and all the possible gains from trade have been achieved. In other words, the optimal amount of each good and service is being produced and consumed.

Practice Questions

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Finding Equilibrium using the Four-Step Process

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

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

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

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

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

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

Exercise 1: Good Weather for Salmon Fishing

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

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

Table 7.17.1:. Salmon Fishing

Price per Pound	Quantity Supplied in 2014	Quantity Supplied in 2015	Quantity Demanded
$2.00	80	400	840
$2.25	120	480	680
$2.50	160	550	550
$2.75	200	600	450
$3.00	230	640	350
$3.25	250	670	250
$3.50	270	700	200

Let's walk through the four steps together using this example, and see how the graph changes. Use the interactive graph below (Figure 3) by clicking on the arrows at the bottom of the activity to navigate through the steps.

Figure 7.17.2: **(Interactive Graph). Good Weather for Salmon Fishing: The Four-Step Process.**

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

Exercise 2: Newspapers and the Internet

According to the Pew Research Center for People and the Press, more and more people, especially younger people, are getting their news from online and digital sources. The majority of U.S. adults now own smartphones or tablets, and most of those Americans say they use them in part to get the news. From 2004 to 2012, the share of Americans who reported getting their news from digital sources increased from 24 percent to 39 percent. How has this trend affected consumption of print news media and radio and television news? Figure 7.17.3 and the text below illustrate the four-step analysis used to answer this question.

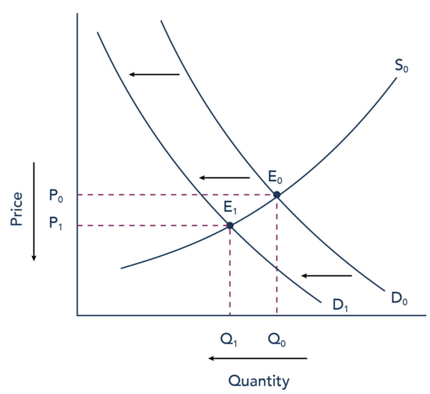

Figure 7.17.3: Graph depicting the changing market for print news.

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

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

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

? Exercise 7.17.1

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

Answer

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

? Exercise 7.17.2

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

Answer

A shift to digital news sources will tend to mean a lower quantity demanded of traditional news sources at every given price, causing the demand curve for print and other traditional news sources to shift to the left, from D_0 to D1.

? Exercise 7.17.3

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

Answer

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

Practice Questions

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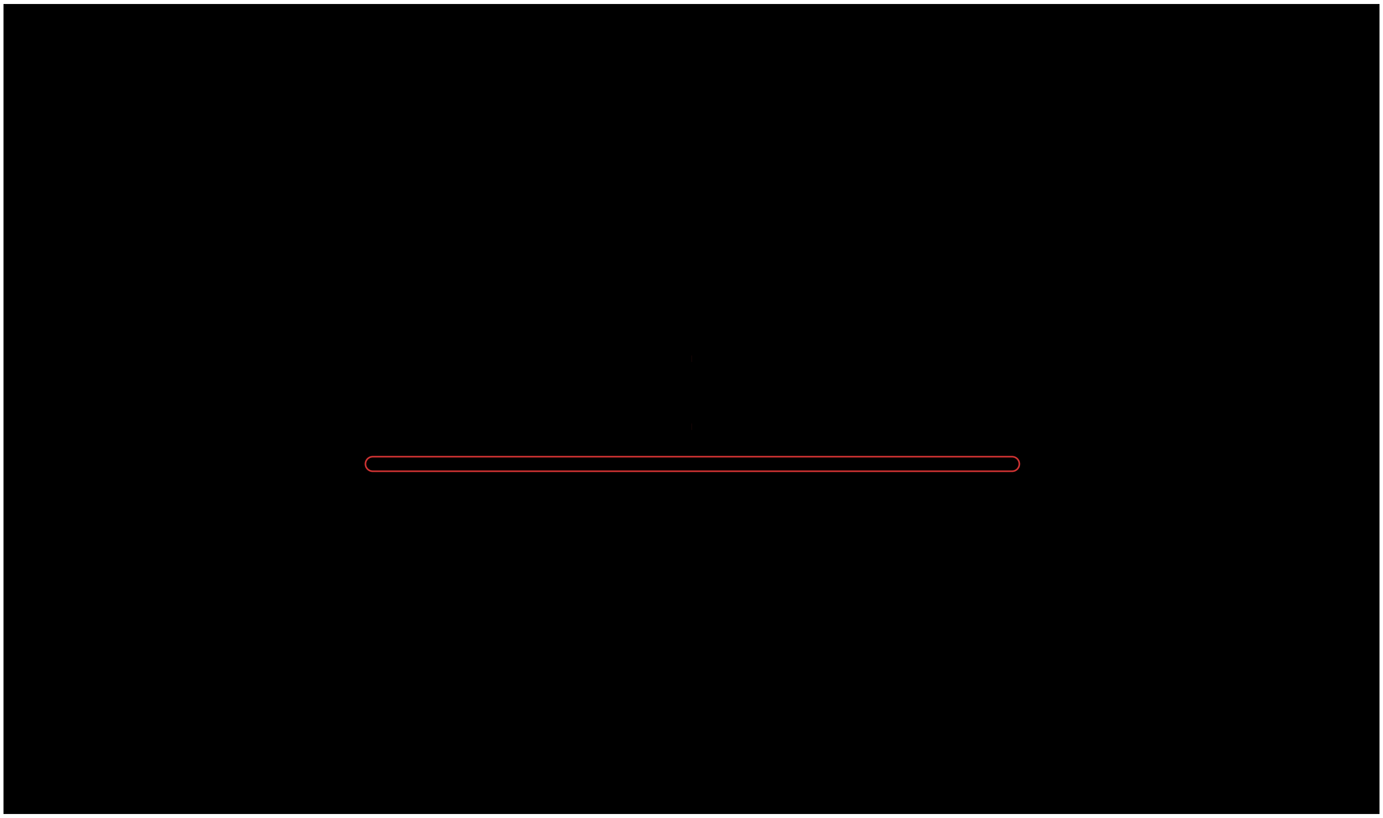
Try It

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.



A link to an interactive elements can be found at the bottom of this page.

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7.18: Practice- Equilibrium

Learning Objectives

- Explain surpluses and shortages
- Explain equilibrium price and quantity

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

Figure 7.18.1: **Money and Mail.** How do changes at the post office impact other aspects of the economy?

First, consider the following questions:

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

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

Exercise: Postal Service

Part 1: A Pay Raise for Postal Workers

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

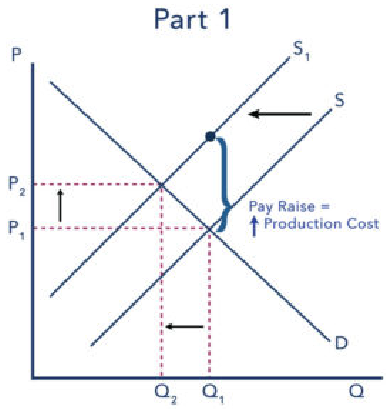

Figure 7.18.2: The supply and demand curves for the U.S. Postal Service after a pay raise for postal workers.

? Exercise 7.18.1

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

Answer

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

? Exercise 7.18.2

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

Answer

Higher labor compensation leads to a lower quantity supplied of postal services at every given price, causing the supply curve for postal services to shift to the left, from S to S1.

? Exercise 7.18.3

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

Answer

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

A pay raise for postal workers would represent an increase in the cost of production for the Postal Service. Production costs are a factor that influences supply; thus, the pay raise should decrease the supply of first-class mail, shifting the supply curve vertically by the amount of the pay raise. Intuitively, all else held constant, the Postal Service would like to charge a higher price that incorporates the higher cost of production. That is not to say the higher price will stick. From the graph (Figure 1), it should be clear that at that higher price, the quantity supplied is greater than the quantity demanded—thus there would be a surplus, indicating that the price the Postal Service desires is not an equilibrium price. Or to put it differently, at the original price (P_1), the decrease in supply causes a shortage driving up the price to a new equilibrium level (P_2). Note that the price doesn't rise by the full amount of the pay increase. In short, a leftward shift in the supply curve causes a movement up the demand curve, resulting in a lower equilibrium quantity (Q_2) and a higher equilibrium price (P2).

Part 2: The Effect of Email and Text Messaging

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

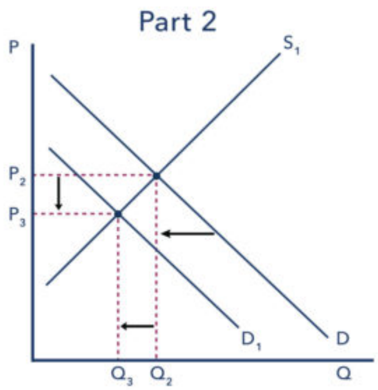

Figure 7.18.3: The impact of email and text messages on the snail mail market.

Exercise 7.18.4

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

Answer

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

Exercise 7.18.5

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

Answer

A change in tastes away from snail mail toward digital messages causes lower quantity demanded of postal services at every given price, causing the demand curve for postal services to shift to the left, from D to D1.

Exercise 7.18.6

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

Answer

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

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

Part 3: Combining Factors

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

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

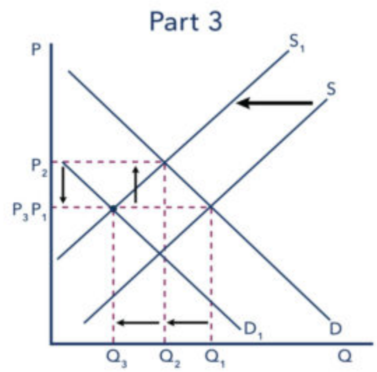

Figure 7.18.4: Decreased supply and decreased demand cause the equilibrium quantity to fall (Q3 is be smaller than the original equilibrium quantity of Q1). It is hard to pinpoint what happens to the price, however, as it may decline with the shrinking demand, but also increase with production costs.

? Practice Questions

https://assessments.lumenlearning.co...essments/14290

https://assessments.lumenlearning.co...essments/14291

? Practice Questions

These questions allow you to get as much practice as you need, as you can click the link at the top of the first question ("Try another version of these questions") to get a new set of questions. Practice until you feel comfortable doing the questions and then move on.

Note that you will use the information provided in the first question for all of the questions on this page.

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7.19: Introduction to the Health of the Economy

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

With a nominal GDP of over $20 trillion in 2018, the United States is the world's largest economy (China was #2 at over $13 trillion) and represents approximately one forth of the global economy. But what does that mean? And what does that say about future business, investment and employment prospects? In this section, you will be introduced to the three primary objectives of all market-based economies and the associated key indicators used to measure success in achieving those objectives. Understanding these economic indicators will allow you to not only evaluate the health of our and other economies but develop perspective on relative standards of living.

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7.20: Health of the Economy

Learning Objectives

- Explain the use of GDP as an economic indicator

Economic Indicators

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

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

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

Economic Goals

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

1. Growth
2. High employment
3. Price stability

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

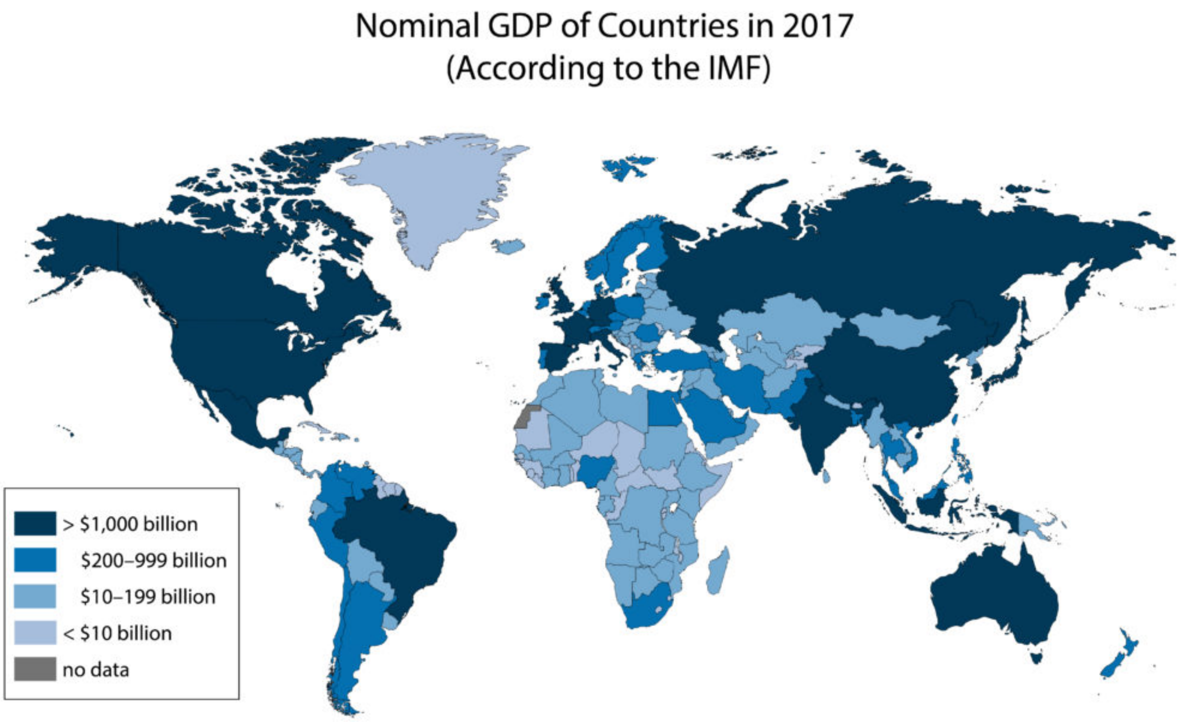
Growth

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

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

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

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



If you want more information, you can download the IMF dataset of 2017 Nominal GDP by Country or you can visit the IMF Website for more information on country GDP.

High Employment

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

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

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

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

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

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

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

Practice Questions

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Price Stability

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

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

Figure $7.20.1$, below, shows the U.S. inflation rate from 1910 to 2012. Looking back at the twentieth century, there have been several periods when inflation caused the price level to rise at double-digit rates, but nothing has come close to hyperinflation.

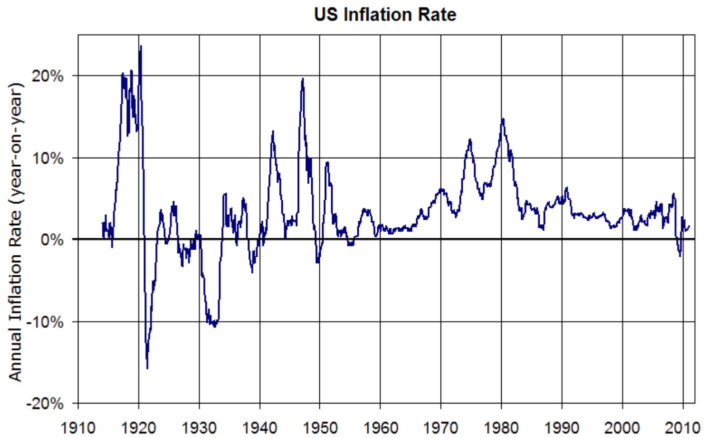

Figure 7.20.1: U.S. inflation rate from 1910 to 2012

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

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

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

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

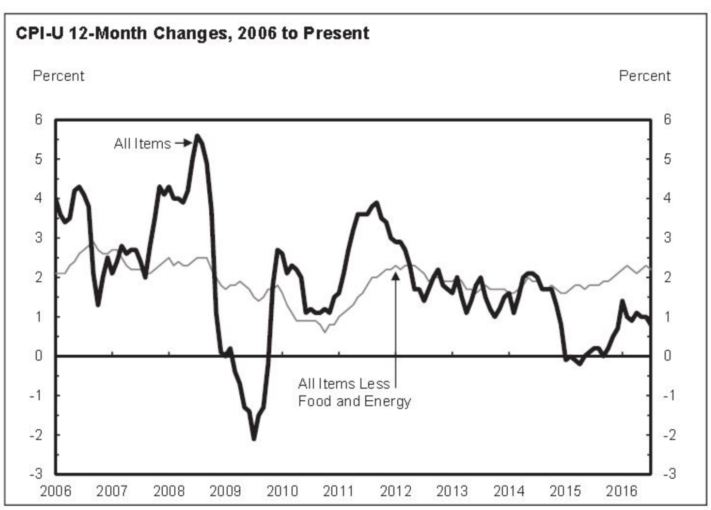

Figure 7.20.2: Consumer Price Index 2006 to 2016 (Source: US BLS)

Table 7.20.1. Consumer Price Index 2006 to 2016

Year	All Items (CPI)	All Items Less Food and Energy (CPI)
2006	4%	2%
2007	2%	3%
2008	4%	3%
2009	negative 2%	2%
2010	2%	1%
2011	1%	1%
2012	4%	2%
2013	3%	2%
2014	2%	2%
2015	0%	2%
2016	1%	2%

Consumer Confidence Index

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

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

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

? Practice Question

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

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7.21: Introduction to Economic Stages

What you'll learn to do: identify and explain the four stages of an economy and describe their impact on business operations

In this section, we will consider the economy over time, introducing the concepts of the economic cycle and the four distinct and recognizable (albeit, sometimes in hindsight) stages of the economy. This section builds on learning from the prior section on economic indicators, associating economic stages with identifying characteristics in terms of the priorities of growth, employment and prices. Economic stages aren't simply an academic concept; they have implications for all of us—as employees, business and public/social service managers and consumers. The scenario in this section illustrates the impact of the economic cycles on a small business and the ripple effect on customers, workers and suppliers.

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7.22: Stages of the Economy

Learning Objectives

- Explain the business cycle
- Differentiate between expansion, recession, and depression

Economic Cycle

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

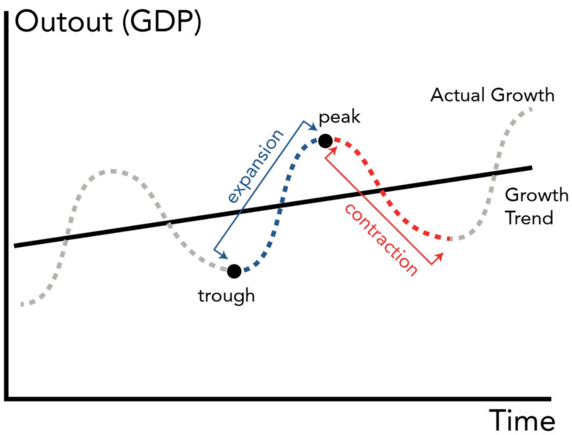
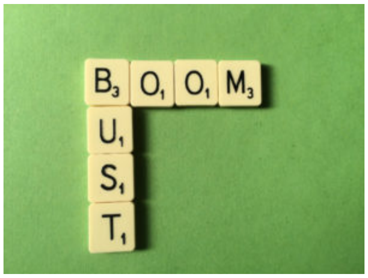


Figure 7.22.1: Economic cycle



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

An **expansion** is characterized by increasing employment, economic growth, and upward pressure on prices. A **peak** is the highest point of the business cycle, when the economy is producing at maximum allowable output, employment is at or above full employment, and inflationary pressures on prices are evident. Following a peak, the economy typically enters into a correction which is characterized by a **contraction** where growth slows, employment declines (unemployment increases), and pricing pressures subside.

The slowing ceases at the **trough** and at this point the economy has hit a bottom from which the next stage of expansion and contraction will emerge. In the United States, it is generally accepted that the National Bureau of Economic Research (NBER) is the final arbiter of the dates of the peaks and troughs of the economic cycle.

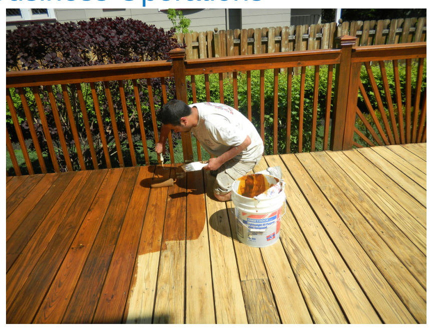
Since the economy is made up of businesses (both private and public), businesses are impacted by the stages of the economy or perhaps they cause the stages of the economy—or maybe a little of both! When we move from talking about stages of the economy, the terms used to describe the business cycle differ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

Business Cycle Fluctuations

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

An **expansion** is the period from a trough to a peak, and a **recession** is the period from a peak to a trough. The NBER identifies a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production.” This is significantly different from the commonly cited definition of a recession being signaled by two consecutive quarters of decline in real GDP. If the economy does not begin to expand again, then the economy may be considered to be in a state of **depression**.

Impact of the Economic Cycle on Business Operations



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

Expansion

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

Peak

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

Contraction

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

Trough

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

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

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

? Practice Questions

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7.23: Putting It Together- Economic Environment

Synthesis

In this module you learned about the fundamental economic principles that affect the environment in which businesses operate. Understanding the economy is like getting the weather forecast before you head out the door. Might you need to pack a sweater or an umbrella or grab some sunscreen? Perhaps, you need to be like Dorothy in the *Wizard of Oz*, head for the nearest cellar. If you ignore the forecast, you can find yourself unprepared and caught in a storm.

Of course economic forecasts aren't totally reliable—sometimes there's a freak weather event that no one saw coming. Nonetheless, having a basic understanding of how supply and demand work, how different economic systems function, and how the business cycle connects to the economy can help you make informed decisions—and make the best out of a rainy day.

Summary

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

What Is Economics?

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

Economic Systems

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

Demand

Demand is the quantity of a good or service that consumers are willing and able to purchase at any given price. There is an inverse relationship between price and quantity demanded. In general, consumers demand more of a good or service when prices are lower and less of a good as prices increase. This relationship is referred to as the law of demand and is illustrated on a graph as a downward-sloping curve, with price on the vertical axis and quantity on the horizontal axis. There is a distinction made between the term demand, which refers to the demand curve, and quantity demanded, which refers to a specific quantity and price point on the demand curve.

Supply

Supply is the quantity of a good or service that a business is willing to produce at any given price. There is a positive relationship between price and quantity supplied. In general, an increase in price will result in an increase in quantity supplied and a decrease in price will result in a reduction in quantity supplied. This relationship is referred to as the law of supply and is illustrated on a graph as an upward-sloping curve, with price on the vertical axis and quantity on the horizontal axis. There is a distinction made between the term supply, which refers to the supply curve, and quantity supplies, which refers to a specific quantity and price point on the supply curve.

Equilibrium

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

Health of the Economy

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

Economic Stages

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

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7.24: Discussion- Supply and Demand in Your Life

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

According to a recent article in *Forbes Magazine*, "The demand for additional battery life is so large *Pokémon GO* is already having an impact on the sales of external batteries and phone cases with extra battery capacity." Popular portable battery makers told *Forbes* that the sales of certain products have grown significantly, up to double or triple just in *Pokémon GO*'s first week in the United States. On a less technological front, coffee prices are up by 13 percent due to increased demand, and the supply of Corvettes is not sufficient to meet the current demand. All of these statements come from headlines from the past three months, indicating that the laws of supply and demand impact everything from your phone to your car to MY coffee. This is the basis for our discussion this week!

For Discussion

1. Choose an article on a topic (product/good/service) that affects your daily life.
    - For example, I found an article in the *Chicago Tribune* about coffee prices.
2. Briefly tell us what your article is about.
    - My article reported that although coffee prices are high, the price being paid to the coffee producers in Brazil has remained constant.
3. Which aspect of the article's discussion affects your daily life?
    - Coffee growers are threatening to cut production in order to force the prices higher. This means that my $6 cup of coffee at Starbucks could become even more expensive.
4. What factors do you think are influencing the supply and demand of the product/good/service that is the subject of your article?
    - Americans have been conditioned by marketing to agree to pay $5 for a cup of coffee, so there is no reason for retailers to charge less.
5. Include the URL of the Web site where you found the article, so your classmates can access it.
    - Coffee Prices to Rise Again

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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7.25: Discussion- Supply and Demand at Salty Pawz

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Between recalls on mass-produced commercial dog food and a general understanding of the benefits of a healthier diet for pets, the demand for natural or organic dog food is experiencing a significant increase. Wanda's treats are more expensive than the mass-produced treats found in most grocery and big box stores, but she prides herself on providing high-quality products and believes that her customers are willing to pay the extra money for quality.

For Discussion

How does Wanda's strategy of being a high-quality provider take advantage of the shifts in consumer demand for healthy dog treats?

Identify and describe an event that might occur in the economy that would cause Wanda's strategy to no longer be successful for Salty Pawz. If this event occurred, what actions would Wanda have to take in response, and what impact might they have on her business?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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7.26: Assignment- Supply and Demand for Salty Pawz

Scenario

Between recalls on mass-produced commercial dog food and a growing understanding of the benefits of a healthier diet for pets, the demand for natural or organic dog food is experiencing a significant increase. Wanda's treats are not cheap, and she wonders if maybe Salty Pawz products are overpriced. Wanda knows nothing about the economics of supply and demand, so she comes to you for advice.

Your Task

The Salty Pawz margins are good, but would Wanda be better off by lowering prices and potentially selling more? Would dropping her price even make a difference, or would she just be giving away her profits? What would be the impact on demand if she reduced her price?

Use the "Supply and Demand" data beginning on page 9 of the Salty Pawz Case Study. The information there illustrates the potential impacts on quantity supplied and quantity demanded at various price points for Salty Pawz products.

- Using the charts and data, create a graphical representation of Supply and Demand Curves for the four Salty Pawz products that Wanda sells.
- For each product, determine the equilibrium point where Quantity Supplied = Quantity Demanded.

NOTE: In order to facilitate your creation of these charts, an Excel spreadsheet is provided containing the figures shown in the case study. When you download this file, use "Save As" and rename the file. If for some reason you overwrite the file, don't panic. You can always come back to the course and download a clean copy.

Download the spreadsheet "Salty Pawz Product Response in Supply & Demand to Price Changes".

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Create graphical representations of the supply and demand curves for the four *Salty Pawz* products.	0 points	11 points	16 points	20 points	20%
Accurately determines equilibrium point for each Salty Pawz product.	0 points	11 points	16 points	20 points	20%
Provides analysis of impact of lower product prices that is qualified with data from data and graphical representations.	0 points	7.5 points	12 points	15 points	15%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Provides explanation of impact of dropping price that is qualified with data from data and graphical representations.	0 points	7.5 points	12 points	15 points	15%
Explains impact on demand based on reduction of product price, and substantiates with data and graphical representations.	0 points	7.5 points	12 points	15 points	15%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	7.5 points	12 points	15 points	15%

Total points possible: 100.

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7.27: Assignment- Price Inelasticity of Demand

Preparation

This is a *written* assignment: In order to complete this assignment you will need to take the following steps:

1. Review the written assignment guidelines.
2. Refer to the provided grading rubric. This is how your submission will be evaluated.

Your **Task**

Write **the DRAFT of Your Paper**

The assignment is as follows:

1. Select a product, good, or service for which you believe there is, if not perfect, *close to perfect* price inelasticity of demand. Refer back to course materials for clarification of what price inelasticity means.
2. Research the product, good, or service so that you have a general understanding of the market, customers, suppliers, and competition. Consult at least one reliable, credible source and be sure to include a citation so we can see where you got your information.
3. Discuss the following questions(s) with regard to the product, good, or service. Remember, you are NOT to turn in a numbered list of responses. This is a written paper, so your responses should form a cohesive set of paragraphs, with appropriate transitions, and so on.
   1. Describe in 50 words or less the product, good, or service that you chose.
   2. Why did you choose this product, good, or service?
   3. Why do you believe the demand is *inelastic* with regard to price? What factors are at work here? (Hint: Think back to the external factors you read about in module 1.)
   4. What, if anything, could change and make the product, good, or service price *elastic*?

Last Steps to Completion

1. Proofread your papers for spelling and grammar errors. Spell check thinks that *eBook* is a misspelling of *Ebola* (TRUE—it happened to me last week!), so don't rely on software to catch all mistakes.
2. Verify that you have consulted one source for research besides text materials and that proper APA citation is included in your document.
3. Remember to put your name on the paper so I know it's yours.
4. Submit your assignment on or before the due date.

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CHAPTER OVERVIEW

8: Module 2 Readings - Economic Environment

8.1: Reading- The Business Cycle- Definition and Phases

The Business Cycle

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

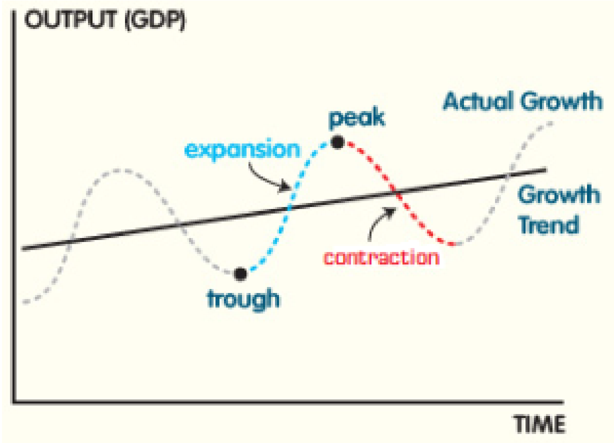

Figure 8.1.1: Business Cycles: The phases of a business cycle follow a wave-like pattern over time with regard to GDP, with expansion leading to a peak and then followed by contraction.

Business Cycle Phases

Business cycles are identified as having four distinct phases: expansion, peak, contraction, and trough.

An **expansion** is characterized by increasing employment, economic growth, and upward pressure on prices. A **peak** is the highest point of the business cycle, when the economy is producing at maximum allowable output, employment is at or above full employment, and inflationary pressures on prices are evident. Following a peak, the economy typically enters into a correction which is characterized by a **contraction** where growth slows, employment declines (unemployment increases), and pricing pressures subside. The slowing ceases at the **trough** and at this point the economy has hit a bottom from which the next phase of expansion and contraction will emerge.

Business Cycle Fluctuations

Business cycle fluctuations occur around a long-term growth trend and are usually measured in terms of the growth rate of real gross domestic product.

In the United States, it is generally accepted that the National Bureau of Economic Research (NBER) is the final arbiter of the dates of the peaks and troughs of the business cycle. An **expansion** is the period from a trough to a peak, and a **recession** as the period from a peak to a trough. The NBER identifies a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production. " This is significantly different from the commonly cited definition of a recession being signaled by two consecutive quarters of decline in real GDP. If the economy does not begin to expand again then the economy may be considered to be in a state of **depression**.

Impact on Business Operations

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

Expansion

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

Peak

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

Contraction

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

Trough

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

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

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

KEY TAKEAWAYS

- Business cycles are identified as having four distinct phases: peak, trough, contraction, and expansion.
- Business cycle fluctuations occur around a long-term growth trend and are usually measured by considering the growth rate of real gross domestic product.
- In the United States, it is generally accepted that the National Bureau of Economic Research (NBER) is the final arbiter of the dates of the peaks and troughs of the business cycle.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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8.2: Reading- Economics and Scarcity

Economics and Scarcity

Economics is the study of how humans make decisions in the face of scarcity. These can be individual decisions, family decisions, business decisions or societal decisions. If you look around carefully, you will see that scarcity is a fact of life. **Scarcity** means that human wants for goods, services and resources exceed what is available. Resources, such as labor, tools, land, and raw materials are necessary to produce the goods and services we want but they exist in limited supply. Of course, the ultimate scarce resource is time—everyone, rich or poor, has just twenty-four hours in the day to try to acquire the goods they want. At any point in time, there are only a finite number of resources available.

Think about it this way: In 2012 the labor force in the United States contained over 155.5 million workers, according to the U.S. Bureau of Labor Statistics. Similarly, the total area of the United States is 3,794,101 square miles. These are large numbers for such crucial resources, however, they are limited. Because these resources are limited, so are the numbers of goods and services we produce with them. Combine this with the fact that human wants seem to be virtually infinite, and you can see why scarcity is a problem.

Scarcity of Resources

Figure 8.2.1: Homeless people are a stark reminder that scarcity of resources is real.

If you still do not believe that scarcity is a problem, consider the following: Does everyone need food to eat? Does everyone need a decent place to live? Does everyone have access to healthcare? In every country in the world, there are people who are hungry, homeless (for example, those who call park benches their beds, as shown in Figure 1), and in need of healthcare, just to focus on a few critical goods and services. Why is this the case? It is because of scarcity. Let's delve into the concept of scarcity a little deeper, because it is crucial to understanding economics.

The Problem of Scarcity

Think about all the things you consume: food, shelter, clothing, transportation, healthcare, and entertainment. How do you acquire those items? You do not produce them yourself. You buy them. How do you afford the things you buy? You work for pay. Or if you do not, someone else does on your behalf. Yet most of us never have enough to buy all the things we want. This is because of scarcity. So how do we solve it?

LINK IT UP

Visit this website to read about how the United States is dealing with scarcity in resources.

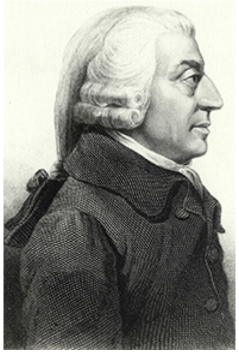

Figure 8.2.1: Adam Smith introduced the idea of dividing labor into discrete tasks.

Every society, at every level, must make choices about how to use its resources. Families must decide whether to spend their money on a new car or a fancy vacation. Towns must choose whether to put more of the budget into police and fire protection or into the school system. Nations must decide whether to devote more funds to national defense or to protecting the environment. In most cases, there just isn't enough money in the budget to do everything. So why do we not each just produce all of the things we consume? The simple answer is most of us do not know how, but that is not the main reason. (When you study economics, you will discover that the obvious choice is not always the right answer—or at least the complete answer. Studying economics teaches you to think in a different of way.)

Think back to pioneer days, when individuals knew how to do so much more than we do today, from building their homes, to growing their crops, to hunting for food, to repairing their equipment. Most of us do not know how to do all—or any—of those things. It is not because we could not learn. Rather, we do not have to. The reason why is something called *the division and specialization of labor*, a production innovation first put forth by Adam Smith (see Figure 2) in his book *The Wealth of Nations*.

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8.3: Reading- The Division of and Specialization of Labor

The Division of and Specialization of Labor

The formal study of economics began when Adam Smith (1723–1790) published his famous book *The Wealth of Nations* in 1776. Many authors had written on economics in the centuries before Smith, but he was the first to address the subject in a comprehensive way. In the first chapter, Smith introduces the **division of labor**, which means that the way a good or service is produced is divided into a number of tasks that are performed by different workers, instead of all the tasks being done by the same person.

To illustrate the division of labor, Smith counted how many tasks went into making a pin: drawing out a piece of wire, cutting it to the right length, straightening it, putting a head on one end and a point on the other, and packaging pins for sale, to name just a few. Smith counted 18 distinct tasks that were often done by different people—all for a pin, believe it or not!

Figure 8.3.1: Workers on an assembly line are an example of the divisions of labor. (Credit: Nina Hale/Flickr Creative Commons)

Modern businesses divide tasks as well. Even a relatively simple business like a restaurant divides up the task of serving meals into a range of jobs like top chef, sous chefs, less-skilled kitchen help, servers to wait on the tables, a greeter at the door, janitors to clean up, and a business manager to handle paychecks and bills—not to mention the economic connections a restaurant has with suppliers of food, furniture, kitchen equipment, and the building where it is located. A complex business, like a large manufacturing factory such as the shoe factory shown in Figure 3, or a hospital, can have hundreds of job classifications.

Why the Division of Labor Increases Production

When the tasks involved with producing a good or service are divided and subdivided, workers and businesses can produce a greater quantity of output. In his observations of pin factories, Smith observed that one worker alone might make twenty pins in a day, but that a small business of ten workers (some of whom would need to do two or three of the eighteen tasks involved with pin-making), could make 48,000 pins in a day. How can a group of workers, each specializing in certain tasks, produce so much more than the same number of workers who try to produce the entire good or service by themselves? Smith offered three reasons.

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

Second, workers who specialize in certain tasks often learn to produce more quickly and with higher quality. This pattern holds true for many workers, including assembly line laborers who build cars, stylists who cut hair, and doctors who perform heart surgery. In fact, specialized workers often know their jobs well enough to suggest innovative ways to do their work faster and better.

A similar pattern often operates within businesses. In many cases, a business that focuses on one or a few products (sometimes called its "core competency") is more successful than firms that try to make a wide range of products.

Third, specialization allows businesses to take advantage of **economies of scale**, which means that for many goods, as the level of production increases, the average cost of producing each individual unit declines. For example, if a factory produces only 100 cars per year, each car will be quite expensive to make on average. However, if a factory produces 50,000 cars each year, then it can set up an assembly line with huge machines and workers performing specialized tasks, and the average cost of production per car will be lower. The ultimate result of workers who can focus on their preferences and talents, learn to do their specialized jobs better, and work in larger organizations is that society as a whole can produce and consume far more than if each person tried to produce all of their own goods and services. The division and specialization of labor has been a force against the problem of scarcity.

Trade and Markets

Specialization only makes sense, though, if workers can use the pay they receive for doing their jobs to purchase the other goods and services that they need. In short, specialization requires trade.

You do not have to know anything about electronics or sound systems to play music—you just buy an iPod or MP3 player, download the music and listen. You do not have to know anything about artificial fibers or the construction of sewing machines if you need a jacket—you just buy the jacket and wear it. You do not need to know anything about internal combustion engines to operate a car—you just get in and drive. Instead of trying to acquire all the knowledge and skills involved in producing all of the goods and services that you wish to consume, the market allows you to learn a specialized set of skills and then use the pay you receive to buy the goods and services you need or want. This is how our modern society has evolved into a strong economy.

Why Study Economics?

Now that we have gotten an overview on what economics studies, let's quickly discuss why you are right to study it. Economics is not primarily a collection of facts to be memorized, though there are plenty of important concepts to be learned. Instead, economics is better thought of as a collection of questions to be answered or puzzles to be worked out. Most important, economics provides the tools to work out those puzzles. If you have yet to be been bitten by the economics "bug," there are other reasons why you should study economics.

- Virtually every major problem facing the world today, from global warming, to world poverty, to the conflicts in Syria, Afghanistan, and Somalia, has an economic dimension. If you are going to be part of solving those problems, you need to be able to understand them. Economics is crucial.
- It is hard to overstate the importance of economics to good citizenship. You need to be able to vote intelligently on budgets, regulations, and laws in general. When the U.S. government came close to a standstill at the end of 2012 due to the "fiscal cliff," what were the issues involved? Did you know?
- A basic understanding of economics makes you a well-rounded thinker. When you read articles about economic issues, you will understand and be able to evaluate the writer's argument. When you hear classmates, co-workers, or political candidates talking about economics, you will be able to distinguish between common sense and nonsense. You will find new ways of thinking about current events and about personal and business decisions, as well as current events and politics.

The study of economics does not dictate the answers, but it can illuminate the different choices.

Key Concepts and Summary

Economics seeks to solve the problem of **scarcity**, which is when human wants for goods and services exceed the available supply. A modern economy displays a division of labor, in which people earn income by specializing in what they produce and then use that income to purchase the products they need or want. The **division of labor** allows individuals and firms to specialize and to produce more for several reasons: a) It allows the agents to focus on areas of advantage due to natural factors and skill levels; b) It encourages the agents to learn and invent; c) It allows agents to take advantage of economies of scale. Division and specialization of labor only work when individuals can purchase what they do not produce in markets. Learning about economics helps you understand the major problems facing the world today, prepares you to be a good citizen, and helps you become a well-rounded thinker.

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8.4: Reading- Microeconomics and Macroeconomics

Microeconomics and Macroeconomics

Economics is concerned with the well-being of *all* people, including those with jobs and those without jobs, as well as those with high incomes and those with low incomes. Economics acknowledges that production of useful goods and services can create problems of environmental pollution. It explores the question of how investing in education helps to develop workers' skills. It probes questions like how to tell when big businesses or big labor unions are operating in a way that benefits society as a whole and when they are operating in a way that benefits their owners or members at the expense of others. It looks at how government spending, taxes, and regulations affect decisions about production and consumption.

It should be clear by now that economics covers a lot of ground. That ground can be divided into two parts: **Microeconomics** focuses on the actions of individual agents within the economy, like households, workers, and businesses; **Macroeconomics** looks at the economy as a whole. It focuses on broad issues such as growth of production, the number of unemployed people, the inflationary increase in prices, government deficits, and levels of exports and imports. Microeconomics and macroeconomics are not separate subjects, but rather complementary perspectives on the overall subject of the economy.

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

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

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

Microeconomics

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

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

Macroeconomics

What determines the level of economic activity in a society? In other words, what determines how many goods and services a nation actually produces? What determines how many jobs are available in an economy? What determines a nation's standard of living? What causes the economy to speed up or slow down? What causes firms to hire more workers or to lay workers off? Finally, what causes the economy to grow over the long term?

An economy's macroeconomic health can be defined by a number of goals: growth in the standard of living, low unemployment, and low inflation, to name the most important. How can macroeconomic policy be used to pursue these goals? **Monetary policy**, which involves policies that affect bank lending, interest rates, and financial capital markets, is conducted by a nation's central bank. For the United States, this is the Federal Reserve. **Fiscal policy**, which involves government spending and taxes, is determined by a nation's legislative body. For the United States, this is the Congress and the executive branch, which originates the federal budget. These are the main tools the government has to work with. Americans tend to expect that government can fix whatever economic problems we encounter, but to what extent is that expectation realistic? These are just some of the issues that will be explored in the macroeconomic chapters of this book.

KEY TAKEAWAYS

- Microeconomics and macroeconomics are two different perspectives on the economy.
  - The microeconomic perspective focuses on parts of the economy: individuals, firms, and industries.
  - The macroeconomic perspective looks at the economy as a whole, focusing on goals like growth in the standard of living, unemployment, and inflation.
- Macroeconomics has two types of policies for pursuing these goals:
  - monetary policy
  - fiscal policy

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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8.5: Reading- Demand, Supply, and Equilibrium in Markets for Goods and Services

Demand for Goods and Services

First let's first focus on what economists mean by *demand*, what they mean by *supply*, and then how demand and supply interact in a market.

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

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

An example from the market for gasoline can be shown in the form of a table or a graph. A table that shows the quantity demanded at each price, such as the table below, is called a **demand schedule**. Price in this case is measured in dollars per gallon of gasoline. The quantity demanded is measured in millions of gallons over some time period (for example, per day or per year) and over some geographic area (like a state or a country). A **demand curve** shows the relationship between price and quantity demanded on a graph like Figure 1, with quantity on the horizontal axis and the price per gallon on the vertical axis. (Note that this is an *exception* to the normal rule in mathematics that the independent variable (x) goes on the horizontal axis and the dependent variable (y) goes on the vertical. Economics is not math.)

The demand schedule shown by the table below and the demand curve shown by the graph in Figure 8.5.1 are two ways of describing the same relationship between price and quantity demanded.

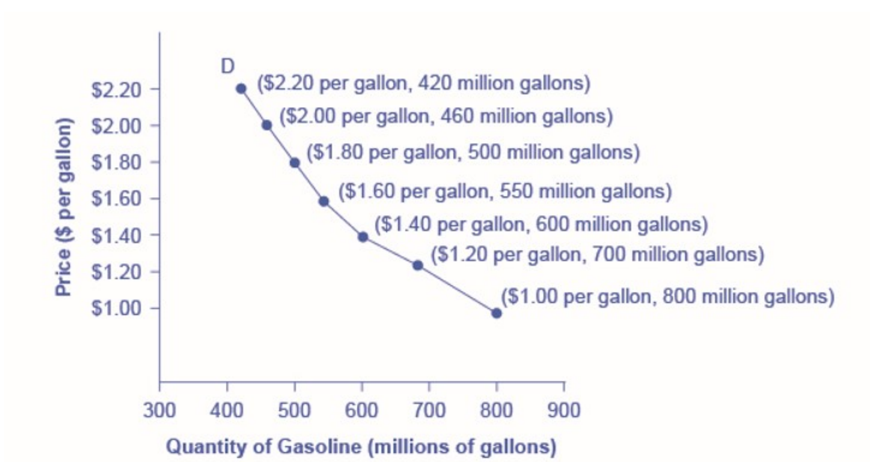

Figure 8.5.1: The demand schedule shows that as price rises, quantity demanded decreases, and vice versa. These points are then graphed, and the line connecting them is the demand curve (D). The downward slope of the demand curve again illustrates the law of demand—the inverse relationship between prices and quantity demanded.

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

Price (per gallon)	Quantity Demanded (millions of gallons)
$2.00	460
$2.20	420

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

Confused about these different types of demand?

Is Demand the Same as Quantity Demanded?

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

Supply of Goods and Services

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

Still unsure about the different types of supply?

Is Supply the Same as Quantity Supplied?

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

Figure 8.5.2 illustrates the law of supply, again using the market for gasoline as an example. Like demand, supply can be illustrated using a table or a graph. A **supply schedule** is a table, like the table below, that shows the quantity supplied at a range of different prices. Again, price is measured in dollars per gallon of gasoline and quantity demanded is measured in millions of gallons. A **supply curve** is a graphic illustration of the relationship between price, shown on the vertical axis, and quantity, shown on the horizontal axis. The supply schedule and the supply curve are just two different ways of showing the same information. Notice that the horizontal and vertical axes on the graph for the supply curve are the same as for the demand curve.

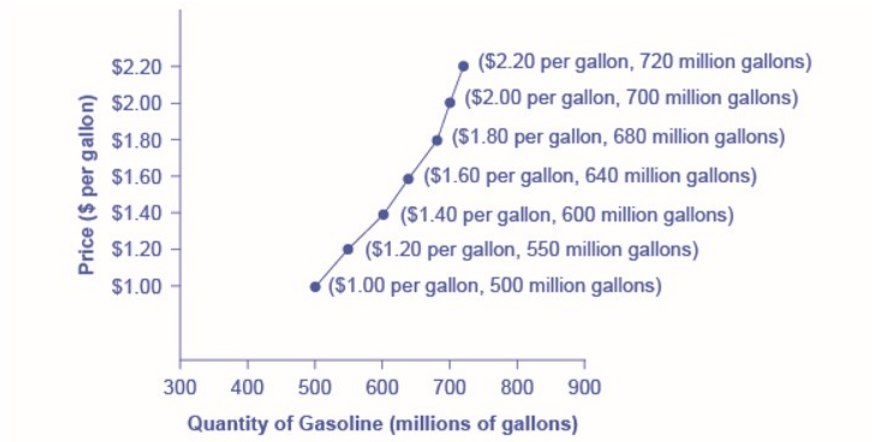

Figure 8.5.2: The supply schedule is the table that shows quantity supplied of gasoline at each price. As price rises, quantity supplied also increases, and vice versa. The supply curve (S) is created by graphing the points from the supply schedule and then connecting them. The upward slope of the supply curve illustrates the law of supply—that a higher price leads to a higher quantity supplied, and vice versa.

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

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

Equilibrium—Where Demand and Supply Meet

Because the graphs for demand and supply curves both have price on the vertical axis and quantity on the horizontal axis, the demand curve and supply curve for a particular good or service can appear on the same graph. Together, demand and supply determine the price and the quantity that will be bought and sold in a market.

Figure 8.5.3 illustrates the interaction of demand and supply in the market for gasoline. The demand curve (D) is identical to Figure 8.5.1. The supply curve (S) is identical to Figure 8.5.2. The table below contains the same information in tabular form.

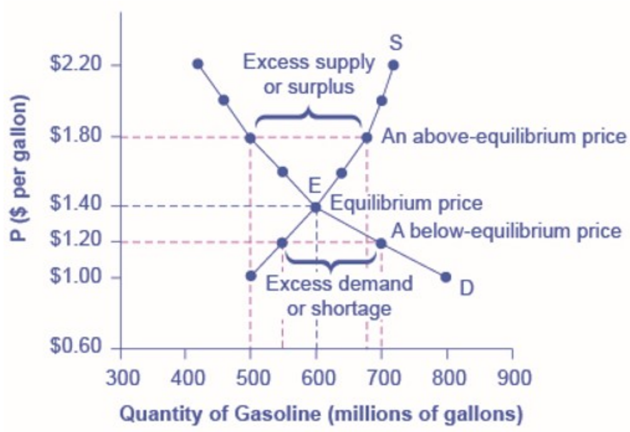

Figure 8.5.3: The demand curve (D) and the supply curve (S) intersect at the equilibrium point E, with a price of $1.40 and a quantity of 600. The equilibrium is the only price where quantity demanded is equal to quantity supplied. At a price above equilibrium like $1.80, quantity supplied exceeds the quantity demanded, so there is excess supply. At a price below equilibrium such as $1.20, quantity demanded exceeds quantity supplied, so there is excess demand.

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

Remember this: When two lines on a diagram cross, this intersection usually means something. The point where the supply curve (S) and the demand curve (D) cross, designated by point E in Figure 8.5.3, is called the **equilibrium**. The **equilibrium price** is the only price where the plans of consumers and the plans of producers agree—that is, where the amount of the product consumers want to buy (quantity demanded) is equal to the amount producers want to sell (quantity supplied). This common quantity is called the **equilibrium quantity**. At any other price, the quantity demanded does not equal the quantity supplied, so the market is not in equilibrium at that price.

In Figure 8.5.3, the equilibrium price is $1.40 per gallon of gasoline and the equilibrium quantity is 600 million gallons. If you had only the demand and supply schedules, and not the graph, you could find the equilibrium by looking for the price level on the tables where the quantity demanded and the quantity supplied are equal.

The word "**equilibrium**" means "balance." If a market is at its equilibrium price and quantity, then it has no reason to move away from that point. However, if a market is not at equilibrium, then economic pressures arise to move the market toward the equilibrium price and the equilibrium quantity.

Imagine, for example, that the price of a gallon of gasoline was above the equilibrium price—that is, instead of $1.40 per gallon, the price is $1.80 per gallon. This above-equilibrium price is illustrated by the dashed horizontal line at the price of $1.80 in Figure 3. At this higher price, the quantity demanded drops from 600 to 500. This decline in quantity reflects how consumers react to the higher price by finding ways to use less gasoline.

Moreover, at this higher price of $1.80, the quantity of gasoline supplied rises from the 600 to 680, as the higher price makes it more profitable for gasoline producers to expand their output. Now, consider how quantity demanded and quantity supplied are related at this above-equilibrium price. Quantity demanded has fallen to 500 gallons, while quantity supplied has risen to 680 gallons. In fact, at any above-equilibrium price, the quantity supplied exceeds the quantity demanded. We call this an **excess supply** or a **surplus**.

With a surplus, gasoline accumulates at gas stations, in tanker trucks, in pipelines, and at oil refineries. This accumulation puts pressure on gasoline sellers. If a surplus remains unsold, those firms involved in making and selling gasoline are not receiving enough cash to pay their workers and to cover their expenses. In this situation, some producers and sellers will want to cut prices, because it is better to sell at a lower price than not to sell at all. Once some sellers start cutting prices, others will follow to avoid losing sales. These price reductions in turn will stimulate a higher quantity demanded. So, if the price is above the equilibrium level, incentives built into the structure of demand and supply will create pressures for the price to fall toward the equilibrium.

Now suppose that the price is below its equilibrium level at $1.20 per gallon, as the dashed horizontal line at this price in Figure 3 shows. At this lower price, the quantity demanded increases from 600 to 700 as drivers take longer trips, spend more minutes warming up the car in the driveway in wintertime, stop sharing rides to work, and buy larger cars that get fewer miles to the gallon. However, the below-equilibrium price reduces gasoline producers' incentives to produce and sell gasoline, and the quantity supplied falls from 600 to 550.

When the price is below equilibrium, there is **excess demand**, or a **shortage**—that is, at the given price the quantity demanded, which has been stimulated by the lower price, now exceeds the quantity supplied, which had been depressed by the lower price. In this situation, eager gasoline buyers mob the gas stations, only to find many stations running short of fuel. Oil companies and gas stations recognize that they have an opportunity to make higher profits by selling what gasoline they have at a higher price. As a result, the price rises toward the equilibrium level.

KEY TAKEAWAYS

A demand schedule is a table that shows the quantity demanded at different prices in the market. A demand curve shows the relationship between quantity demanded and price in a given market on a graph. The law of demand states that a higher price typically leads to a lower quantity demanded.

A supply schedule is a table that shows the quantity supplied at different prices in the market. A supply curve shows the relationship between quantity supplied and price on a graph. The law of supply says that a higher price typically leads to a higher quantity supplied.

The equilibrium price and equilibrium quantity occur where the supply and demand curves cross. The equilibrium occurs where the quantity demanded is equal to the quantity supplied. If the price is below the equilibrium level, then the quantity demanded will exceed the quantity supplied. Excess demand or a shortage will exist. If the price is above the equilibrium level, then the quantity supplied will exceed the quantity demanded. Excess supply or a surplus will exist. In either case, economic pressures will push the price toward the equilibrium level.

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8.6: Reading- Shifts in Demand

What Factors Affect Demand?

You may think that the only thing that affects the quantity demanded and the quantity supplied is price. Price, however, is not the only thing that influences demand. Nor is it the only thing that influences supply. For example, how is demand for vegetarian food affected if, say, health concerns cause more consumers to avoid eating meat? Or how is the supply of diamonds affected if diamond producers discover several new diamond mines? What are the major factors, in addition to the price, that influence demand or supply?

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

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

The *Ceteris Paribus* Assumption

A **demand curve** or a **supply curve** is a relationship between two, and only two, variables: quantity on the horizontal axis and price on the vertical axis. The assumption behind a demand curve or a supply curve is that no relevant economic factors, other than the product's price, are changing. Economists call this assumption ***ceteris paribus***, a Latin phrase meaning "other things being equal." Any given demand or supply curve is based on the *ceteris paribus* assumption that all else is held equal. A demand curve or a supply curve is a relationship between two, and only two, variables when all other variables are kept constant. If all else is not held equal, then the laws of supply and demand will not necessarily hold, as the following section shows.

When Does *Ceteris Paribus Apply?*

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

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

How Does Income Affect Demand?

Let's use income as an example of how factors other than price affect demand. Figure 8.6.1 below shows the initial demand for automobiles as D_0. At point Q, for example, if the price is $20,000 per car, the quantity of cars demanded is 18 million. D_0 also shows how the quantity of cars demanded would change as a result of a higher or lower price. For example, if the price of a car rose to $22,000, the quantity demanded would decrease to 17 million, at point R.

The original demand curve D_0, like every demand curve, is based on the *ceteris paribus* assumption that no other economically relevant factors change. Now imagine that the economy expands in a way that raises the incomes of many people, making cars more affordable. How will this affect demand? How can we show this graphically?

Return to Figure 8.6.1. The price of cars is still $20,000, but with higher incomes, the quantity demanded has now increased to 20 million cars, shown at point S. As a result of the higher income levels, the demand curve shifts to the right to the new demand curve D_1, indicating an increase in demand. The table below shows clearly that this increased demand would occur at every price, not just the original one.

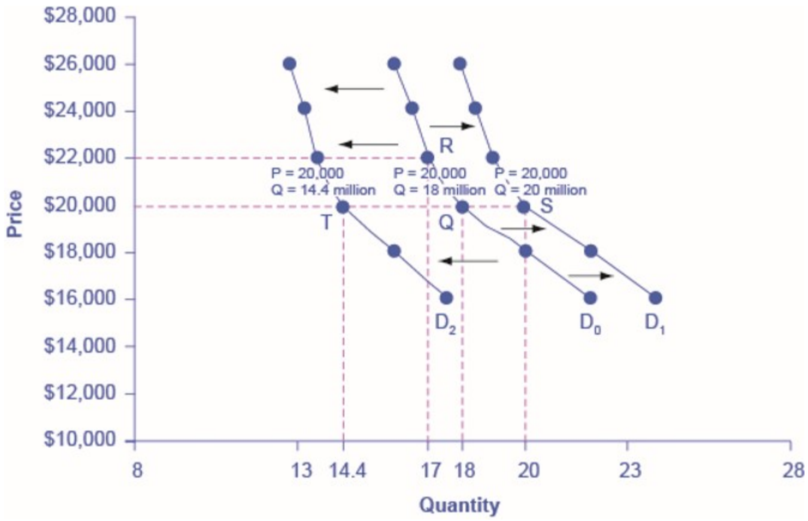

Figure 8.6.1: Increased demand means that at every given price, the quantity demanded is higher, so that the demand curve shifts to the right from D0 to D1. Decreased demand means that at every given price, the quantity demanded is lower, so that the demand curve shifts to the left from D0 to D2.

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

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

When a demand curve shifts, it does not mean that the quantity demanded by every individual buyer changes by the same amount. In this example, not everyone would have higher or lower income and not everyone would buy or not buy an additional car. Instead, a shift in a demand curve captures an pattern for the market as a whole.

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

Other Factors That Shift Demand Curves

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

Changing Tastes or Preferences

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

Changes in the Composition of the Population

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

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

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

Changes in Expectations about Future Prices or Other Factors that Affect Demand

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

Shift in Demand

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

Step 1. Draw the graph of a demand curve for a normal good like pizza. Pick a price (like P_0). Identify the corresponding Q_0. An example is shown in Figure 2.

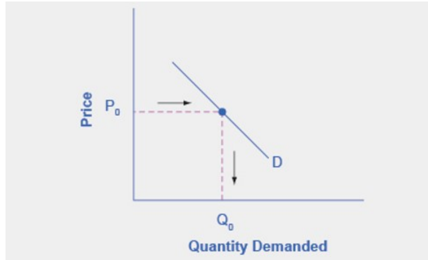

Figure 8.6.2: The demand curve can be used to identify how much consumers would buy at any given price.

Step 2. Suppose income increases. As a result of the change, are consumers going to buy more or less pizza? The answer is more. Draw a dotted horizontal line from the chosen price, through the original quantity demanded, to the new point with the new Q_1. Draw a dotted vertical line down to the horizontal axis and label the new Q_1. An example is provided in Figure 3.

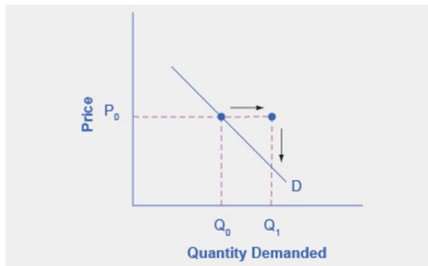

Figure 8.6.3: With an increase in income, consumers will purchase larger quantities, pushing demand to the right.

Step 3. Now, shift the curve through the new point. You will see that an increase in income causes an upward (or rightward) shift in the demand curve, so that at any price the quantities demanded will be higher, as shown in Figure 4.

Figure 8.6.4:With an increase in income, consumers will purchase larger quantities, pushing demand to the right, and causing the demand curve to shift right.

KEY TAKEAWAYS

Six factors that can shift demand curves are summarized in Figure 5. The direction of the arrows indicates whether the demand curve shifts represent an increase in demand or a decrease in demand. Notice that a change in the price of the good or service itself is not listed among the factors that can shift a demand curve. A change in the price of a good or service causes a movement along a specific demand curve, and it typically leads to some change in the quantity demanded, but it does not shift the demand curve.

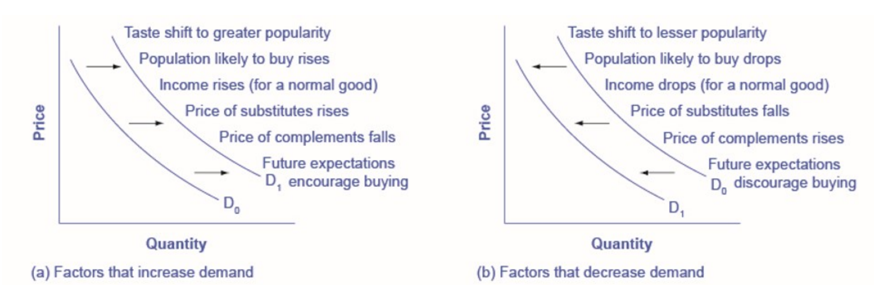

Figure 8.6.5: (a) A list of factors that can cause an increase in demand from D0 to D1. (b) The same factors, if their direction is reversed, can cause a decrease in demand from D0 to D1.

When a demand curve shifts, it will then intersect with a given supply curve at a different equilibrium price and quantity. We are, however, getting ahead of our story. Before discussing how changes in demand can affect equilibrium price and quantity, we first need to discuss shifts in supply curves.

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8.7: Reading- Shifts in Supply

How Production Costs Affect Supply

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

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

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

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

Consider the supply for cars, shown by curve S_0 in Figure 8.7.1. Point J indicates that if the price is $20,000, the quantity supplied will be 18 million cars. If the price rises to $22,000 per car, *ceteris paribus*, the quantity supplied will rise to 20 million cars, as point K on the S_0 curve shows. The same information can be shown in table form, as in the table below.

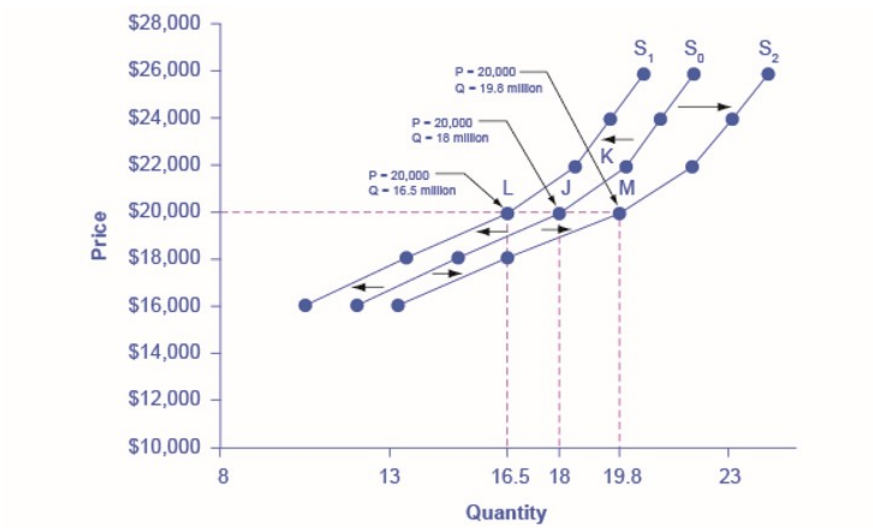

Figure 8.7.1: Decreased supply means that at every given price, the quantity supplied is lower, so that the supply curve shifts to the left, from S0 to S1. Increased supply means that at every given price, the quantity supplied is higher, so that the supply curve shifts to the right, from S0 to S2.

Price and Shifts in Supply: A Car Example			
Price	Decrease to S_1	Original Quantity Supplied S_0	Increase to S_2
$16,000	10.5 million	12.0 million	13.2 million
$18,000	13.5 million	15.0 million	16.5 million
$20,000	16.5 million	18.0 million	19.8 million

Price and Shifts in Supply: A Car Example			
Price	Decrease to S_1	Original Quantity Supplied S_0	Increase to S_2
$22,000	18.5 million	20.0 million	22.0 million
$24,000	19.5 million	21.0 million	23.1 million
$26,000	20.5 million	22.0 million	24.2 million

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

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

Other Factors That Affect Supply

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

The cost of production for many agricultural products will be affected by changes in natural conditions. For example, the area of northern China which typically grows about 60% of the country's wheat output experienced its worst drought in at least 50 years in the second half of 2009. A drought decreases the supply of agricultural products, which means that at any given price, a lower quantity will be supplied; conversely, especially good weather would shift the supply curve to the right.

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

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

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

Shift in Supply

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

Step 1. Draw a graph of a supply curve for pizza. Pick a quantity (like Q_0). If you draw a vertical line up from Q_0 to the supply curve, you will see the price the firm chooses. An example is shown in Figure 8.7.2.

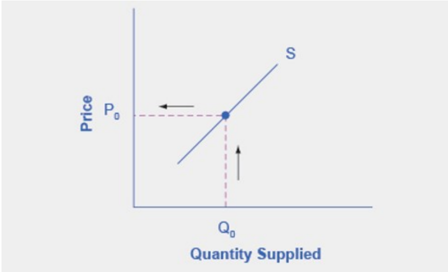

Figure 8.7.2: The supply curve can be used to show the minimum price a firm will accept to produce a given quantity of output

Step 2. Why did the firm choose that price and not some other? One way to think about this is that the price is composed of two parts. The first part is the average cost of production, in this case, the cost of the pizza ingredients (dough, sauce, cheese, pepperoni, and so on), the cost of the pizza oven, the rent on the shop, and the wages of the workers. The second part is the firm's desired profit, which is determined, among other factors, by the profit margins in that particular business. If you add these two parts together, you get the price the firm wishes to charge. The quantity Q_0 and associated price P0 give you one point on the firm's supply curve, as shown in Figure 8.7.3.

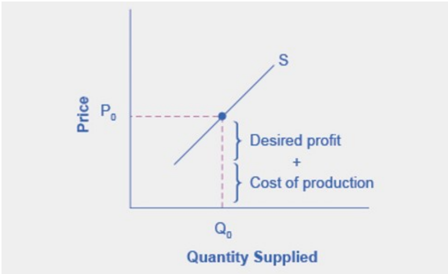

Figure 8.7.3: The cost of production and the desired profit equal the price a firm will set for a produc

Step 3. Now, suppose that the cost of production goes up. Perhaps cheese has become more expensive by $0.75 per pizza. If that is true, the firm will want to raise its price by the amount of the increase in cost ($0.75). Draw this point on the supply curve directly above the initial point on the curve, but $0.75 higher, as shown in Figure 8.7.4.

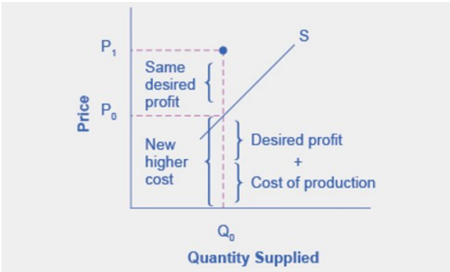

Figure 8.7.4: Because the cost of production and the desired profit equal the price a firm will set for a product, if the cost of production increases, the price for the product will also need to increase.

Step 4. Shift the supply curve through this point. You will see that an increase in cost causes an upward (or a leftward) shift of the supply curve so that at any price, the quantities supplied will be smaller, as shown in Figure 8.7.5.

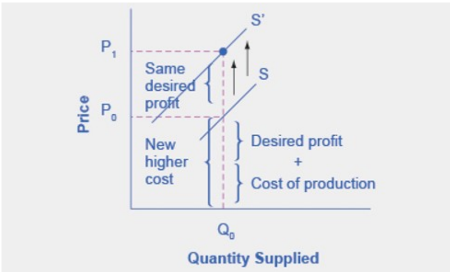

Figure 8.7.5: When the cost of production increases, the supply curve shifts upwardly to a new price level.

KEY TAKEAWAYS

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

Figure 8.7.6 summarizes factors that change the supply of goods and services. Notice that a change in the price of the product itself is not among the factors that shift the supply curve. Although a change in price of a good or service typically causes a change in quantity supplied or a movement along the supply curve for that specific good or service, it does not cause the supply curve itself to shift.

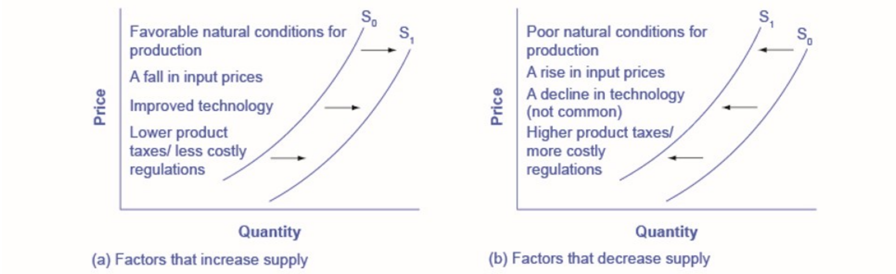

Figure 8.7.6: (a) A list of factors that can cause an increase in supply from S0 to S1. (b) The same factors, if their direction is reversed, can cause a decrease in supply from S0 to S1.

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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8.8: Reading- How Economies Can Be Organized

Organizing Economies

Think about what a complex system a modern economy is. It includes all production of goods and services, all buying and selling, all employment. The economic life of every individual is interrelated, at least to a small extent, with the economic lives of thousands or even millions of other individuals. Who organizes and coordinates this system? Who ensures that, for example, the number of televisions a society provides is the same as the amount it needs and wants? Who ensures that the right number of employees work in the electronics industry? Who ensures that televisions are produced in the best way possible? How does it all get done?

There are at *least* three ways societies have found to organize an economy. The first is the **traditional economy**, which is the oldest economic system and can be found in parts of Asia, Africa, and South America. Traditional economies organize their economic affairs the way they have always done (i.e., tradition). Occupations stay in the family. Most families are farmers who grow the crops they have always grown using traditional methods. What you produce is what you get to consume. Because things are driven by tradition, there is little economic progress or development.

Figure 8.8.1: Ancient Egypt was an example of a command economy. (Credit: Jay Bergesen/Flickr Creative Commons)

Command Economies

Command economies are very different. In a **command economy**, economic effort is devoted to goals passed down from a ruler or ruling class. Ancient Egypt was a good example: a large part of economic life was devoted to building pyramids, like those shown in Figure 1, for the pharaohs. Medieval manor life is another example: the lord provided the land for growing crops and protection in the event of war. In return, vassals provided labor and soldiers to do the lord's bidding. In the last century, there were two primary examples of command economies: **socialism** and **communism**.

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/itbb/?p=56

Under communism, the government decides what goods and services will be produced and what prices will be charged for them. The government decides what methods of production will be used and how much workers will be paid. Many necessities like healthcare and education are provided for free. Currently, Cuba and North Korea have communist economies.

Another type of command economy is **socialism**. Under socialism, industries that provide essential services, such as utilities, banking, and health care, may be government owned. Other businesses are owned privately. Central planning allocates the goods and services produced by government-run industries and tries to ensure that the resulting wealth is distributed equally. In contrast, privately owned companies are operated for the purpose of making a profit for their owners. In general, workers in socialist economies work fewer hours, have longer vacations, and receive more health, education, and child-care benefits than do workers in capitalist economies. To offset the high cost of public services, taxes are generally steep. Examples of socialist countries include Sweden and France.

Figure
8.8.1
: Nothing says “market” more than the New York Stock Exchange. (Credit: Erik Drost/Flickr Creative Commons)

Market Economies

Unlike command economies, market economies have a very decentralized structure. A **market** is an institution that brings together buyers and sellers of goods or services, who may be either individuals or businesses. The New York Stock Exchange, shown in Figure 2, is a prime example of a market in which buyers and sellers are brought together. In a **market economy**, decision-making is decentralized. Market economies are based on **private enterprise**: the means of production (resources and businesses) are owned and operated by private individuals or groups of private individuals. Businesses supply goods and services based on demand. (In a command economy, by contrast, resources and businesses are owned by the government.) A person’s income is based on his or her ability to convert resources (especially labor) into something that society values. The more society values the person’s output, the higher the income (think Lady Gaga or LeBron James). In this scenario, economic decisions are determined by market forces, not governments.

Mixed Market Economies

Though it’s possible to have a pure communist system, or a pure capitalist (free market) system, in reality many economic systems are mixed. A **mixed market economy** relies on both markets and the government to allocate resources. We’ve already seen that this is what happens in socialist economies in which the government controls selected major industries, such as transportation and health care, while allowing individual ownership of other industries. Even previously communist economies, such as those of

Eastern Europe and China, are becoming more mixed as they adopt capitalistic characteristics and convert businesses previously owned by the government to private ownership through a process called privatization.

How Economic Systems Compare

In comparing economic systems, it’s helpful to think of a continuum with communism at one end and pure capitalism at the other, as in Figure 3. As you move from left to right, the amount of government control over business diminishes. So, too, does the level of social services, such as health care, child-care services, social security, and unemployment benefits. Most economies in the real world are mixed; they combine elements of command and market (and even traditional) systems. The U.S. economy is positioned toward the market-oriented end of the spectrum. Many countries in Europe and Latin America, while primarily market-oriented, have a greater degree of government involvement in economic decisions than does the U.S. economy. China and Russia, while they are closer to having a market-oriented system now than several decades ago, remain closer to the command economy end of the spectrum.

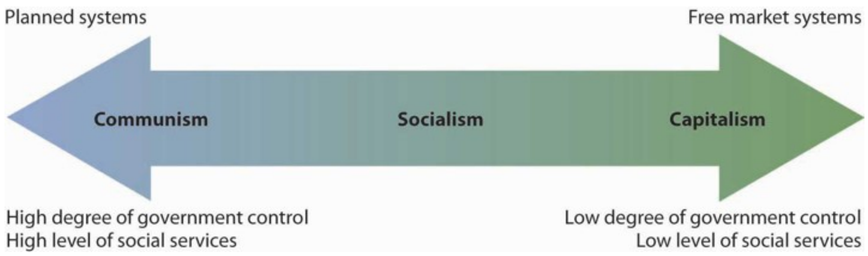

Figure 8.8.3: The Spectrum of Economic Systems CC licensed content, Original

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8.9: Reading- Control of Economic Decisions

What Countries Are Considered Economically Free?

Who is in control of economic decisions? Are people free to do what they want and to work where they want? Are businesses free to produce when they want and what they choose, and to hire and fire as they wish? Are banks free to choose who will receive loans? Or does the government control these kinds of choices? Each year, researchers at the Heritage Foundation and the *Wall Street Journal* look at 50 different categories of economic freedom for countries around the world. They give each nation a score based on the extent of economic freedom in each category.

The 2013 Heritage Foundation's Index of Economic Freedom report ranked 177 countries around the world: some examples of the most free and the least free countries are listed in the table below. Several countries were not ranked because of extreme instability that made judgments about economic freedom impossible. These countries include Afghanistan, Iraq, Syria, and Somalia.

The assigned rankings are inevitably based on estimates, yet even these rough measures can be useful for discerning trends. In 2013, 91 of the 177 included countries shifted toward greater economic freedom, although 78 of the countries shifted toward less economic freedom. In recent decades, the overall trend has been a *higher level of economic freedom around the world*.

Economic Freedoms, 2013

Most Economic Freedom	Least Economic Freedom
1. Hong Kong	168. Iran
2. Singapore	169. Turkmenistan
3. Australia	170. Equatorial Guinea
4. New Zealand	171. Democratic Republic of Congo
5. Switzerland	172. Burma
6. Canada	173. Eritrea
7. Chile	174. Venezuela
8. Mauritius	175. Zimbabwe
9. Denmark	176. Cuba
10. United States	177. North Korea

Source: The Heritage Foundation, 2013 Index of Economic Freedom, Country Rankings, http://www.heritage.org/index/ranking

Regulations: The Rules of the Game

Markets and government regulations are always entangled. There is no such thing as an absolutely free market. Regulations always define the "rules of the game" in the economy. Economies that are primarily market-oriented have fewer regulations—ideally just enough to maintain an even playing field for participants. At a minimum, these laws govern matters like safeguarding private property against theft, protecting people from violence, enforcing legal contracts, preventing fraud, and collecting taxes. Conversely, even the most command-oriented economies operate using markets. How else would buying and selling occur? But the decisions of what will be produced and what prices will be charged are heavily regulated. Heavily regulated economies often have **underground economies**, which are markets where the buyers and sellers make transactions without the government's approval.

The question of how to organize economic institutions is typically not a black-or-white choice between all market or all government, but instead involves a balancing act over the appropriate combination of market freedom and government rules.

The Rise of Globalization

Figure 8.9.1: Cargo ships are one mode of transportation for shipping goods in the global economy. (Credit: Raul Valdez/Flickr Creative Commons)

Recent decades have seen a trend toward **globalization**, which is the expanding cultural, political, and economic connections between people around the world. One measure of this is the increased buying and selling of goods, services, and assets across national borders—in other words, international trade and financial capital flows.

Globalization has occurred for a number of reasons. Improvements in shipping, as illustrated by the container ship shown in Figure 4, and air cargo have driven down transportation costs. Innovations in computing and telecommunications have made it easier and cheaper to manage long-distance economic connections of production and sales. Many valuable products and services in the modern economy can take the form of information—for example: computer software; financial advice; travel planning; music, books and movies; and blueprints for designing a building. These products and many others can be transported over telephones and computer networks at ever-lower costs. Finally, international agreements and treaties between countries have encouraged greater trade.

The table below presents one measure of globalization. It shows the percentage of domestic economic production that was exported for a selection of countries from 1970 to 2010, according to an entity known as The World Bank. **Exports** are the goods and services that are produced domestically and sold abroad. **Imports** are the goods and services that are produced abroad and then sold domestically. The size of total production in an economy is measured by the **gross domestic product (GDP)**. Thus, the ratio of exports divided by GDP measures what share of a country's total economic production is sold in other countries.

The Extent of Globalization (exports/GDP)					
Country	1970	1980	1990	2000	2010
Some High Income Countries					
United States	6%	10%	10%	11%	13%
Belgium	52%	58%	71%	86%	80%
Canada	23%	28%	26%	46%	29%
France	16%	21%	21%	29%	26%
Italy	16%	22%	20%	29%	27%
Japan	11%	14%	10%	11%	15%
Sweden	24%	29%	30%	46%	49%
Some Middle Income Countries					
Brazil	7%	9%	8%	11%	11%
Mexico	8%	11%	19%	31%	30%
South Korea	14%	32%	28%	41%	52%
Some Low Income Countries					

Source: http://databank.worldbank.org/data/In recent decades, the export/GDP ratio has generally risen, both worldwide and for the U.S. economy. Interestingly, the share of U.S. exports in proportion to the U.S. economy is well below the global average, in part because large economies like the United States can contain more of the division of labor inside their national borders. However, smaller economies like Belgium, Korea, and Canada need to trade across their borders with other countries to take full advantage of division of labor, specialization, and economies of scale. In this sense, the enormous U.S. economy is less affected by globalization than most other countries.

The Extent of Globalization (exports/GDP)					
Chad	16%	17%	13%	17%	41%
China	3%	11%	19%	23%	31%
India	4%	6%	7%	6%	22%
Nigeria	8%	29%	43%	53%	35%

Source: http://databank.worldbank.org/data/In recent decades, the export/GDP ratio has generally risen, both worldwide and for the U.S. economy. Interestingly, the share of U.S. exports in proportion to the U.S. economy is well below the global average, in part because large economies like the United States can contain more of the division of labor inside their national borders. However, smaller economies like Belgium, Korea, and Canada need to trade across their borders with other countries to take full advantage of division of labor, specialization, and economies of scale. In this sense, the enormous U.S. economy is less affected by globalization than most other countries.

The table above also shows that many medium and low income countries around the world, like Mexico and China, have also experienced a surge of globalization in recent decades. If an astronaut in orbit could put on special glasses that make all economic transactions visible as brightly colored lines and look down at Earth, the astronaut would see the planet covered with connections.

KEY TAKEAWAYS

- Economies address these three questions: (1) What goods and services should be produced to meet consumer needs? (2) How should they be produced, and who should produce them? (3) Who should receive goods and services?
- The answers to these questions depend on a country's **economic system**. The primary economic systems that exist today are command (planned) and free market systems.
- In a planned system, such as **communism** and **socialism**, the government exerts control over the production and distribution of all or some goods and services.
- In a **free market system**, also known as **capitalism**, business is conducted with only limited government involvement. Competition determines what goods and services are produced, how they are produced, and for whom.
- More countries' economies are evolving into a **mixed-economy** which has characteristics of more than one system.
- The last few decades have seen **globalization** evolve as a result of growth in commercial and financial networks that cross national borders, making businesses and workers from different economies increasingly interdependent.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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8.10: Reading- Measuring the Health of the Economy

Measuring the Health of the Economy

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

Economic Indicators

An economic indicator is a statistic that provides valuable information about the economy. The majority of economic indicators are collected and released by government and/or non-profit groups. In the U.S., Department of Commerce and the Department of Labor track and publish key indicators such as the unemployment rate and GDP. There is no shortage of economic indicators, and trying to follow them all would be an overwhelming task. Thus, economists and businesspeople typically track only a select few that are most pertinent to their professional, financial and economic interests.

Economic Goals

All the world's economies share the following three main goals:

1. Growth
2. High employment
3. Price stability

Economic indicators provide information about how an economy is performing relative to these goals. Let's take a closer look at each of these goals, both to find out what they mean and to show how we determine whether they're being met.

Growth

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

By itself, GDP doesn't necessarily tell us much about the state of the economy. But *change* in GDP does. If GDP (after adjusting for inflation) goes up, the economy is growing. If it goes down, the economy is contracting.

High Employment

To keep the economy going strong, people must spend money on goods and services. A reduction in personal expenditures for things like food, clothing, appliances, automobiles, housing, and medical care could severely reduce GDP and weaken the economy. Because most people earn their spending money by working, an important goal of all economies is making jobs available to everyone who wants one. In principle, full employment occurs when everyone who wants to work has a job. In practice, we say that we have "full employment" when about 95 percent of those wanting to work are employed.

The Unemployment Rate

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

Figure 1 below traces the U.S. unemployment rate between 1970 and 2010. If you want to know the current unemployment rate, go to CNNMoney, click on "Economy," and then on "Job Growth."

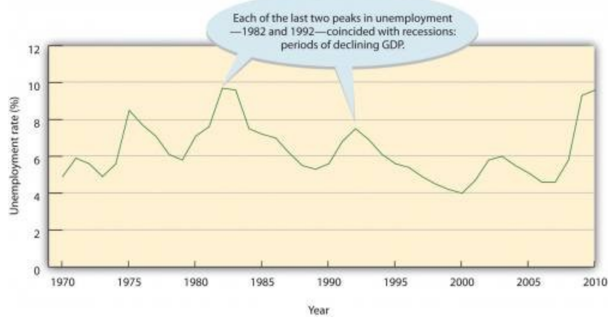

Figure 8.10.1: The U.S. Unemployment Rate, 1970–2010

Price Stability

A third major goal of all economies is maintaining price stability. Price stability occurs when the average of the prices for goods and services either doesn't change or changes very little. Rising prices are troublesome for both individuals and businesses. For individuals, rising prices mean you have to pay more for the things you need. For businesses, rising prices mean higher costs, and, at least in the short run, businesses might have trouble passing on higher costs to consumers. When the overall price level goes up, we have inflation. Figure 2 below shows inflationary trends in the U.S. economy since 1960. When the price level goes down (which rarely happens), we have deflation.

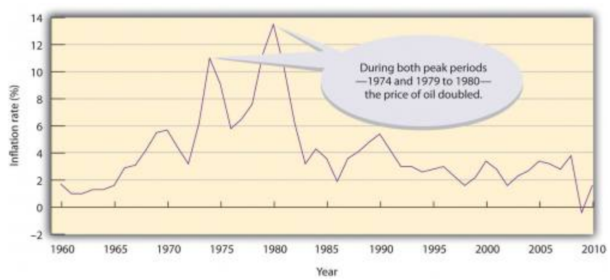

Figure 8.10.1: The U.S. Inflation Rate, 1960–2010

The Consumer Price Index

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

The CPI base period is 1982 to 1984, which has been given an average value of 100. The table below "Selected CPI Values, 1950–2010″ gives CPI values computed for selected years. The CPI value for 1950, for instance, is 24. This means that $1 of typical purchases in 1982 through 1984 would have cost $0.24 in 1950. Conversely, you would have needed $2.18 to purchase the same $1 worth of typical goods in 2010. The difference registers the effect of inflation. In fact, that's what an *inflation rate* is—*the percentage change in a price index*.

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

LINK IT UP

You can find out the current CPI by going to CNNMoney. Click on "Economy" and then on "Inflation (CPI)."

Consumer Confidence Index

A private research firm called the Conference Board publishes a consumer confidence index based on results of a monthly survey of five thousand U.S. households. The survey gathers consumers' opinions on the health of the economy and their plans for future purchases. It's often a good indicator of consumers' future buying intent. When consumers are confident, they tend to spend more money and increase economic activity. When consumers are less confident, they typically spend less money and economic activity declines.

LINK IT UP

For information on current consumer confidence, go to the Conference Board and click on "consumer confidence."

Economic Forecasting

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

Lagging and Leading Indicators

Statistics that report the status of the economy a few months in the past are called lagging economic indicators. One such indicator is *average length of unemployment*. If unemployed workers have remained out of work for a long time, we may infer that the economy has been slow. Indicators that predict the status of the economy three to twelve months in the future are called leading economic indicators. If such an indicator rises, the economy is likely to expand in the coming year. If it falls, the economy is likely to contract.

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

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

Finally, if you want a measure that combines all these economic indicators, as well as others, the Conference Board publishes a U.S. *leading index*. To get an idea of what leading economic indicators are telling us about the state of the economy today, go to the Conference Board and click on "U.S. Indicators" and then "leading economic index."

KEY TAKEAWAYS

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

- The **consumer price index (CPI)** measures inflation by determining the change in prices of a hypothetical basket of goods bought by a typical household.
- Indicators that, like average length of unemployment, report the status of the economy a few months in the past are **lagging economic indicators**.
- Those, like new claims for unemployment insurance, that predict the status of the economy three to twelve months in the future are **leading economic indicators.**

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

9: Module 3- Global Environment

9.1: Why It Matters- Global Environment

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

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

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

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

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9.2: Introduction to Globalization

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

Spice Route. Salt Road. Trans-Saharan Trade Route. Trade has been an aspect of the human experience for literally thousands of years, with merchants hazarding mountains, rivers, deserts and seas to obtain rare commodities. However, the environment of pre-21st century traders operated is significantly different than our current business environment.

In this section, we will draw a distinction between international trade and globalization and discuss the implications for businesses, workers, and societies. We will also introduce the concepts of comparative and absolute advantage and illustrate how these concepts relate to opportunity cost that serve as the basis for making specialization and trade decisions. We'll conclude with a video and interactive exercise that reinforces learning and the relationship between international trade, productivity, and standards of living—be it on Gilligan's Island or in the real world.

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9.3: Globalization and Business

Learning Objectives

- Explain the concept of globalization and its impact on global business

Globalization

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

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

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

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

You can view the transcript for “Globalization easily explained” (opens in new window) or the text alternative for “Globalization easily explained” (opens in new window).

Impact of Globalization on Global Business

The video, above, provides a good bird’s eye view of the affect of globalization on business—from opening up new markets to increasing the level of competition within markets and industries. Let’s take a look at particular example, though, to think through the various implications of conducting business on a global scale. Consider McDonald’s, which was started by two brothers in San Bernadino, California, sixty-eight years ago. As a result of globalization, nearly 69 *million* people in 118 different countries eat at McDonald’s every day. The first McDonald’s outside the U.S. and Canada was established in Costa Rica in 1970, and since the 1990s, most of the company’s growth has taken place in foreign countries. The process of building a global presence, entering new markets, and capitalizing on growing international demand for American fast food has enabled McDonald’s to expand from a single location to a global corporation with over 37,000 locations in over 100 countries.[1] However, entering new markets—whether at home or abroad—means contending with increased competition in those markets, including competition with other globally minded companies. In 2010, Subway surpassed McDonald’s to become the largest single-brand restaurant chain and the largest restaurant operator globally (though since 2014 Subways’ sales have lagged behind McDonald’s).[2]

What is it like for companies that decide to take advantage of global opportunities as McDonald’s and Subway have? Return to the discussion of “external forces” in Module 1, but now consider them from a global business perspective. Globalization certainly means that businesses can reach consumers around the word more rapidly and efficiently—thanks to cell phones, airplanes, and the Internet, we are all so much more interconnected and “accessible” now. But globalization also means incredible complexity.

✔ McDonald’s in the Global Business Environment

The list below sketches out just a few of the complexities and challenges that an American fast-food company like McDonald’s faces when it takes on the global business environment.

The Global Economic Environment

McDonald’s is a corporation based in the United States, where all business transactions are conducted using the U.S. dollar, but there are 164 official national currencies in the world, each with a different value and purchasing power. Imagine trying to balance the corporate checkbook at McDonald’s when your deposits have been made in more than a hundred different currencies.

The Global Legal Environment

In 2012 Greece established a municipal ordinance banning eating food at certain historic, artistic, and culturally important sites, and fines can reach up to $650. If you are the operator of a McDonald’s near the Parthenon, should you remove the ice cream cones and McFlurries (and other easily portable food) from your menu to protect your customers against being fined, or not?

The Global Competitive Environment

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

The Global Technological Environment

What does technology have to do with fast food or McDonald's? Consider the company's presence in China, where there are nearly 1.3 billion mobile users, and say hello to "McDonald's Next," a "modern and progressive" version of the restaurant that first opened in Hong Kong in 2017, featuring mobile-phone-charging platforms, free Wi-Fi, and self-ordering kiosks. This next generation of McDonald's is a response to increased expectations around speed, service, economy, and availability across established and developing economies, mostly fueled by consumers' growing access to affordable technology. As global businesses respond to demands created *by* technology, they must also leverage technology to move products, people, and supplies around the globe in a cost-effective and efficient manner.

The Global Social Environment

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

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

? Practice Question

https://assessments.lumenlearning.co...essments/14296

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1. "McDonald's Reports Fourth Quarter And Full Year 2018 Results And Quarterly Cash Dividend." McDonald's Corporation. January 30, 2019. Accessed May 13, 2019. https://news.mcdonalds.com/news-releases/news-release-details/mcdonalds-reports-fourth-quarter-and-full-year-2018-results-and. ↵
2. Shedd, Karin. "The Most Franchised Company in the World Isn't McDonald's or Starbucks." CNBC. August 15, 2018. Accessed May 13, 2019. https://www.cnbc.com/2018/08/14/subway-franchises-mcdonalds-starbucks-fast-food.html. ↵

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9.4: Absolute and Comparative Advantage

Learning Objectives

- Differentiate between comparative and absolute advantage

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

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

Advantage

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

Absolute Advantage

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

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

same amount of resources (labor, land, water, equipment, etc.). Put another way, Ecuador's direct cost of producing bananas is lower than the banana spy's. Assuming that the bananas can be grown in the new country, it will take that country a very long time to match Ecuador's skill, efficiency, and output level, and until it does, Ecuador will retain its absolute advantage.

Comparative Advantage

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

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

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

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

You can view the transcript for "Episode 34: Comparative Advantage & Trade" (opens in new window) or the text alternative for "Episode 34: Comparative Advantage & Trade" (opens in new window).

? Practice Question

https://assessments.lumenlearning.co...essments/14297

Game: Absolute and Comparative Advantage

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

A link to an interactive elements can be found at the bottom of this page.

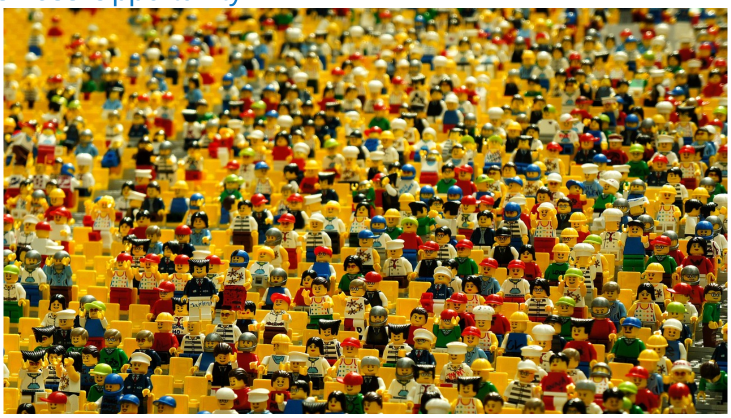
Contributors and Attributions

9.5: Global Markets

Learning Objectives

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

Global Markets and Business Opportunity



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

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

Later in this module we'll discuss how nations like Ecuador enter foreign markets, but for now let's look more closely at the size of the world's largest markets. The following table shows population and GDP data for the top five economies in the world as of 2017.[1] You'll recall from the economic environment module that GDP, or gross domestic product, is a monetary measure of the market value of all final goods and services produced in a period, and the GDP growth rate is the increase or decrease in GDP over a period of time, expressed as a percentage.

Top Five Economies in the World as of 2017

Country	GDP	Population	GDP Growth Rate
China	$23,210,000,000,000	1,384,688,986	6.9%
United States	$19,490,000,000,000	329,256,465	2.2%
India	$9,474,000,000,000	1,296,834,042	6.7%
Japan	$5,443,000,000,000	126,168,156	1.7%
Germany	$4,199,000,000,000	80,457,737	2.5%

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

Consider some of the following benefits nations and firms realize by entering foreign markets.

Access to Factors of Production

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

Innovation and Ideas

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

Risk Reduction

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

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

? Practice Question

https://assessments.lumenlearning.co...essments/14298

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1. "Country Comparison: GDP (Purchasing Power Parity)." Central Intelligence Agency. February 01, 2018. Accessed May 13, 2019. www.cia.gov/library/publications/the-world-factbook/fields/208rank.html. ↵

Contributors and Attributions

9.6: Introduction to Measuring Global Trade

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

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

Contributors and Attributions

9.7: Balance of Trade and Balance of Payments

Learning Objectives

- Differentiate between balance of trade and balance of payments
- Differentiate between trade deficits and trade surpluses

Nations and businesses that trade back and forth, buy and sell companies, loan one another money, and invest in real estate around the globe need to have a way to evaluate the impact of these transactions on the economy. They need to make decisions about trade policies, regulations, and trade agreements, and until they can get a snapshot of what global trade is doing to hurt or help its economy, they can't make these decisions.

It's a lot like your own finances, just on a much larger scale. At the end of the month have you spent more than you earned? Do you have a large positive balance in your bank account as a result of receiving a financial aid check? Did you need to borrow money from your parents to buy books or clothes? Until you really examine where your money is coming from and balance your checkbook, it's hard to make long-term financial plans—like, say, deciding whether or not to buy a new car or purchase a home.

This is very similar to what countries do when they measure the impact of trade on their economy. In this section we'll look at two key measurements of trade: balance of trade and balance of payments.

Balance of Trade

One of the ways that a country measures global trade is by calculating its balance of trade.

Balance of trade is the difference between the value of a country's imports and its exports, as follows:

value of exports – value of imports = balance of trade

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

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

Because the balance of trade is calculated using **all** imports and exports, it's possible for the United States to run a surplus with some nations and a deficit with others. As with your checkbook, the balance reflects the difference between *total* exports (sales, which result in a deposit in your account or "deposits") and *total* imports (purchases, which result in a withdrawal from your account or "withdrawals"). When a nation exports, other nations pay it for goods or services, so it gets to take their money and make a deposit. When a nation imports, it pays other nations for their goods and services, and they would need to make a withdrawal to pay for them.

✓ Imagine Nation's Balance of Trade

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

Imagine Nation is located in a region that lacks phosphate as a natural resource. However, it does have an abundance of sugarcane. As a result of its comparative advantages, Imagine Nation imports phosphate from Christmas Island (it's a real place in Australia—look it up!) to fertilize the sugarcane it grows, and it uses the sugarcane to manufacture saltwater taffy, which it exports to Christmas Island.

The following table shows Imagine Nation's imports and exports with Christmas Island in 2017.

Imagine Nation 2017 Import and Exports with Christmas Island

Year	Imports (phosphate)	Exports (taffy)
2017	$45,000,000	$75,000,000

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

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

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

However, the picture changed in 2018 when the Australian government closed the phosphate mine on Christmas Island. Imagine Nation had to import phosphate from Morocco, instead, and was not able to get the same favorable pricing as before. Consequently, sugarcane farmers paid more for fertilizer, the price of sugarcane went up, and Imagine Nation had to raise the price on its saltwater taffy. Sadly, the people of Morocco aren't really big fans of saltwater taffy, so exports fell. The following table shows Imagine Nation's imports and exports with Morocco in 2018.

Imagine Nation 2018 Imports and Exports with Morocco

Year	Imports (phosphates)	Exports (taffy)
2018	$65,000,000	$55,000,000

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

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

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

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

Balance of Payments

Balance of Payments is the difference between the total flow of money coming into a country and the total flow of money going out of a country during a period of time. Although related to the balance of trade, balance of payments is the record of **all** economic transactions between individuals, firms, and the government and the rest of the world in a particular period. Thus the balance of payments includes **all** external transactions of a country, including payments for the country's exports and imports of goods, services, foreign investments, loans and foreign aid, financial capital, and financial transfers.

For instance, if a US company buys land or a factory in another country, that investment is included in the US balance of payments as an *outflow*. Likewise, if a US company is sold to a foreign company, it's included in the balance of payments. Just recently, Didi Chuxing, the Chinese ride-hailing service, bought Uber's subsidiary in China in a deal valued at $35 billion. This sale will create a *cash inflow* to the United States, but over the long term it will decrease the revenue flowing in from China through Uber.

If a nation receives foreign aid or borrows money from another country, this amount is also reflected in its balance of payments as a *cash inflow***.** For example, the bailout Greece received from the Eurozone and IMF in 2010 to help stabilize its failing economy affected the balance of payments for all of the nations involved. Greece recorded the €110 billion loan as an *inflow* in its balance of payments, while the Eurozone members recorded it as an *outflow* in their balance of payments.

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

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

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

Imagine Nation's Balance of Payments

Let's examine Imagine Nation's balance of payments in 2018. The following table shows all of its external transactions during the year.

Imagine Nation 2018 External Transactions

Year	Imports (phosphates)	Exports (taffy)	Foreign aid (loan) from Hooperland	Purchase of Wandaland assets
2018	$65,000,000	$55,000,000	$25,000,000	$30,000,000

When we calculated Imagine Nation's balance of trade in 2018, we *did not* take into account the following two transactions:

1. Imagine Nation received foreign aid in the form of a loan from the government of Hooperland in the amount of $25,000,000. This *inflow* of funds will affect Imagine Nation's balance of payments.
2. Imagine Nation invested in a factory in Wandaland and purchased the factory from the government for $30,000,000. This *outflow* of funds will affect Imagine Nation's balance of payments.

When we calculate Imagine Nation's 2018 balance of payments, by taking the inflows (revenue from exports and foreign aid) and subtracting the outflows (payments for imports and purchase of foreign assets), the balance is negative, as shown below:

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

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

At this point it's tempting to make judgments about these different types of trade measurements and conclude that trade surpluses and favorable balance of payments are always indicators of a strong economy, but unfortunately it's not so cut and dried. Balance of trade and balance of payments are starting points—much in the way that an individual's credit rating might be a starting point for seeking a loan. How the numbers are interpreted and viewed by the country's leaders, other countries, and the world depends on many factors, such as where a country is in its economic development, the factors contributing to the balance of trade or payments, the health of the overall global economy, what the country is doing with its imports, and so on. As you might guess, assessments of these factors can be intensely political. You'll learn more about these considerations later in this module when we discuss how nations attempt to restrict or control trade.

Practice Questions

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https://assessments.lumenlearning.co...essments/14300

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9.8: Countertrade

Learning Objectives

- Explain how countertrade contributes to the measure of global trade

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

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

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

PRactice Question

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

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9.9: Introduction to Global Business Strategies

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

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

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

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9.10: Global Business Strategies

Learning Objectives

- Explain how firms use importing and exporting to reach global markets
- Explain how firms use licensing and franchising to reach global markets
- Explain how firms use foreign direct investments (FDI) to reach global markets
- Explain how firms use joint ventures and foreign strategic alliances to reach global markets

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

Exporting/Importing

Figure 9.10.1: Shipping containers

Exporting is the easiest and most straightforward way to engage with the global market. **Exporting** is taking goods that were produced within a company's home country and shipping them to another country. The party sending the good is called an *exporter*. It is impossible to discuss exporting without mentioning its complement, *importing*.

Importing is the process by which a good is brought into a jurisdiction, especially across a national border, from an external source. The party bringing in the good is called an *importer*. Simply put, one country's exports become another country's imports. Examples of U.S. imports are everywhere: Take a look at the labels in your clothes or the contents of your backpack. From our vantage point, U.S. exports may be a little harder to see, but they exist all the same and are plenty visible in other countries.

According to *World's Top Exports*, the following export product groups represent the highest dollar value in American global shipments during 2018. In parentheses is the percentage share each export category represents in terms of overall U.S. exports:[1]

1. Machinery including computers: US$213.1 billion (12.8% of total exports)
2. Mineral fuels including oil: $189.9 billion (11.4%)
3. Electrical machinery, equipment: $176.1 billion (10.6%)
4. Aircraft, spacecraft: $139.1 billion (8.4%)
5. Vehicles: $130.6 billion (7.8%)
6. Optical, technical, medical apparatus: $89.6 billion (5.4%)
7. Plastics, plastic articles: $66.5 billion (4%)
8. Gems, precious metals: $63.8 billion (3.8%)
9. Pharmaceuticals: $48.4 billion (2.9%)
10. Organic chemicals: $40.2 billion (2.4%)

Advantages and Disadvantages of Exporting and Importing

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

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

Practice Question

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Outsourcing/Offshoring

Figure 9.10.2: Garment factory, Jiaxing, China

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

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

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

You can view the transcript for “Chinese Manufacturing for American Products” (opens in new window).

Advantages and Disadvantages of Outsourcing and Offshoring

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

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

Licensing and Franchising

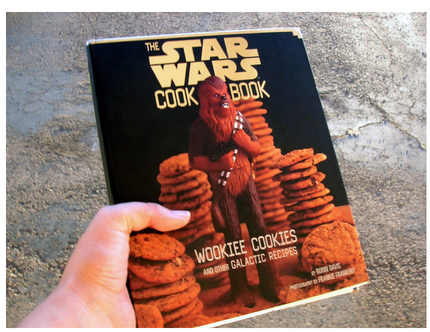

Figure 9.10.3:The Star Wars Cookbook

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

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

Advantages and Disadvantages of Licensing and Franchising

Licensing and franchising both offer advantages for the involved parties: The licensee and franchisee both gain a competitive advantage in the market. The licensee/franchisee gets immediate brand recognition and may quickly overtake the competition by offering a product or service for which there is existing unmet demand. For example, a local sandwich shop may have a hard time competing when a Subway franchise opens because the brand is so well known. Also, because franchises are usually “turnkey” operations in which processes, supply chains, training, and products are already in place, the new business can quickly begin efficient and profitable operations. For the franchisor, this arrangement enables them to gain inexpensive access to a new market, since the initial cost of the franchise is borne by the franchisee. Under a licensing agreement, all of the costs of production, sales, and distribution are the responsibility of the licensee. If financial capital is scarce, both approaches allow companies to have a global presence without heavy investments.

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

Practice Question

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Foreign Direct Investment (FDI)

Figure 9.10.4: BMW US Manufacturing Company, South Carolina

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

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

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

U.S. companies completed 116 emerging market acquisitions in the first half of 2013, up from 110 in the second half of 2012. . . . The most popular geographic targets for U.S. companies in the first half of 2013 were Brazil (25 deals), India (18 deals), South

American countries excluding Brazil (15), South and East Asia (15), and Central America and Caribbean (14).[2]

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

Advantages and Disadvantages of FDI

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

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

Practice Question

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Joint Ventures/Strategic Alliances

Figure 9.10.5: Honey Nut Cheerios

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

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

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

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

Advantages and Disadvantages of Joint Ventures and Strategic Alliances

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

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

? Practice Question

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9.11: Introduction to Global Trade Forces

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

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

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9.12: Sociocultural Differences

> **Learning Objectives**
>
> - Describe the impact of sociocultural forces on global trade

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

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

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

Language

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

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

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

Customs and Taboos

All cultures have their own unique sets of customs and taboos. It's important for businesses to learn about these customs and taboos so they'll know what is acceptable and unacceptable for their foreign operations. For example, in Japan, the number four is considered unlucky, and product packages containing four items are avoided by many consumers. In Middle Eastern countries where Islamic law is strictly observed, images displaying the uncovered arms or legs of the female body are considered offensive. Meanwhile in Egypt, where many women wear the headscarf or hijab in public, an increasing number of younger women are in work and educational settings where gender segregation does not exist. Businesses struggle with whether to portray women with or without the hijab, knowing that they risk offending some of their target audience with either choice. Businesses should seek guidance from native experts familiar with local culture and customers.

Values

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

Time and Punctuality

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

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

Business Norms

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

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

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

Religious Beliefs and Celebrations

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

For example, all the major world religions observe holidays that include feasting and gift giving. These festival seasons tend to be prime shopping seasons as well. Holidays originating from the prominent religion of a country or region create sensitivities about certain products: in the Hindu religion, cows are considered sacred and people refrain from eating beef. Observant Jews and

Muslims consider pork unclean, and they consume only kosher or halal meats, respectively. Many religions eschew alcohol: for example, devout Sikhs, Muslims, Mormons, Buddhists, and conservative Southern Baptists all refrain from drinking.

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

? Practice Question

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9.13: Political and Economic Differences

Learning Objectives

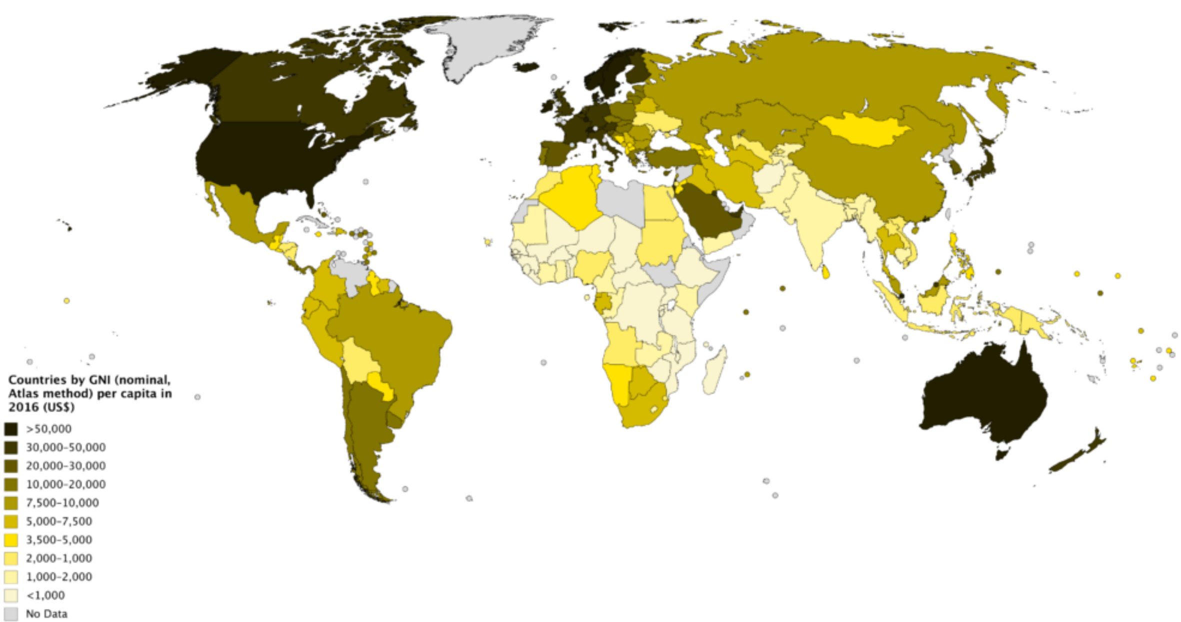
- Describe the impact of political and economic forces on global trade

The **political economy** of a country refers to its political and economic systems, together. The political system includes the set of formal and informal legal institutions and structures that comprise the government or state and its sovereignty over a territory or people.

As you know, political systems can differ in the way they view the role of government and the rights of citizens (compare, for example, the market economy of Canada with the command economy of North Korea). The economic system refers to the way in which a country organizes its economy: most are command, market, or mixed economies.

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

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



If you want more information about GNI per country, you can download the World bank dataset of 2016 GNI (atlas method) by country or you can visit the World Bank website to browse datasets including GNI.

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

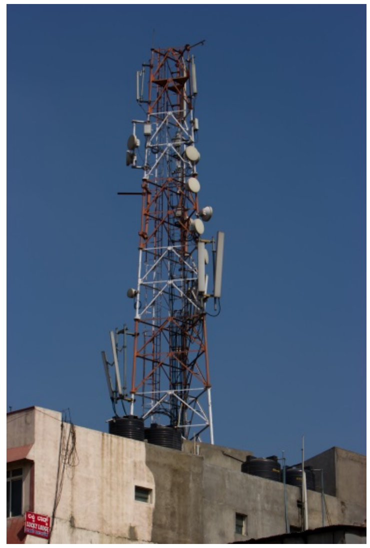


Figure 9.13.1: India has the world’s second-largest mobile-phone user base: 996.66 million users as of September 2015. Shown here is a rooftop mobile phone tower in Bangalore.

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

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

Another aspect of a country’s political economy is the stability of its current government. Business activity tends to grow and thrive when a country is politically stable. When a country is politically unstable, multinational firms can still conduct business profitably, but there are higher risks and often higher costs associated with business operations. Political instability makes a country less attractive from a business investment perspective, so foreign and domestic companies doing business there must often pay higher insurance rates, higher interest rates on business loans, and higher costs to protect the security of their employees and operations. Alternatively, in countries with stable political environments, the market and consumer behavior are more predictable, and organizations can rely on governments to enforce the rule of law.

As you can see, the desirability of a country as a potential market or investment site depends on a host of complex, interrelated factors.

Exchange Rates

To further complicate matters, conducting business globally involves the uncertainty of exchange rates. An **exchange rate** is the value of one country’s currency relative to the value of another country’s currency. For example, the exchange rate for the U.S.

dollar relative to the Japanese yen has ranged from 1:105 to 1:115 in the last year. At a current exchange rate of $1 to ¥111.81, the United States dollar (US$) could be exchanged for 111.81 Japanese yen (JPY, ¥) and, vice versa, ¥111.81 could be exchanged for US$1.

Currency exchange rates have been based on a variety of mechanisms over time, including fixed, floating and managed floating systems. For example, the United States used to fix the value of the dollar relative to gold, a practice known as the "gold standard". The International Monetary Fund classifies exchange rate mechanisms based on the role of a country's Central Bank and/or government in managing exchange rates. The two extremes are a market-based or floating system, in which exchange rates are "largely set by market forces" and a fixed system, in which the official rate is set by a country's authorities. A third category includes all other mechanisms that are used to maintain a stable currency value relative to another currency or a composite of currencies.[1]

Most industrialized nations now use a floating currency exchange system managed by a Central Bank. In the United States, the Federal Reserve System is the Central Bank. The Fed, as it's known, is charged with regulating money policy, including the money supply and interest rates and, by extension, the value of the country's currency. Thus, the relative value of a currency is largely determined by supply and demand, including Central bank or government action, investment and trade. For example, higher interest rates will increase demand and therefore the value of a given country's currency. Similarly, if investment opportunities are perceived to be relatively better in a country, the desire to invest will increase demand for the currency and the currency's relative value.

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

You can view the transcript for "Imports, Exports, and Exchange Rates: Crash Course Economics #15" (opens in new window).

As the video noted: "Trade between countries depends on the demand for a country's goods and services, political stability and interest rates. But one of the most important factors is exchange rates." Exchange rates are a key risk factor for multi-national and global businesses and, as The Trump Administration's "America First" trade policy has illustrated, for national businesses with global supply chains. If the U.S. dollar appreciates or increases in value relative to other currencies, national consumers may benefit (at least initially) because imports and international travel is relatively cheaper. However, a stronger dollar makes exports more expensive, reducing export revenue and, potentially, resulting in a loss of jobs in related businesses or industries.

Clearly, exchange rate fluctuations can change the underlying fundamentals of a business investment or trade agreement. An unfavorable change in the exchange rate can increase the cost of resources, including labor, raw materials and intermediate goods, and the relative value of a finished product or completed service. Relatively stable exchange rates provide an economic environment that decreases the risk inherent in working across borders and political economic systems and gives businesses the confidence to make investment and expansion decisions and, therefore, to contribute to economic growth and prosperity.

? PRactice Question

https://assessments.lumenlearning.co...essments/14307

1. "Conversion Rates - Exchange Rates - OECD Data." OECD. Accessed June 24, 2019. https://data.oecd.org/conversion/exchange-rates.htm. ↵

Contributors and Attributions

9.14: Legal Differences

Learning Objectives

- Describe the impact of legal differences on global trade

Governments around the world maintain laws that regulate business practices. In some countries, these laws are more heavy-handed, and in others, the business climate is less regulated and structured. Some laws and regulations, such as ones governing property rights and contracts, are designed to create a stable environment for business (both domestic and international)—by establishing and enforcing property rights and contracts, for example. Others are designed to protect consumers and the environment, requiring businesses to adhere to responsible, safe, and ethical practices. Still other laws and regulations privilege domestic businesses and protect or partially shield them from foreign competition. There are even laws and regulations that affect what marketers are allowed to include in marketing communications, although these are more strict in some countries than in others. And of course, some laws and regulations deal with taxation and other costs of conducting business.

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

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

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

Practice Question

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9.15: Physical and Environmental Differences

Learning Objectives

- Describe the impact of physical and environmental forces on global trade

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

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

Practice Question

https://assessments.lumenlearning.co...essments/14309

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9.16: Tariff and Nontariff Trade Restrictions

Learning Objectives

- Describe the impact of tariff and nontariff restrictions on global trade

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

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

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

Import Tariffs

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

Nontariff Restrictions

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

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

The most extreme form of trade restriction is the **embargo**. An embargo is an official ban on trade or other commercial activity with a particular country. The reasons for a country to place an embargo on another country range from human rights violations to ideological differences to national security interests. Embargoes are considered strong diplomatic measures imposed in an effort, by the imposing country, to elicit a given national-interest result from the country on which it is imposed. Although trade and commercial activities are barred under an embargo, medical and humanitarian supplies are usually exempt. The most enduring of all trade embargoes is the United States' embargo against Cuba, which has been in effect for almost 59 years. Although diplomatic relations were re-established and some restrictions eased under President Barack Obama, the trade embargo, which requires an act of Congress to rescind, has remained in force. Restrictions were re-established by President Trump and diplomatic relations with Cuba have deteriorated. This embargo has not come without contest. For the last 26 years, the UN General Assembly has passed an annual resolution condemning the embargo and declaring it a violation of international law.

? Practice Question

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

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

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/afm/?p=184

You can view the transcript for "Episode 36: Types of Trade Restrictions" (opens in new window).

Contributors and Attributions

9.17: Introduction to Global Trade Agreements and Organizations

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

If you think achieving peace and shared prosperity is a daunting objective, imagine trying to achieve that on a global scale. In this section, you will be introduced to the primary organizations working towards that end: the WTO (World Trade Organization, an evolution of GATT or the General Agreement on Tariffs & Trade), The World Bank and the International Monetary Fund. The first video, in particular, is worth watching for its stark illustration of the connection between trade and prosperity as well as for the political perspective. This section also identifies and compares four different types of trade agreements, ranging from regional agreements such as the North American Free Trade Agreement (NAFTA) to economic unions, such as the European Union.

Contributors and Attributions

9.18: The World Trade Organization (WTO)

Learning Objectives

- Describe the role of the WTO in promoting global trade

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Figure 9.18.1: Copy and Paste Caption here. (Copyright; author via source)

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

GATT: How the World Trade Organization Got Its Start

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

Enjoy!

You can view the transcript for “Episode 37: GATT/WTO” (opens in new window) or the text alternative for “Episode 37: GATT/WTO” (opens in new window).

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

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

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

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

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

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

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

Practice Question

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Whether or not the WTO is doing its duty and accomplishing its mission is a matter of ongoing debate. Nonetheless, the WTO currently has 164 members and 23 observer governments. WTO member states account for almost 97 percent of global trade and 98 percent of global GDP. Once the observer governments become members, it is possible that the WTO will oversee the entire world economy. What began in 1947 in Geneva, with twenty-three nations focused solely on tariff reduction, has grown into a truly global organization that deals with agriculture, labor standards, environmental issues, competition, and intellectual property rights.

Try It

Check out this talk for a broader view on trade.

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "What global trade is really about (hint: it's not trade) | Hayley Edwards | TEDxMidAtlantic" (opens in new window).

Contributors and Attributions

9.19: The World Bank

Learning Objectives

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

Figure 9.19.1: World Bank Group president Jim Yong Kim visits an integrated child development services and skills center in Delhi, India.

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

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

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

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

The following video shows how a World Bank project works:

You can view the transcript for “How a World Bank Project Works: Inside the Efficient Lighting and Appliances Project in Mexico” (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/14312

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9.20: The International Monetary Fund (IMF)

Learning Objectives

- Describe the role of the IMF in promoting global trade

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

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

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

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

Practice Question

https://assessments.lumenlearning.co...essments/14313

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

You can view the transcript for "About the IMF" (opens in new window).

Contributors and Attributions

9.21: Trade Agreements

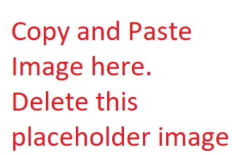
Learning Objectives

- Describe the role of trade agreements in global business

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

Regional trade agreements are reciprocal trade agreements between two or more partners (nations). Almost all countries are part of at least one RTA. Under an RTA, countries “huddle together,” forming an international community that facilitates the movement of goods and services between them. Let’s take a look at a few examples of regional trade agreements:

- The United States-Mexico-Canada Agreement (USMCA) facilitates trade among these countries through tariff reductions and elimination of a number of duties and quotas. You can view the full text of the USUMA agreement. The USMCA was signed on November 30, 2018 and is pending ratification. This agreement was created to replace the North American Free Trade Agreement (NAFTA), which was established in 1994.
- The Association of Southeast Asian Nations (ASEAN), shown in Figure 1, provides for the free exchange of trade, service, labor, and capital across ten independent member nations to provide a balance of power to China and Japan.
- The Central American Free Trade Agreement (CAFTA) (Costa Rica, Dominican Republic, Guatemala, Honduras, Nicaragua, and El Salvador) eliminated tariffs on more than 80 percent of U.S. exports and opened U.S. trade restrictions for Central American sugar, textiles, and apparel imports, thereby reducing costs on these products for American consumers[1].



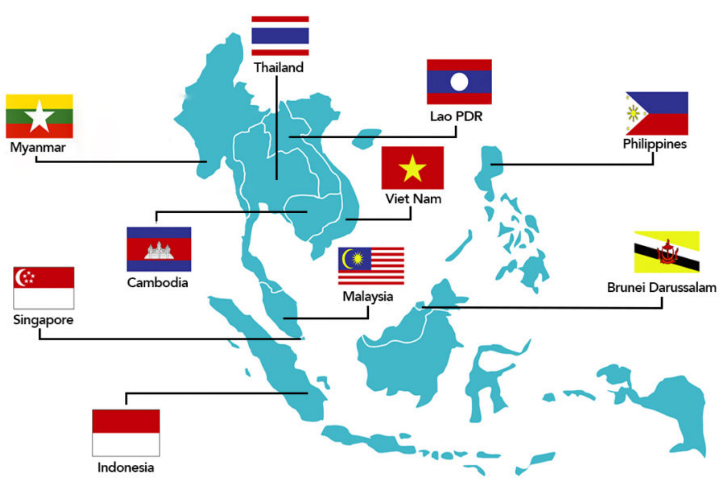


Figure 9.21.1: The Association of Southeast Asian Nations (ASEAN)

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

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

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

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

can view the transcript for “Episode 38: Trade Blocs” (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/14314

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

Contributors and Attributions

9.22: Introduction to Ethical Challenges in the Global Environment

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

Conducting business internationally involves more than currency, time and language differences. Different societies have different expectations regarding how things get done—what is permissible and what is not. Add to that variations in political and legal systems and competitive pressures and the line between ethical and unethical business practices can be difficult to identify. In this section, we will discuss the ethical issues of operating in a global environment and the laws, organizations and groups working to enforce codes of conduct and hold businesses responsible for their business practices and the health, safety and welfare of employees throughout their supply chain.

Contributors and Attributions

9.23: Corruption

Learning Objectives

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

Try It

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

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "Ethics and International Standards of Behavior" (opens in new window) or the text alternative for "Ethics and International Standards of Behavior" (opens in new window).

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

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

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

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

Another factor that has heightened the sense of urgency among regulators is the magnitude of recent cases of corruption (several of which are described in greater detail below). The cost to shareholders as well as stakeholders and society has proven enormous. Governments and international organizations have ramped up their enforcement of anti-corruption laws and sought increasingly severe penalties, sometimes imposing fines amounting to hundreds of millions of dollars. Largely as a result of these efforts, most multinational corporations have developed internal policies to ensure compliance with anti-corruption legislation.

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

Walmart in Mexico

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

GlaxoSmithKline in China

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

Alcatel in Costa Rica

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

Anti-corruption Laws and Regulations

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

The FCPA applies only to bribes paid (or offered) to foreign government officials to obtain or retain business or to develop an unfair competitive advantage. The concepts of *bribe* and *foreign government official* can be interpreted broadly. While companies and executives charged with FCPA violations have often sought to characterize their payments as business "gifts," this has not shielded them from liability when there was evidence that the payments were intended as a means of obtaining illicit objectives. However, where payments have been characterized as "facilitation" or "lubrication" payments, meaning that they merely created an incentive for an official to promptly execute legal actions, such as mandatory customs inspections, the payments have been allowed. In numerous countries, the state owns all or part of commercial enterprises, so a great number of business executives could be classified as foreign government officials.

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

Corruption from a Cross-Cultural Perspective

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

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

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

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

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

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

? Practice Questions

https://assessments.lumenlearning.co...essments/14315

https://assessments.lumenlearning.co...essments/14316

1. Sharon Eiher, "Corruption in International Business: The Challenge of Cultural and Legal Diversity," Wichita, KS: Friends University, accessed October 29, 2013, www.ashgate.com/pdf/SamplePages/Corruption_in_International_Business_Ch1.pdf. ↵

Contributors and Attributions

9.24: Labor Abuses

Learning Objectives

- Define sweatshop, and explain how it relates to global business

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

Rana Plaza

Garment factory collapse, Rana Plaza, Bangladesh.

Figure 9.24.1: Garment factory collapse, Rana Plaza, Bangladesh.

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

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

How did this situation arise?

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

The outsourcing movement was accompanied by increasing reports of sweatshop abuses. As a result, a number of nongovernmental organizations (NGOs), such as the National Labor Committee, became involved in anti-sweatshop activities. Throughout the 1990s, a number of sweatshop-related abuses came to light in factories used by American brands. Several of these involved the island of Saipan, a small American protectorate in the Pacific. A number of factory owners discovered that since Saipan is technically American territory, clothing produced in Saipan could enter the United States duty-free and carry the label “Made in America.” Since Saipan is much closer to Vietnam and the Philippines than to the United States, a number of these factories recruited Vietnamese and Filipino natives as factory workers. Upon their arrival in Saipan, however, some of these workers were exposed to flagrant human rights abuses and, in the worst of cases, outright slavery. In one notorious case, workers were literally imprisoned in the factory and forced to work without pay. Eventually, these abuses were revealed and U.S. prosecutors filed charges against factory owners, some of whom were sentenced to substantial prison sentences.

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

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

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

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

? Practice Question

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9.25: Putting It Together- Global Environment

Synthesis

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

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

You can view the transcript for "Global Mind: The Future of Globalization and Its Impact On Our World" (opens in new window).

Summary

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

Globalization

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

Measuring Global Trade

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

Global Business Strategies

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

Global Trade Forces

Firms desiring to enter international business face a variety of barriers. Common barriers to effective global business are cultural, social, and political barriers, and tariffs and trade restrictions.

Ethical Challenges in the Global Environment

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

Global Trade Agreements and Organizations

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

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9.26: Discussion- Sending Salty Pawz Global

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda thinks the domestic market has been flooded with start-up companies offering gourmet dog treats. As a result, she believes that perhaps she has a real opportunity to grow her business by participating in the global market. She has heard of other small businesses "going global" but is not sure how she should proceed.

For Discussion

Which of the following strategies for going global would you recommend to Wanda?

- Exporting
- Licensing
- Franchising
- Foreign direct investment
- Joint venture

Support your choice with the reasons you think this is the best way for Salty Pawz to enter a foreign market. When making your selection, consider Wanda's product, potential markets, business experience, and finances.

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

Contributors and Attributions

9.27: Discussion- Made in America

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Few topics associated with global trade are more vehemently debated than outsourcing. For this discussion, you will watch two video clips that provide some perspective on outsourcing. Using the information you gain from the videos and the materials you studied in the course module, respond to the discussion question below.

The following video clip is from the film *Outsourced.* It covers American sentiment on losing jobs to India and the availability of Chinese goods. We want cheap stuff; however, most of it comes from China.

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for “Made in China” (opens in new window).

As countries like China and India become leaders in manufacturing, the costs of their expertise rises, diminishing their advantage against U.S. counterparts. At the same time, convoluted and increasingly risky supply chains dependent on inexperienced vendors have turned once stable brands like Boeing into the perfect “reshoring” case study. The following video explains why outsourcing can be bad for business.

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for “Why Outsourcing is Bad for Business” (opens in new window).

For Discussion

Select ONE of the following perspectives on outsourcing, and answer the related questions. Although your opinion is always valued, be sure to support your opinion with facts obtained from your course materials, the videos, or a reliable source. Make sure to cite your sources.

- The consumer: Does the consumer benefit? Are prices lowered by outsourcing? Why or why not?
- Efficiency and productivity: Does outsourcing enhance efficiency and productivity? Why or why not?
- Competition: Does outsourcing encourage competition? Is this a good thing? Why or why not?
- Developing countries: Does outsourcing benefit developing countries? Why or why not?
- International stability: Does outsourcing foster international cooperation, respect, and stability? Why or why not?

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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9.28: Assignment- Taking Salty Pawz to the Global Market

Scenario

Wanda thinks the domestic market has been flooded with start-up companies offering gourmet dog biscuits. But she believes that perhaps she has a real opportunity to grow her business by participating in the global market. She has heard of other small businesses "going global," but she isn't sure what that would entail.

Your Task

Conduct research on taking Salty Pawz into the global economic environment, into a global market and then present your research to Wanda detailing what it would take for her business to go global.

Begin by identifying four key issues Wanda should consider before expanding Salty Pawz globally, using global business issues discussed in the text for this course as your reference. It may be helpful for you to think about these four issues as major questions that will need to answered in order for Wanda to make a sound business decision on whether or not to take Salty Pawz global. For example, does Wanda need to consider cultural issues because not every culture has the same attitude toward pets as people in the United States do? Are there legal restrictions on exporting food products to certain countries or restrictions on their import in the destination country?

For each issue present the following:

- Describe the issue and provide evidence to support any conclusions or recommendations that you give Wanda—your evidence could also serve as resources that Wanda could use to learn more about each of the issues.
- Explain why each of the four issues is important and the implications they have for Salty Pawz. Be sure to address the characteristics, opportunities, and challenges of operating a business in the global economic environment.
- Provide resources where Wanda can learn more information about the issue, so she will be prepared beyond the introduction you have shared. You should point her to other sources and/or Web sites and explain how each one is important and can help her.

In addition to using information provided in the text, your research should include other articles and sources as evidence to support your explanations. For example, you may find related evidence in the following external sources:

- Entrepreneur.com: How to Take Your Company Global
- International Trade Administration: National Export Initiative—Next

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Identified four issues to consider before expanding Salty Pawz globally, and provides evidence to support.	0 points	11 points	16 points	20 points	20%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explains important considerations and their implications for the four issues as they relate to Salty Pawz, and addressed the characteristics, opportunities, and challenges of operating a business in the global economic environment.	0 points	22 points	32 points	40 points	40%
Provided additional resources to extend learning about the issues.	0 points	11 points	16 points	20 points	20%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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9.29: Assignment- We Do It Better Here

Preparation

This assignment requires you to research a country's trade advantages within the global economy. In order to successfully complete this assignment, please follow these instructions carefully.

Your **Task**

Select a Country

You are to select a country whose name begins with the same letter as YOUR first name. For instance, Linda could select Latvia!

Research

Begin by going to the Global Edge website of Michigan State University. At the Home Page, click on "Global Insights," which will take you to the page where you can search by Trade Bloc, Country, State, and Industry. Select "Country" from the drop-down menu and begin to find out about your country. Other sources you may want to consider are the U.S. Department of State website —see "Countries and Regions" from the menu at the top of the home page. Also consider the C.I.A. World Fact Book—see the drop-down menu on the home page for a list of countries.

Respond

Answer the following questions about your country:

- Based on your research, does your country have an **absolute advantage** in any area of international trade? If so, please describe this advantage and explain why you think they have this characteristic.
  - Remember: Absolute advantage is the ability of a country, individual, company, or region to produce a good or service at a lower cost per unit than the cost at which any other entity produces that good or service.
- Based on your research, does your country have **comparative advantages**?
  - Remember: Comparative advantage refers to the ability of a party to produce a particular good or service at a lower marginal and opportunity cost over another. Even if one country is more efficient in the production of all goods compared to the other, both countries will still gain by trading with each other, as long as they have different relative efficiencies.

Write

Prepare a written summary of your findings, following the guidelines for written assignments. You must include the following information in your summary:

- A brief overview of the country you selected (fewer than 50 words)
- The advantage you identified (absolute or comparative)
- Explanation and justification for making the decision you did. For example, if you selected Latvia and decided that they have an absolute advantage in Gizmos, you would include the following:
  - Latvia accounts for 80 percent of the world Gizmo markets. The world market for Gizmos is _______ per year;
  - The reason why Latvia has an absolute advantage is _______;
  - Latvia benefits from this advantage by _______.

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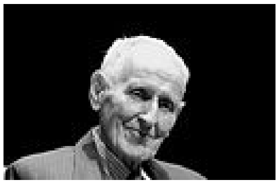
CHAPTER OVERVIEW

10: Module 3 Readings - Business Ethics

10.1: Reading- Moral, Ethical, and Legal Perspectives

“Dying Is Not a Crime”—or Is It?

Dr. Jack Kevorkian



Dr. Jack Kevorkian was both famous and infamous for championing the patient’s “right to die” through physician-assisted suicide. During his career he claimed to have helped at least 130 patients end their lives, believing that physicians (and society) have a moral obligation to help end the pain and suffering of the terminally ill. His work sparked a national debate on patients’ right to end their own life; some in the media portrayed him as “Dr. Death,” while others treated him as a hero of medicine and the spokesman of the dying. He once famously said, “Dying is not a crime.”

Kevorkian’s case (described below) raises some interesting questions about the nature of moral, ethical, and legal behavior in our society, but it also offers us a way to think about some of the differences between these ideas and how the tensions between them play out in the real world. Sometimes, acting in ways that are moral, ethical, and legal are one and the same thing. Other times—as Dr. Kevorkian’s story reveals—they’re not.

As you read the definitions below, see if you can think of examples from your own or others’ experience.

Moral Behavior

Morals are concerned with, or come from, an unwritten code of behavior concerning what’s right or acceptable in a particular society. Traditionally, morals have been the special province of religion and cultural groups.

Ethical Behavior

Ethics are a set of standards that govern the conduct of a person, especially a member of a profession. In the medical profession, for instance, doctors take an ethical oath to “do no harm.”

Legal Behavior

Legal behavior follows the dictates of laws, which are written down and interpreted by the courts. Interpretations can change over time (through new legal precedents, for example) and laws can change, as well. These changes are negotiated within our political and legal systems.

Using these as working definitions, let’s return to Dr. Kevorkian and consider a brief chronology of the events in his case:

- Kevorkian was tried four times for assisting suicides between May 1994 to June 1997. He was acquitted three times; the fourth trial ended in a mistrial.
- On the November 22, 1998, broadcast of CBS News’ *60 Minutes*, Kevorkian allowed the airing of a videotape he made on September 17, 1998, which depicted the voluntary euthanasia of Thomas Youk, 52, who was in the final stages of Lou Gehrig’s Disease. After Youk provided his fully informed consent, Kevorkian himself gave Thomas Youk a lethal injection. This was highly significant, as all of his earlier clients had reportedly performed this procedure on their on their own. Youk’s family described the lethal injection as humane, not murder.
- On March 26, 1999, Kevorkian was charged with second-degree murder and the delivery of a controlled substance (administering the lethal injection to Thomas Youk).
- After a two-day trial, the Michigan jury found Kevorkian guilty of second-degree homicide. Judge Jessica Cooper sentenced Kevorkian to 10–25 years in prison.
- After serving eight years, Kevorkian was paroled on June 1, 2007, on the condition that he not help anyone else die and not provide care for anyone with a disability or over the age of 62. He was also prohibited from publicly commenting on assisted suicide.
- On June 3, 2011, Dr. Kevorkian died of natural causes—not assisted suicide.

Moral Considerations

Although simplified here, much of the opposition to Kevorkian's behavior on "moral grounds" centered on religious and cultural beliefs:

> In his March 19, 2002, article "Opposing Assisted Suicide: More Americans Don't Want Doctors to Help People Kill Themselves" (which appeared on the ABC website), Gary Langer, director of polling at ABC News, wrote:
>
> "When it's posed in broad strokes, 48 percent of Americans oppose legalizing assisted suicide, while 40 percent support it . . . A variety of factors inform these views, and religious belief is central among them. Non-Christians and people who profess no religion overwhelmingly support assisted suicide. But it's opposed by most Christians, who account for 8 in 10 Americans, and especially by evangelical Christians, who oppose assisted suicide by a 2-1 margin."[1]

Ethical Considerations

Dr. Kevorkian was a licensed physician until his license was revoked in 1991. Bound by the obligation to do no harm, Kevorkian acted in ways that other doctors and health-care workers considered injurious to their profession:

> The American Medical Association (AMA), in an October 10, 1995, letter by then AMA General Counsel Kirk Johnson to then Michigan Attorney General Frank Kelley, stated the following:
>
> By invoking the physician-patient relationship to cloak his actions, Jack Kevorkian perverts the idea of the caring and committed physician, and weakens the public's trust in the medical profession.
>
> The AMA establishes the Code of Ethics for the medical profession. One of the fundamental principles of that code is that physicians must not act with the intent of causing the death of their patients. Physician-assisted suicide is simply incompatible with the physician's role as healer. When faced with patients who are terminally ill and suffering, physicians must relieve their suffering by providing adequate comfort care.[2]

Legal Considerations

Laws change over time, reflecting changes in society. By 2014, four states had passed laws legalizing physician-assisted suicide. Although there is no federal law specifically prohibiting it, assisted suicide falls under the jurisdiction of the laws against homicide. How the law changes—or doesn't change—is summarized here by the court's position:

> In *Washington v. Glucksberg*, the U.S. Supreme Court declared in its June 26, 1997 ruling (9-0):
>
> The history of the law's treatment of assisted suicide in this country has been and continues to be one of the rejection of nearly all efforts to permit it. That being the case, our decisions lead us to conclude that the asserted "right" to assistance in committing suicide is not a fundamental liberty interest protected by the Due Process Clause. " [3]

That was in 1997, but in 2014 a New Mexico judge made the following ruling:

> In *Morris v. New Mexico* the New Mexico Second Judicial District in a January 13, 2014, ruling by Judge Nan Nash stated:
>
> This Court cannot envision a right more fundamental, more private or more integral to the liberty, safety and happiness of a New Mexican than the right of a competent, terminally ill patient to choose aid in dying. If decisions made in the shadow of one's imminent death regarding how they and their loved ones will face that death are not fundamental and at the core of these constitutional guarantees, than what decisions are? As recognized by the United States Supreme Court in Cruzan "[t]he choice between life and death is a deeply personal decision of obvious and overwhelming finality. . . ."
>
> The Court therefore declares that the liberty, safety, and happiness interest of a competent, terminally ill patient to choose aid in dying is a fundamental right under our New Mexico Constitution.

As the Kevorkian example shows, people take positions and make choices within different frameworks, and those frameworks, while overlapping, are not always perfectly aligned. The legal framework establishes laws that govern behavior; ethical frameworks contain sets of standards and rules governing the behavior of individuals within groups or professions; and morals concern fundamental beliefs about right and wrong behavior. As you will see in the rest of this module, when businesses try to "do the right" thing—by the law, by their shareholders, by their employees, by their customers and other stakeholders (for example, environmental groups)—there is often a complex interplay of moral, ethical, and legal considerations.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. ProCon.org. (2008, June 5). "Is the Debate over Euthanasia and Physician-Assisted Suicide Primarily Religious in Nature?" ↵
2. ProCon.org. (2010, April 26). "Did Dr. Jack Kevorkian Ethically Serve the Best Interests of His Patients?" ↵
3. ProCon.org. (2014, August 11). "Is There a Legal Right to Die?" ↵

Contributors and Attributions

10.2: Reading- Ethical and Unethical Business Decisions

Misgoverning Corporations

At the very beginning of this module you watched a video that showed two young, powerful, and ultimately criminal corporate executives from WorldCom head to jail. For many of you this story is probably either ancient news or just another exposé on corporate malfeasance. But it's worth learning a little more about what happened behind the scenes in order to see how unethical decisions get made—and by whom. It's often the executives who star in the headlines when such scandals break, since they carry the most responsibility for the company's actions, but employees all the way down can play their role, too—by joining in, by caving to pressure from the top, or by refusing to play along.

"Mommy, Why Do You Have to Go to Jail?"

The one question Betty Vinson would rather avoid is "Mommy, why do you have to go to jail?" Vinson graduated with an accounting degree from Mississippi State and married her college sweetheart. After a series of jobs at small banks, she landed a midlevel accounting job at WorldCom, at the time still a small long-distance provider. Sparked by the telecom boom, however, WorldCom soon became a darling of Wall Street, and its stock price soared. Now working for a wildly successful company, Vinson rounded out her life by reading legal thrillers and watching her twelve-year-old daughter play soccer.

Her moment of truth came in mid-2000, when company executives learned that profits had plummeted. They asked Vinson to make some accounting adjustments to boost income by $828 million. She knew that the scheme was unethical (at the very least) but gave in and made the adjustments. Almost immediately, she felt guilty and told her boss that she was quitting. When news of her decision came to the attention of CEO Bernard Ebbers and CFO Scott Sullivan, they hastened to assure Vinson that she'd never be asked to cook any more books. Sullivan explained it this way: "We have planes in the air. Let's get the planes landed. Once they've landed, if you still want to leave, then leave. But not while the planes are in the air." Besides, she'd done nothing illegal, and if anyone asked, he'd take full responsibility. So Vinson decided to stay. After all, Sullivan was one of the top CFOs in the country; at age thirty-seven, he was already making $19 million a year. Who was she to question his judgment?

Six months later, Ebbers and Sullivan needed another adjustment—this time for $771 million. This scheme was even more unethical than the first: It entailed forging dates to hide the adjustment. Pretty soon, Vinson was making adjustments on a quarterly basis—first for $560 million, then for $743 million, and yet again for $941 million. Eventually, Vinson had juggled almost $4 billion, and before long, the stress started to get to her: She had trouble sleeping, lost weight, looked terrible, and withdrew from people at work. But when she got a promotion and a $30,000 raise, she decided to hang in.

By spring 2002, however, it was obvious that adjusting the books was business as usual at WorldCom. Vinson finally decided that it was time to move on, but, unfortunately, an internal auditor had already put two and two together and blown the whistle. The Securities and Exchange Commission charged WorldCom with fraud amounting to $11 billion—the largest in U.S. history. Seeing herself as a valuable witness, Vinson was eager to tell what she knew. The government, however, regarded her as more than a mere witness. When she was named a co-conspirator, she agreed to cooperate fully and pleaded guilty to criminal conspiracy and securities fraud. And that's why Betty Vinson spent five months in jail. But she wasn't the only one doing time: Scott Sullivan—who claimed he was innocent—got sentenced to jail for five years, and Bernie Ebbers—who swore he was innocent also—got locked up for twenty-five years.

So where did Betty Vinson, mild-mannered midlevel executive and mother, go wrong? How did she manage to get involved in a scheme that not only bilked investors out of billions but also cost seventeen thousand people their jobs? Ultimately, of course, we can only guess. Maybe she couldn't say no to her bosses; maybe she believed that they'd take full responsibility for her accounting "adjustments." Possibly she was afraid of losing her job. Perhaps she didn't fully understand the ramifications of what she was doing. What we do know is that she disgraced herself and headed for jail.

Misgoverning Corporations

The WorldCom situation is not an isolated incident.

- In fall 2001, executives at Enron, an energy supplier, admitted to accounting practices concocted to overstate the company's income over a period of four years. In the wake of the company's collapse, stock prices plummeted from $90 to $1 a share, inflicting massive financial losses on the investment community. Thousands of employees lost not only their jobs but their retirement funds, as well.

- Officials at Adelphia, the nation's sixth-largest cable company, disclosed that founder and CEO John Rigas had treated the publicly owned firm as a personal piggy bank, siphoning off *billions* of dollars to support his family's extravagant lifestyle and bankrupting the company in the process.
- CEO Dennis Koslowzki of conglomerate Tyco International was apparently confused about what was his and what belonged to the company. Besides treating himself to a $30 million estate in Florida and a $7 million Park Avenue apartment, Koslowzki indulged in a taste for expensive office accessories—such as a *$15,000 umbrella stand*, a $17,000 traveling toilette box, and a $2,200 wastebasket—that eventually drained $600 million from company coffers.
- Bernie Madoff, founder of Bernard L. Madoff Investment Securities, is alleged to have run a giant Ponzi scheme that cheated investors out of up to *$65 billion.* Madoff convinced investors to give him large sums of money. In return, he gave them an impressive 8 percent to 12 percent return a year. But Madoff *never* really invested their money. *Instead, he kept it for himself*. Thousands of investors, including many of his wealthy friends, not-so-rich retirees who trusted him with their life savings, and charitable foundations, were financially ruined. All those harmed by Madoff either directly or indirectly were pleased when he was *sentenced to jail for 150 years*.

Are these cases merely aberrations? Why do such incidents happen (and with such apparent regularity)? Who are the usual suspects? How long until the next corporate bankruptcy record is set? What action can be taken—by individuals, organizations, and the government—to discourage such behavior?

The Idea of Business Ethics

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

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

What Is Ethics?

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

What Is Social Responsibility?

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

How Can You Recognize an Ethical Organization?

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

- Treating employees, customers, investors, and the public fairly
- Making fairness a top priority
- Holding every member personally accountable for his or her action
- Communicating core values and principles to all members
- Demanding and rewarding integrity from all members in all situations (Alan Axelrod, *My First Book of Business Ethics,* Philadelphia: Quirk Books, 2004, p 7.)

Whether you work for a business or for a nonprofit organization, you probably have a sense of whether your employer is ethical or unethical. Employees at companies that consistently make *Business Ethics* magazine's list of the "100 Best Corporate Citizens" regard the items on the previous list as business as usual in the workplace. Companies that routinely win good-citizenship awards include Procter & Gamble, Hewlett-Packard, Intel, Avon Products, Cisco Systems, and Merck ("100 Best Corporate Citizens for 2010," *Corporate Responsibility Magazine*, no. 11, Spring 2011, accessed September 5, 2011).

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

- They consistently feel uneasy about the work they do.
- They object to the way they're treated.
- They're uncomfortable about the way coworkers are treated.
- They question the appropriateness of management directives and policies (Alan Axelrod, *My First Book of Business Ethics*, Philadelphia: Quirk Books, 2004, p 7).

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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10.3: Reading- Identifying Ethical Issues

Identifying Ethical Issues

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

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

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

Bribes vs. Gifts

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

There's often a fine line between a gift and a bribe. The questions that we've just asked, however, may help in drawing it, because they raise key issues in determining how a gesture should be interpreted: the cost of the item, the timing of the gift, the type of gift, and the connection between the giver and the receiver. If you're on the receiving end, it's a good idea to refuse any item that's overly generous or given for the purpose of influencing a decision. But because accepting even small gifts may violate company rules, the best advice is to check on company policy.

JCPenney's "Statement of Business Ethics," for instance, states that employees can't accept any cash gifts or any noncash gifts except those that have a value below $50 and that are generally used by the giver for promotional purposes. Employees can attend paid-for business functions, but other forms of entertainment, such as sports events and golf outings, can be accepted only if it's practical for the Penney's employee to reciprocate. Trips of several days can't be accepted under any circumstances. (JCPenney Co. "Statement of Business Ethics for Associates and Officers: The 'Spirit' of This Statement," accessed April 24, 2006).

Conflicts of Interest

Conflicts of interest occur when individuals must choose between taking actions that promote their personal interests over the interests of others or taking actions that don't. A conflict can exist, for example, when an employee's own interests interfere with, or have the potential to interfere with, the best interests of the company's stakeholders (management, customers, owners). Let's say that you work for a company with a contract to cater events at your college and that your uncle owns a local bakery. Obviously, this situation could create a conflict of interest (or at least give the appearance of one—which, by the way, is a problem in itself). When you're called on to furnish desserts for a luncheon, you might be tempted to throw some business your uncle's way even if it's not in the best interest of the catering company that you work for.

What should you do? You should probably disclose the connection to your boss, who can then arrange things so that your personal interests don't conflict with the company's. You may, for example, agree that if you're assigned to order products like those that your uncle makes, you're obligated to find another supplier. Or your boss may make sure that someone else orders bakery products.

The same principle holds that an employee shouldn't use private information about an employer for personal financial benefit. Say that you learn from a coworker at your pharmaceutical company that one of its most profitable drugs will be pulled off the market because of dangerous side effects. The recall will severely hurt the company's financial performance and cause its stock price to plummet. Before the news becomes public, you sell all the stock you own in the company. What you've done isn't merely unethical: It's called insider trading, it's illegal, and you could go to jail for it.

Conflicts of Loyalty

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

Issues of Honesty and Integrity

Master investor Warren Buffet once told a group of business students the following:

I cannot tell you that honesty is the best policy. I can't tell you that if you behave with perfect honesty and integrity somebody somewhere won't behave the other way and make more money. But honesty is a good policy. You'll do fine, you'll sleep well at night, and you'll feel good about the example you are setting for your coworkers and the other people who care about you.

Quoted by Adrian Gostick and Dana Telford, *The Integrity Advantage (*Salt Lake City: Gibbs Smith, 2003), 103.

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

Think about this story:

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

Adapted from Adrian Gostick and Dana Telford, *The Integrity Advantage* (Salt Lake City: Gibbs Smith, 2003), 16.

So, what's the moral of the story? Don't sit around in an ethically toxic environment and lose your integrity a little at a time; get out before the water gets too hot and your options have evaporated.

KEY TAKEAWAYS

- When you enter the business world, you'll find yourself in situations in which you'll have to choose the appropriate behavior.
- You'll need to know how to distinguish a bribe from an acceptable gift.
- You'll encounter situations that give rise to a **conflict of interest**—situations in which you'll have to choose between taking action that promotes your personal interest and action that favors the interest of others.
- Sometimes you'll be required to choose between loyalty to your employer and loyalty to a friend or family member.
- In business, as in all aspects of your life, you should act with honesty and integrity.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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10.4: Reading- The Organizational Approach to Ethics

The Organizational Approach to Ethics

Ethics is more than a matter of individual behavior; it's also about organizational behavior. Employees' actions aren't based solely on personal values alone: They're influenced by other members of the organization, from top managers and supervisors to coworkers and subordinates. So how can ethical companies be created and sustained? In this section, we'll examine some of the most reasonable answers to this question.

How to Create and Sustain Ethical Companies

As an Employee

How, as an employee, can you maintain an ethical position? A few rules of thumb can guide you. We've summed them up in Figure 1, "How to Maintain Honesty and Integrity," below:

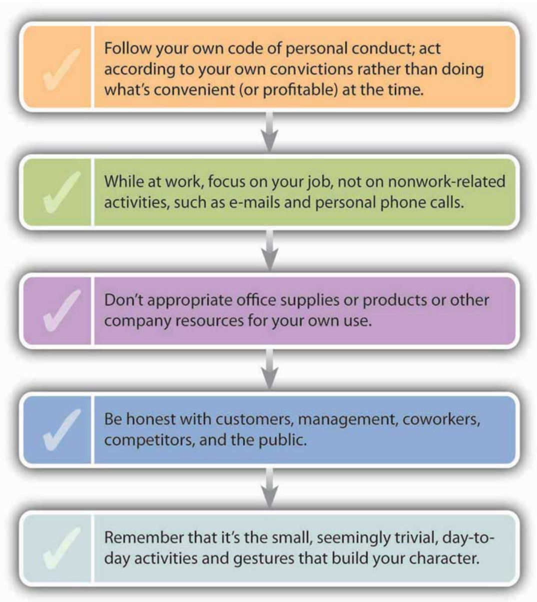

Figure 10.4.1: How to Maintain Honesty and Integrity

Whistle-Blowing

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

As a result of Cooper's actions, executives came clean about the company's financial situation. The conspiracy of fraud was brought to an end, and though public disclosure of WorldCom's problems resulted in massive stock-price declines and employee layoffs, investor and employee losses would have been greater without Cooper's intervention. Even though Cooper did the right thing, the experience wasn't exactly gratifying. A lot of people applauded her action, but many coworkers shunned her; some even blamed *her* for the company's troubles. She's never been thanked by any senior executive at WorldCom.

Refusing to Rationalize

Despite all the good arguments in favor of doing the right thing, why do many reasonable people act unethically (at least at times)? Why do good people make bad choices? According to one study, there are four common rationalizations for justifying misconduct[1]

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

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

So, how do organizations establish a culture of ethics from the "top down"?

Ethical Leadership

Organizations have unique *cultures*—ways of doing things that evolve through shared values and beliefs. An organization's culture is strongly influenced by senior executives, who tell members of the organization what's considered acceptable behavior and what happens if it's violated. In theory, the tone set at the top of the organization promotes ethical behavior, but sometimes (as at Enron) it doesn't.

Before its sudden demise, Enron fostered a growth-at-any-cost culture that was defined by the company's top executives. Said one employee, "It was all about taking profits now and worrying about the details later. The Enron system was just ripe for corruption." Coupled with the relentless pressure to generate revenue—or at least to look as if you were generating it—was a climate that discouraged employees from questioning the means by which they were supposed to do it. There may have been chances for people to speak up, but no one did. "I don't think anyone started out with a plan to defraud the company," reflects another ex-employee. "Everything at Enron seemed to start out right, but somewhere something slipped. People's mentality switched from focusing on the future good of the company to 'let's just do it today.'"[3]

Exercising Ethical Leadership

Leaders should keep in constant touch with subordinates about ethical policies and expectations. They should be available to help employees identify and solve ethical problems, and should encourage them to come forward with concerns. They're responsible for minimizing opportunities for wrongdoing and for exerting the controls needed to enforce company policies. They should also think of themselves as role models. Subordinates look to their supervisors to communicate policies and practices regarding ethical behavior, and as a rule, actions speak more loudly than words: If managers behave ethically, subordinates will probably do the same.

This is exactly the message that senior management at Martin Marietta (now a part of Lockheed Martin) sent to members of their organization. A leading producer of construction components, the company at the time was engaged in a tough competitive battle over a major contract. Because both Martin Marietta and its main competitor were qualified to do the work, the job would go to the lower bid. A few days before bids were due, a package arrived at Martin Marietta containing a copy of the competitor's bid sheet (probably from a disgruntled employee trying to sabotage his or her employer's efforts). The bid price was lower than Martin Marietta's. In a display of ethical backbone, executives immediately turned the envelope over to the government and informed the competitor. No, they didn't change their own bid in the meantime, and, no, they didn't get the job. All they got was an opportunity to send a clear message to the entire organization.[4]

By the same token, leaders must be willing to hold subordinates accountable for their conduct and to take appropriate action. The response to unethical behavior should be prompt and decisive. One CEO of a large company discovered that some of his employees were "Dumpster diving" in the trash outside a competitor's offices (which is to say, they were sifting around for information that would give them a competitive advantage). The manager running the espionage operation was a personal friend of the CEO's, but he was immediately fired, as were his "operatives." The CEO then informed his competitor about the venture and returned all the materials that had been gathered. Like the top managers at Martin Marietta, this executive sent a clear message to people in his organization: namely, that deviations from accepted behavior would not be tolerated.[5]

It's always possible to send the wrong message. In August 2004, newspapers around the country carried a wire-service story titled "Convicted CEO Getting $2.5 Million Salary While He Serves Time." Interested readers found that the board of directors of Fog Cutter Capital Group had agreed to pay CEO Andrew Wiederhorn (and give him a bonus) while he served an eighteen-month federal-prison term for bribery, filing false tax returns, and financially ruining his previous employer (from which he'd also borrowed $160 million). According to the board, they couldn't afford to lose a man of Wiederhorn's ability. The entire episode ended up on TheStreet.com's list of "The Five Dumbest Things on Wall Street This Week."[6]

Tightening the Rules

In response to the recent barrage of corporate scandals, more large companies have taken additional steps to encourage employees to behave according to specific standards and to report wrongdoing. Even companies with excellent reputations for integrity have stepped up their efforts.

Codes of Conduct

Like many firms, Hershey Foods now has a formal code of conduct: a document describing the principles and guidelines that all employees must follow in the course of all job-related activities. It's available on the company intranet and in printed form and, to be sure that everyone understands it, the company offers a training program. The Hershey code covers such topics as the use of corporate funds and resources, conflict of interest, and the protection of proprietary information. It explains how the code will be enforced, emphasizing that violations won't be tolerated. It encourages employees to report wrongdoing and provides instructions on reporting violations (which are displayed on posters and printed on wallet-size cards). Reports can be made though a Concern Line, by e-mail, or by regular mail; they can be anonymous; and retaliation is also a serious violation of company policy.[7]

KEY TAKEAWAYS

- At some point in your career, you might become aware of wrongdoing on the part of others and will have to decide whether to report the incident and become a **whistle-blower**—an individual who exposes illegal or unethical behavior in an organization.
- Despite all the good arguments in favor of doing the right thing, some businesspeople still act unethically (at least at times). Sometimes they use one of the following rationalizations to justify their conduct:
    - The behavior isn't really illegal or immoral.
    - The action is in everyone's best interests.
    - No one will find out what I've done.
    - The company will condone my action and protect me.

- Ethics is more than a matter of individual behavior; it's also about organizational behavior. Employees' actions aren't based solely on personal values; they're also influenced by other members of the organization.
- Organizations have unique *cultures*—ways of doing things that evolve through shared values and beliefs.
- An organization's culture is strongly influenced by top managers, who are responsible for letting members of the organization know what's considered acceptable behavior and what happens if it's violated.
- Subordinates look to their supervisors as role models of ethical behavior. If managers act ethically, subordinates will probably do the same.
- Those in positions of leadership should hold subordinates accountable for their conduct and take appropriate action.
- Many organizations have a formal **code of conduct** that describes the principles and guidelines that all members must follow in the course of job-related activities.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. Saul W. Gellerman, "Why 'Good' Managers Make Bad Ethical Choices," *Harvard Business Review on Corporate Ethics*, Boston: Harvard Business School Press, 2003, p 59. ↵
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3. See especially Tom Fowler, "The Pride and the Fall of Enron," *Houston Chronicle*, October 20, 2002, accessed April 24, 2006. ↵
4. Episode recounted by Norm Augustine, "Business Ethics in the 21st Century," speech, Ethics Resource Center, accessed April 24, 2006.↵
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7. Hershey Foods, "Code of Ethical Business Conduct," accessed January 22, 2012. ↵

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10.5: Reading- Corporate Social Responsibility

Corporate Social Responsibility

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

Figure 1 presents a model of corporate responsibility based on a company’s relationships with its *stakeholders*. In this model, the focus is on managers—not owners—as the principals involved in all these relationships. Here, owners are the stakeholders who invest risk capital in the firm in expectation of a financial return. Other stakeholders include employees, suppliers, and the communities in which the firm does business. Proponents of this model hold that customers, who provide the firm with revenue, have a special claim on managers’ attention. The arrows indicate the two-way nature of corporation-stakeholder relationships: All stakeholders have some claim on the firm’s resources and returns, and it’s management’s job to make decisions that balance these claims.

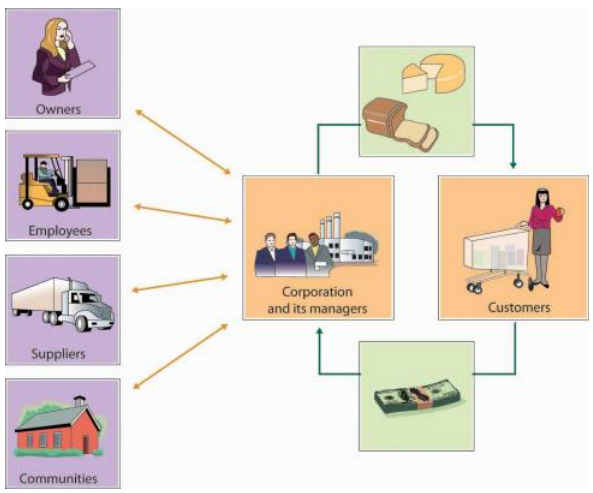

Figure 10.5.1: The Corporate Citizen

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

Owners

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

Fiduciary Responsibilities

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

Employees

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

Safety and Health

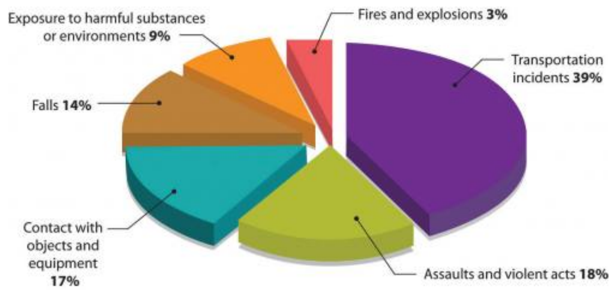

Figure 10.5.1: orkplace Deaths by Event or Exposure, 2010

Though it seems obvious that companies should guard workers' safety and health, a lot of them simply don't. For over four decades, for example, executives at Johns Manville suppressed evidence that one of its products, asbestos, was responsible for the deadly lung disease developed by many of its workers. The company concealed chest X-rays from stricken workers, and executives decided that it was simply cheaper to pay workers' compensation claims (or let workers die) than to create a safer work environment. A New Jersey court was quite blunt in its judgment: Johns Manville, it held, had made a deliberate, cold-blooded decision to do nothing to protect at-risk workers, in blatant disregard of their rights.

About four in one hundred thousand U.S. workers die in workplace "incidents" each year. The Department of Labor categorizes deaths caused by conditions like those at Johns Manville as "exposure to harmful substances or environments." How prevalent is this condition as a cause of workplace deaths? See Figure 2, above, which breaks down workplace fatalities by cause. Some jobs are more dangerous than others. For a comparative overview based on workplace deaths by occupation, see Figure 3, below:

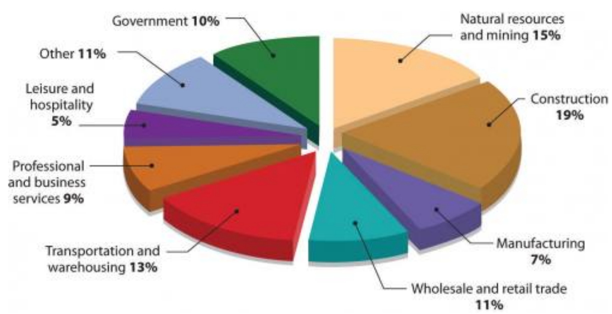

Figure 10.5.2: Workplace Deaths by Industry, 2010

For most people, fortunately, things are better than they were at Johns Manville. Procter & Gamble (P&G), for example, considers the safety and health of its employees paramount and promotes the attitude that "Nothing we do is worth getting hurt for." With nearly one hundred thousand employees worldwide, P&G uses a measure of worker safety called "total incident rate per employee," which records injuries resulting in loss of consciousness, time lost from work, medical transfer to another job, motion restriction, or medical treatment beyond first aid. The company attributes the low rate of such incidents—less than one incident per hundred employees—to a variety of programs to promote workplace safety.

Freedom from Sexual Harassment

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

- Sexual harassment occurs when an employee makes "unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature" to another employee who doesn't welcome the advances.
- It's also sexual harassment when "submission to or rejection of this conduct explicitly or implicitly affects an individual's employment, unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment."

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

Equal Opportunity and Diversity

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

Equal Pay and the Wage Gap

The Equal Pay Act of 1963 requires equal pay for both men and women in jobs that entail equal skill, equal effort, equal responsibility, or similar working conditions. What has been the effect of the law after forty years? In 1963, women earned, on average, $0.589 for every $1 earned by men. By 2010, that difference—which we call the *wage gap*—has been closed to $0.812 to $1, or approximately 81 percent. Figure 10.5.3, below, provides some interesting numbers on the differences in annual earnings based not only on gender but on race, as well. Figure 10.5.4 throws further light on the wage and unemployment gap when education is taken into consideration.

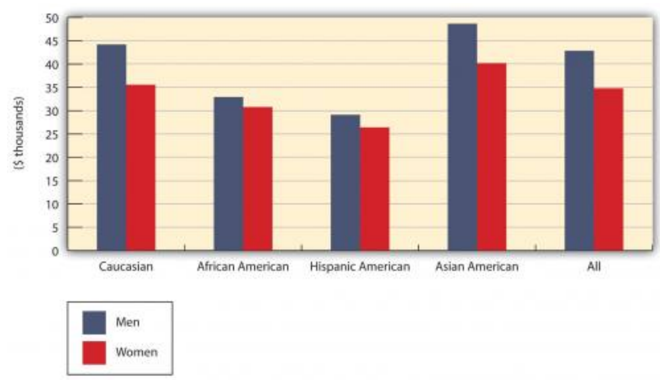

Figure 10.5.3: Median Annual Earnings by Gender and Race

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

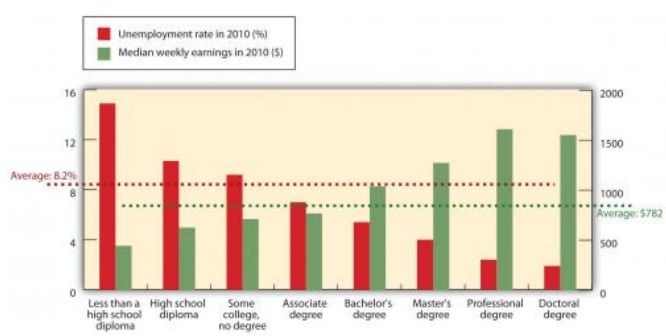

Figure \(\PageIndex{14rages for persons age 25 and over. Earnings are for full-time wage and salary workers. Source: Bureau of Labor Statistics, Current Population Survey.

Building Diverse Workforces

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

Wages and Benefits

At the very least, employers must obey laws governing minimum wage and overtime pay. A minimum wage is set by the federal government, though states can set their own rates. The current federal rate, for example, is $7.25, while the rate in the state of Washington is $8.67. When there's a difference, the higher rate applies.By law, employers must also provide certain benefits—social security (which provides retirement benefits), unemployment insurance (which protects against loss of income in case of job loss), and workers' compensation (which covers lost wages and medical costs in case of on-the-job injury). Most large companies pay most of their workers more than minimum wage and offer considerably broader benefits, including medical, dental, and vision care, as well as pension benefits.

Customers

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

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

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

Communities

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

Financial Contributions

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

Volunteerism

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

Supporting Social Causes

Companies and executives often take active roles in initiatives to improve health and social welfare in the United States and elsewhere. Microsoft's former CEO Bill Gates intends to distribute more than $3 billion through the Bill and Melinda Gates Foundation, which funds global health initiatives, particularly vaccine research aimed at preventing infectious diseases, such as polio, in undeveloped countries. Noting that children from low-income families have twice as many cavities and often miss school because of dental-related diseases, P&G invested $1 million a year to set up "cavity-free zones" for 3.3 million economically disadvantaged children at Boys and Girls Clubs nationwide. In addition to giving away toothbrushes and toothpaste, P&G provided educational programs on dental hygiene. At some locations, the company even maintained clinics providing affordable oral care to poor children and their families. Proctor & Gamble recently committed to provide more than two billion liters of clean drinking water to adults and children living in poverty in developing countries. The company believes that this initiative will save an estimated ten thousand lives.

KEY TAKEAWAYS

- **Corporate social responsibility** refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions.
- Companies are socially responsible to their various stakeholders—owners, employees, customers, and the communities in which they conduct business.
- Owners invest money in companies. In return, the people who manage companies have a responsibility to increase the value of owners' investments through profitable operations.
- Managers have a responsibility to provide owners and other stakeholders with accurate, reliable financial information.
- They also have a **fiduciary responsibility** to safeguard the company's assets and handle its funds in a trustworthy manner.
- Companies have a responsibility to guard workers' safety and health and to provide them with a work environment that's free from sexual harassment.
- Businesses should pay appropriate wages and benefits, treat all workers fairly, and provide equal opportunities for all employees.
- Many companies have discovered the benefits of valuing diversity. People with diverse backgrounds bring new talents and fresh perspectives, and improve a company's ability to serve an ethically diverse population.
- Sellers are responsible—both ethically and legally—for treating customers fairly. Consumers have certain rights: to use safe products, to be informed about products, to choose what to buy, and to be heard.
- Companies also have a responsibility to the communities in which they produce and sell their products. The economic impact of businesses on local communities is substantial. Companies have the following functions:
  - Provide jobs
  - Pay taxes
  - Support local education, health, and recreation activities
  - Donate funds to community projects
  - Encourage employees to volunteer their time
  - Donate equipment and products for a variety of activities

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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10.6: Reading- Demands for Corporate Social Responsibility

Stakeholder Pressure

Most of the pressure on businesses/corporations in the last twenty-five years has come from shareholders. More recently, however, a different source of pressure—the demand for corporate social responsibility (CSR)—has emerged, which is forcing directors into new governance territory occupied by stakeholders other than shareholders. While pressure on corporate executives to pay greater attention to stakeholder concerns and make CSR an integral part of corporate strategy has been mounting since the early 1990s, such pressure is only now beginning to filter through to the board of directors who are responsible for making decisions for the corporation.

The emergence of CSR as a more prominent item on a board's agenda reflects a shift in popular opinion about the role of business in society and the convergence of environmental forces, such as the following:

Globalization

There are now more than 60,000 multinational corporations estimated to be in the world (World Investment Report, 2004). Perceptions about the growing reach and influence of global companies have drawn attention to the impact of business on society. This has led to heightened demands for corporations to take responsibility for the social, environmental, and economic effects of their actions. It has also spawned more aggressive demands for corporations to set their sights on limiting harm and actively seeking to improve social, economic, and environmental circumstances.

Loss of Trust

High-profile cases of corporate financial misdeeds (Enron, WorldCom, and others) and of social and environmental irresponsibility (e.g., Shell's alleged complicity in political repression in Nigeria; Exxon's oil spill in Prince William Sound in Alaska; Nike's and other apparel makers' links with "sweatshop" labor in developing countries; questions about Nestlé's practices in marketing baby formula in the developing world) have contributed to a broad-based decline in trust in corporations and corporate leaders. The public's growing reluctance to give corporations the benefit of the doubt has led to intensified scrutiny of corporate impact on society, the economy, and the environment, and a greater readiness to assume—rightly or wrongly—immoral corporate intent.

Civil Society Activism

The growing activity and sophistication of "civil society" organizations, many of which are oriented to social and environmental causes, have generated pressure on corporations to take CSR seriously. The International Chamber of Commerce, a global advocacy group for the private sector, observed in 2000 that "non-governmental organizations have gained an enormous influence" over corporate decision making, as quoted in Barrington.[1] Well-known international nongovernmental organizations (NGOs), such as Oxfam, Amnesty International, Greenpeace, the Rainforest Action Network, and the Fair Labor Association, have influenced corporate decision making in areas such as access to essential medicines, labor standards, environmental protection, and human rights. The advent of the Internet has increased the capacity of these organizations—as well as a plethora of national and local civic associations—to monitor corporate behavior and mobilize public opinion."Civil society" is sometimes described as the part of society that exists between the state and the market. A more formal definition is "the voluntary association of citizens, promoting their values and interests in the public domain," according to Saxby and Schacter.[2] Kaldor, Anheier, and Glasius[3] estimate that there are approximately 48,000 international nongovernmental organizations (NGOs) and that total membership in international NGOs grew by about 70% between 1990 and 2000.

Institutional Investor Interest in CSR

The growth in "socially responsible investing" has created institutional demand for equity in corporations that demonstrate a commitment to CSR. Recent growth in assets involved in socially responsible investing has outpaced growth in all professionally managed investment assets in the United States, even though the mainstream financial community has been slow to incorporate nonfinancial factors into its analyses of corporate value."Big investors want SRI research: European institutions to allocate part of brokers' fees to 'nontraditional' information."[4]

These trends indicate that there is both a growing perception that corporations must be more accountable to society for their actions and a growing willingness and capacity within society to make corporations accountable. These developments have profound implications for the future of corporate governance, suggesting that boards will have to deal with many of the following:

- a growing pressure to give stakeholders a role in corporate governance;

- a growing pressure on corporations to disclose more and better information about their management of social, environmental, and economic issues;
- an increasing level of regulatory compulsion related to elements of corporate activity that are currently regarded as voluntary forms of social responsibility;
- a growing interest by the mainstream financial community in the link between shareholder value and nonfinancial corporate performance.

The discussion about corporate accountability to stakeholders, therefore, while often couched in the vocabulary of CSR, is really a discussion about the changing definition of corporate governance, which is why it should receive a greater priority on the board's agenda.

Interestingly, whereas board agendas mostly focus on competition, cooperation may well become the *preferred business strategy* for addressing social and environmental issues. Increasingly, companies are joining forces not only with business competitors but also with human rights and environmental activists (formerly considered enemies), as well as socially responsible investors, academics, and governmental organizations. At the World Economic Forum (WEF) gathering, for example, two such coalitions were announced to address the issue of global online freedom of expression, particularly in repressive regimes. One, facilitated by Business for Social Responsibility (BSR), consists of companies facing intense criticism over complicity with suppressing online free speech in China. This coalition includes big names, such as Google, Microsoft, and Yahoo. The others gathered together socially responsible investing firms and human rights advocates, such as Amnesty International, Human Rights Watch, and Reporters Without Borders.

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1. 2000, January–June. ↵
2. 2003, p. 4. ↵
3. 2003, p. 2. ↵
4. *Financial Times*, UK, October 18, 2004. ↵

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10.7: Reading- Stakeholder Theory and Corporate Social Responsiblity

Stakeholder Theory

Instead of starting with a business and looking out into the world to see what ethical obligations are there, stakeholder theory starts in the world. It lists and describes those individuals and groups who will be affected by (or affect) the company's actions and asks, "What are their legitimate claims on the business?" "What rights do they have with respect to the company's actions?" and "What kind of responsibilities and obligations can they justifiably impose on a particular business?" In a single sentence, stakeholder theory affirms that those whose lives are touched by a corporation hold a right and obligation to participate in directing it.

Corporate Social Responsibility

As a simple example, when a factory produces industrial waste, a CSR perspective attaches a responsibility directly to factory owners to dispose of the waste safely. By contrast, a stakeholder theorist begins with those living in the surrounding community whose environment might be poisoned and begins to talk about business ethics by insisting that they have a right to clean air and water. In other words the community members are stakeholders in the company and their voices must contribute to corporate decisions. It's true that they may own no stock, but they have a moral claim to being involved in the decision-making process. This is a very important point. At least in theoretical form, those affected by a company's actions actually become something like shareholders and owners. Because they're touched by a company's actions, they have a right to participate in managing it.

Who are the stakeholders surrounding companies? The answer depends on the particular business, but the list can be quite extensive. If the enterprise produces chemicals for industrial use and is located in a small Massachusetts town, the stakeholders include:

- Company owners, whether a private individual or shareholders
- Company workers
- Customers and potential customers of the company
- Suppliers and potential suppliers to the company
- Everyone living in the town who may be affected by contamination from workplace operations
- Creditors whose money or loaned goods are mixed into the company's actions
- Government entities involved in regulation and taxation
- Local businesses that cater to company employees (restaurants where workers have lunch, grocery stores where employee families shop, and similar)
- Other companies in the same line of work competing for market share
- Other companies that may find themselves subjected to new and potentially burdensome regulations because of contamination at that one Massachusetts plant

The first five on the list—shareholders, workers, customers, suppliers, and community—may be cited as the five cardinal stakeholders.

In an abstract sense, it's probably true that everyone in the world counts as a stakeholder of any sizable factory—we all breathe the same air, and because the global economy is so tightly linked, decisions made in a boardroom in a small town on the East Coast can end up costing someone in India her job.

Once a discrete set of stakeholders surrounding an enterprise has been located, stakeholder ethics may begin. The purpose of the firm, underneath this theory, is to maximize profit on a collective bottom line, with profit defined not as money but as human welfare. The collective bottom line is the total effect of a company's actions on all stakeholders. Company managers, that means, are primarily charged not with representing the interests of shareholders (the owners of the company) but with the more social task of coordinating the interests of all stakeholders, balancing them in the case of conflict, and maximizing the sum of benefits over the medium and long term. Corporate directors, in other words, spend part of the day just as directors always have: explaining to board members and shareholders how it is that the current plans will boost profits. They spend other parts of the day, however, talking with other stakeholders about their interests: they ask for input from local environmentalists about how pollution could be limited, they seek advice from consumers about how product safety could be improved, and so on. At every turn, stakeholders are treated (to some extent) like shareholders, as people whose interests need to be served and whose voices have real power.

In many cases transparency is an important value for those promoting stakeholder ethics. The reasoning is simple: if you're going to let every stakeholder actively participate in a corporation's decision making, then those stakeholders need to have a good idea about what's going on.

What's certain is that stakeholder theory obligates corporate directors to appeal to all sides and balance everyone's interests and welfare in the name of maximizing benefits across the spectrum of those whose lives are touched by the business.

Consider the role concept of social responsibility had on Starbucks as you watch this video:

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

11: Module 4- Financial Markets and System

11.1: Why It Matters- Financial Markets and System

Why explain the institutions and markets that comprise the financial system, and explain how they impact the economy and the money supply?

Have you heard the saying "Money makes the world go around"?

In many ways money drives almost all of our endeavors. Consider why you are here taking this course. You are obtaining knowledge in order to get a better job, to obtain a degree or other credential, or to be more informed in your daily life so that you can support yourself and provide for those you love. Even if you are interested in charitable endeavors to improve the human condition, such efforts to support a cause will require money—even indirectly. Understanding how money functions—the different forms it takes and where it goes—is the first step in being able to comprehend our financial system.

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11.2: Introduction to Money

What you'll learn to do: explain what money is and what makes it useful

When we think of money, what comes to mind is usually the the paper bills in our wallet or the coins in our pockets. But money is much more than that. How we define money determines where and how we use it to obtain the goods and services that businesses offer the consumer. In this section we'll look at what money is, why it's useful, and what it may be in the future.

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11.3: What Is Money?

Learning Objectives

- Explain the three key functions of money
- Discuss the advantages of using money versus barter

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Money is really anything that people use to pay for goods and services and to pay people for their work. Historically, money has taken different forms in different cultures—everything from salt, stones, and beads to gold, silver, and copper coins and, more recently, virtual currency has been used. Regardless of the form it takes, money needs to be widely accepted by both buyers and sellers in order to be useful.

Barter and the Double Coincidence of Wants

To understand the usefulness of money, we must consider what the world would be like without money. How would people exchange goods and services? Economies without money typically engage in the barter system. **Barter**—literally trading one good or service for another—is highly inefficient for trying to coordinate the trades in a modern advanced economy. In an economy without money, an exchange between two people would involve a double coincidence of wants, a situation in which two people each want some good or service that the other person can provide. For example, if a hairstylist wants a pair of shoes, she must find a shoemaker who has a pair of shoes in the correct size and who is willing to exchange the shoes for a certain number of hairdos. Such a trade is likely difficult to arrange. Think about the complexity of such trades in a modern economy, with its extensive division of labor that involves thousands upon thousands of different jobs and goods.

Another problem with the barter system is that it doesn't allow people to easily enter into future contracts for the purchase of many goods and services. For example, if the goods are perishable, it may be difficult to exchange them for other goods in the future. Imagine a farmer wanting to buy a tractor in six months using a fresh crop of strawberries. Also, while the barter system might work adequately in small economies, it will limit growth. Specifically, time that individuals might otherwise spend producing goods and services and enjoying leisure time is spent bartering.

Functions of Money

Money solves the problems created by the barter system. First, money serves as a **medium of exchange**, which means that money acts as an intermediary between the buyer and the seller. Instead of exchanging hairdos for shoes, the hairstylist now exchanges hairdos for money. This money is then used to buy shoes. To serve as a medium of exchange, money must be very widely accepted as a method of payment in the markets for goods, labor, and financial capital.

In addition, money needs to have the following properties:

1. It must be *divisible*—that is, easily divided into usable quantities or fractions. A $5 bill, for example, is equal to five $1 bills. If something costs $3, you don't have to tear up a $5 bill; you can pay with three $1 bills.
2. It must be *portable*—easy to carry; it can't be too heavy or bulky.
3. It must be *durable*. It can't fall apart or wear out after a few uses.
4. It must be *difficult to counterfeit.* It won't have much value if people can make their own.

Second, money must serve as a **store of value**. Consider the barter between the hairstylist and shoemaker again. The shoemaker risks having his shoes go out of style, especially if he keeps them in a warehouse for future use—their value will decrease with each season. Shoes are not a good store of value. Holding money is a much easier way of storing value. You know that you don't need to spend it immediately, because it will still hold its value the next day or the next year. This function of money doesn't require that money is a *perfect* store of value. In an economy with inflation, money loses some buying power each year, but it remains money.

Third, money serves as a **unit of account**, which means that it's the ruler by which other values are measured. For example, a hairstylist may charge $30 to style someone's hair. That $30 can buy two shirts (but probably not a pair of shoes). Money acts as a common denominator, an accounting method that simplifies thinking about trade-offs.

So money serves all of these functions: medium of exchange, store of value, and unit of account.

Figure 11.3.1: Uninscribed electrum coin from Lydia, 6th century BCE

Commodity versus Fiat Money

Commodity money consists of objects that have value in themselves as well as value in their use as money. Gold, for example, has been used throughout the ages as money, although today it is not used as money but rather is valued for its other attributes. Gold is a good conductor of electricity and is used in the electronics and aerospace industry. Gold is also used in the manufacturing of energy efficient reflective glass for skyscrapers and is used in the medical industry as well. Of course, gold also has value because of its beauty and malleability in the creation of jewelry.

As commodity money, gold has historically served its purpose as a medium of exchange, a store of value, and as a unit of account. Commodity-backed currencies are dollar bills or other currencies with values backed up by gold or another commodity held at a bank. During much of its history, the money supply in the United States was backed by gold and silver. Interestingly, antique dollars dated as late as 1957 have "Silver Certificate" printed above the portrait of George Washington, as shown below. This meant that the holder could take the bill to the appropriate bank and exchange it for a dollar's worth of silver.

Figure 11.3.1: A Silver Certificate and a Modern U.S. Bill. Until 1958, silver certificates were commodity-backed money—backed by silver, as indicated by the words "Silver Certificate" printed on the bill. Today, U.S. bills are backed by the Federal Reserve, but as fiat money.

As economies grew and became more global in nature, the use of commodity monies became more cumbersome. Countries moved toward the use of fiat money. **Fiat money** is legal tender whose value is backed by the government that issued it. The United States' paper money—like the dollar bill, for instance—carries this statement: "This note is legal tender for all debts, public and private." In other words, by government decree, if you owe a debt, then legally speaking, you can pay that debt with the U.S.

currency, even though it's not backed by a commodity. The only backing of our money is widespread faith and trust that the currency has value—and nothing more.

Practice Questions

https://assessments.lumenlearning.co...essments/14318

https://assessments.lumenlearning.co...essments/14319

The following video discusses some additional characteristics of money:

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "Money: An Economist's Perspective – What is Money?" (opens in new window) or the text alternative for "Money: An Economists's Perspective – What is Money?" (opens in new window).

Contributors and Attributions

11.4: Alternatives to Traditional Currency

Learning Objectives

- Discuss alternatives to traditional currency used today

In his TED Talk, brand strategist Paul Kemp-Robertson notes that non-government currencies are gaining consumer trust and asks the rhetorical question "Is there a reason for governments to be in charge of money?"[1] Given the proliferation of alternative currencies—from digital coins and wallets to brand point systems and rewards—the answer may, at some point in the future, be "no." What's clear in the present is that the process of making purchases and other payments is being transformed, with implications for monetary policy.

What constitutes an alternative currency is open to debate. For our purposes, we'll consider three categories of currency: cryptocurrencies, mobile commerce and regionally-based currency. A point worth considering is that "currency" and payment processes are being transformed not only by technology—for example, blockchain and mobile technologies and related services—but, as Kemp-Robertson alluded to, by consumer trust (or lack thereof) in the system.

Investopedia defines a cryptocurrency as "a digital or virtual currency that uses cryptography for security." The most credible cryptocurrencies are those based on blockchain technology that records, validates and stores transaction information across a decentralized and distributed network of personal computers. Although there were earlier versions, the first cryptocurrency to gain broad market attention was Bitcoin, launched in 2009.[2] Retailer acceptance of bitcoin is still limited to early adopters, including a few major retailers such as Microsoft, Overstock and Newegg.[3] However, the currency's volatility—a historical high and low of $20,089 and $65.53 and a range of 4,030.63 over the most current 90 day period—make it more appropriate as a speculative investment than for use as money.

Coinmarketcap.com lists over 2,000 cryptocurrencies with a total market value of roughly $144 billion.[4] As of March 31, 2019, there were approximately 17.6 million bitcoins in circulation with a total market value of $72 billion.[5] To put this in perspective, check out The Money Project's visualization of the world's money and markets. To excerpt, as of 2017 the value of cryptocurrency was $173 billion compared $7.6 trillion in coin and banknotes, $36.8 trillion in "narrow money" (equivalent to M1) and $90.5 trillion in "broad money" (equivalent to M2).

Given those relative values, what is the perceived impact on monetary policy? In a speech at the 2018 Decoding Digital Currency Conference, Federal Governor Lael Brainard stated that "the still relatively small scale of cryptocurrencies in relation to our broader financial system and relatively limited connections to our banking sector suggest that they do not currently pose a threat to financial stability."[6] While recognizing that cryptocurrencies "represent the leading edge" of digital technologies for payments, she also noted that the extreme fluctuations in asset value limit the currency's ability to serve as a "stable store of value" and "meaningful unit of account," two essential functions of money. Additional factors highlighted as risk factors for potential uses:

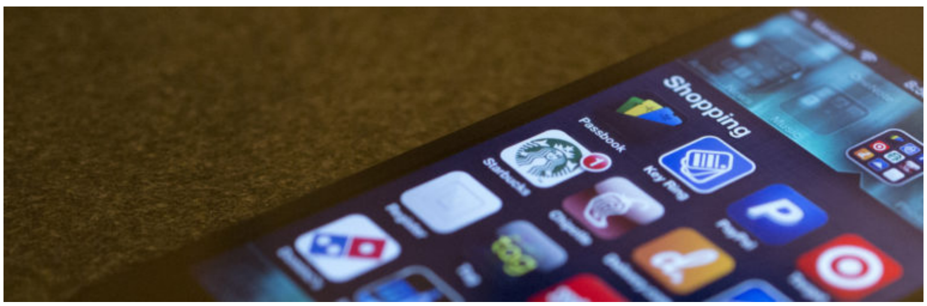
- Cryptocurrency is not backed by the faith and credit of a trusted individual or institution
- Cryptocurrency is not legal tender (has limited acceptance)
- There is no central authority with responsibility for the maintenance, security or reliability of the technology or ecosystem
- There is currently no legal framework to provide recourse for consumers impacted by fraud, theft or other security breach

Reporting on a survey of central banks, the Bank of International Settlements (BIS) found that the majority (58%) reported public adoption of cryptocurrency as minimal ("trivial/no use"), with 28% reporting niche use and 14% do not know; there were no responses to either of two additional options: "Significant use" and "Wider public use." Survey responses indicate that most central banks are still evaluating the situation. Of those that expressed an opinion, the majority expected use in payments to remain low due to limited acceptance, perceived user risk and, in some cases, legal prohibitions. The report concluded that “most central banks consider cryptocurrencies to be a niche technology rather than the future of money.”

Mobile Commerce

Mobile payments aren’t a form of currency per se but a means of accessing financial services and conducting transactions on a mobile device. Although the definition of m-commerce differs somewhat based on authority, a working definition is sales transactions made on a smartphone or tablet. Using this definition, research firm eMarketer projects that m-commerce will represent approximately 50% of U.S. e-commerce sales in 2020, up from approximately 35% in 2017. The majority (over 70%) of mobile commerce transactions are made on smartphones, with the remainder on tablets. Statista.com puts this in perspective with a graph showing U.S. mobile retail commerce revenue percentages and dollars from 2013 to 2021.

Although mobile’s percent of total U.S. retail sales is still relatively low (roughly 3%, with e-commerce representing approximately 10% of retail sales), the impact of mobile technology is not only at the point of sale. Forrester Research estimates that by 2022, m-commerce will impact 42% of total retail sales. Forrester principal Brendan Miller, “shoppers have integrated smartphones into their product research at every phase of the customer life cycle, from discovery to price checking in-store.”



Factors limiting adoption of mobile wallets include fears about security, limited retailer acceptance, the proprietary nature of apps and what Bluefin refers to as “unnecessary payment friction” caused by having to switch between mobile wallets based on where a consumer is shopping. Also, in developed countries, there isn’t a compelling point of pain that would prompt a switch to mobile payments. Visa and MasterCard are widely accepted and use isn’t limited by type of device or operating system as is true with Apple Pay, Android Pay and Samsung Pay. However, the consensus is that ”as smartphones and internet connectivity reach a saturation point, consumers will likely start to view their phones more as banking and shopping devices.”[7] For perspective, mobile wallet transactions are expected to total $800 billion in 2019, up from $718 billion in 2017.[8] As Apple, Google, Samsung and PayPal increase their focus on mobile payments, and merchants ramp up their mobile capabilities.

The fastest growth in mobile money services is in underbanked markets in Africa, Asia and Latin America. The World Bank reports that 69 percent of adults now have access to a bank account or an account through a mobile money provider. World Bank President Jim Yong Kim expresses the economic development view, stating “Having access to financial services is a critical step towards reducing both poverty and inequality, and new data on mobile phone ownership and internet access show unprecedented opportunities to use technology to achieve universal financial inclusion.”[9] However, the implications may be greater for marketers who now have access an additional 3.8 billion people. Indeed, given that lack of central bank comment on mobile commerce, the primary implications will be for the major technology players, marketers and retailers.

Practice Question

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Regionally-Based Currency

Regions develop “currencies” to support a range of local economic development and sustainability initiatives. According to The Schumacher Center for a New Economics, a non-profit promoting local resilience, “Centralized currency issue serves centralized production whereas regional currencies represent a democratization of currency issue, supporting local businesses and educating consumers about how their money circulates in the local economy.”[10]

The Center has been involved in the development of a number of local currencies, including BerkShares, a currency specific to Western Massachusetts. Launched in 2006 and still in operation, The New York Times referred to the BerkShares program as a “great economic experiment.” The program currently involves a network of four community banks, approximately 400 locally owned business and local citizens. BerkShares can be obtained at participating bank branches at an exchange rate of $0.95 to one BerkShire and BerkShares can be exchanged for U.S. dollars at the same exchange rate. BerkShares can be spent at face value—that is, 100 BerkShares equals $100—with participating businesses and can be used by private parties as payment for services, if desired.

There are a number of active regional currency systems in operation in the United States and internationally. Refer to the Schumacher’s Active Programs page for summaries of the initiatives. Although this last category of currency doesn’t have systemic (i.e., monetary policy) impact at the current scale, the potential community impact is worth considering if you’re a local business, non-profit or promoting regional economic development.

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Contributors and Attributions

11.5: Introduction to Role of Banks

What you'll learn to do: explain the role of banks in the U.S. monetary system

In this section, our focus is money at the macro level or the U.S. monetary system. We'll discuss how money is defined, the M1 and M2 categories of money supply, what types of money, deposits or investments is included in each and the role of the Federal Reserve Bank in managing and reporting on money stock measures. We'll continue with an explanation of the critical financial intermediary role that banks play in the payment system, facilitating the exchange of goods and services and acting as intermediaries between borrowers and savers. Our final topic introduces monetary policy and the structure, organization and key functions of the Federal Reserve Bank, our central bank.

Contributors and Attributions

11.6: Measuring and Tracking the Money Supply

Learning Objectives

- Explain the difference between M1 and M2 money supply and how they are measured

Now that you have a good understanding of money, what qualifies as money, and how money facilitates exchanges between buyers and sellers, we need to look at how money evolves from a medium of exchange to a system. There was a time in the United States when there was no monetary system, and buyers and sellers who traveled from state to state had to carry multiple currencies. The Confederate States of America dollar was issued by the newly formed confederacy just before the outbreak of the American Civil War. It wasn't backed by hard assets (i.e., commodities) but simply by a promise to pay the bearer after the war, on the prospect of Southern victory and independence. Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, South Carolina, Tennessee, Texas, and Virginia each printed and circulated currency that had value only within the state. It was not until 1863 when President Lincoln signed the National Banking Act that the federal dollar was established as the sole currency in the United States.

What about other kinds of currency? Cash in your wallet certainly serves as money, but how about checks or credit cards? Are they money, too? Rather than trying to determine a single way of measuring money, economists offer broader definitions of money based on liquidity. **Liquidity** refers to how quickly a financial asset can be used to buy a good or service. For example, cash is very liquid. Your $10 bill can easily be used to buy a hamburger at lunchtime. However, $10 that you have in your savings account is not so easy to use. You must go to the bank or ATM machine and withdraw that cash to buy your lunch. Thus, $10 in your savings account is *less* liquid.

The **Federal Reserve Bank**, which is the central bank of the United States, is a bank regulator. It's responsible for monetary policy, and it defines money according to its liquidity. You will learn more about the Federal Reserve System in the next section. There are two definitions of money: M1 and M2 money supply. **M1 money supply** includes those monies that are very liquid such as cash, checkable (demand) deposits, and traveler's checks. **M2 money supply** is less liquid in nature and includes M1 monies plus savings and time deposits, certificates of deposits, and money market funds.

M1 money supply includes **coins and currency in circulation**—the coins and bills that circulate in an economy that are not held by the U.S. Treasury, at the Federal Reserve Bank, or in bank vaults. Closely related to currency are checkable deposits, also known as **demand deposits**. These are the amounts held in checking accounts. They are called demand deposits or checkable deposits because the banking institution must give the deposit holder his money "on demand" when a check is written or a debit card is used. These items together—currency, and checking accounts in banks—comprise the money defined as M1, which is measured daily by the Federal Reserve System. Traveler's checks are also included in M1 but have recently decreased in use.

M2 is a broader category of money. It includes everything in M1 but also adds other types of deposits. For example, M2 includes **savings deposits** in banks, which are bank accounts on which you cannot write a check directly, but from which you can easily withdraw the money at an automatic teller machine or bank. Many banks and other financial institutions also offer a chance to invest in **money market funds**, where the deposits of many individual investors are pooled together and invested in a safe way, such as in short-term government bonds. Another portion of M2 are the relatively small (that is, less than about $100,000) **certificates of deposit** (CDs) or **time deposits**, which are accounts that the depositor has committed to leaving in the bank for a certain period of time, ranging from a few months to a few years, in exchange for a higher interest rate. In short, all these types of M2 are money that you can withdraw and spend, but which require a greater effort to do so than the items in M1. Figure 1, below, should help you visualize the relationship between M1 and M2. Note that M1 is included in the M2 calculation.

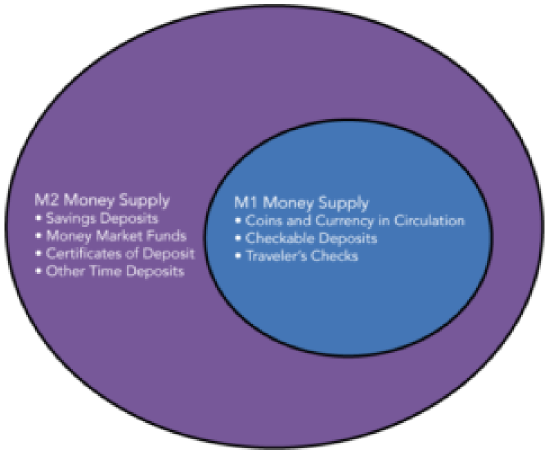

Figure 11.6.1: The Relationship between M1 and M2 Money.

The Federal Reserve System is responsible for tracking the amounts of M1 and M2 and prepares a weekly release of information about the money supply. For example, according to the Federal Reserve Bank's measure of the U.S. money stock, at the end of January 2019, M1 in the United States was $3.7 trillion, while M2 was $14.5 trillion. A breakdown of the portion of each type of money that comprised M1 and M2 in January 2019, as reported by the Federal Reserve Bank, is provided in Table 11.6.1.[1]

Table 11.6.1. M1 Federal Reserve Statistical Release, Money Stock Measures

Components of M1 in the U.S. (February 2019, seasonally adjusted)	$ billions
Currency	$1,632.7
Traveler's checks	$0
Demand deposits and other checking accounts	$2,104.4
Total M1	*$3,737.1 (or $3.7 trillion)*

Table 11.6.2. M2 Federal Reserve Statistical Release, Money Stock Measures

Components of M2 in the U.S. (February 2019, seasonally adjusted)	$ billions
M1 money supply	$3,737.1
Savings accounts	$9,306.0
Time deposits	$566.0
Individual money market mutual fund balances	$856.5
Total M2	*$14,465.7 (or $14.5 trillion)*

The lines separating M1 and M2 can become a little blurry. Sometimes elements of M1 are not treated alike; for example, some businesses will not accept personal checks for large amounts but will accept traveler's checks or cash. Changes in banking practices and technology have made the savings accounts in M2 more similar to the checking accounts in M1. For example, some savings accounts will allow depositors to write checks, use automatic teller machines, and pay bills over the Internet, which has made it easier to access savings accounts. As with many other economic terms and statistics, the important point is to know the strengths and limitations of the various definitions of money, not to believe that such definitions are as clear-cut to economists as, say, the definition of nitrogen is to chemists.

Where does "plastic money" like debit cards, credit cards, and smart money fit into this picture? A debit card, like a check, is an instruction to the user's bank to transfer money directly and immediately from your bank account to the seller. It is important to note that in our definition of money, it's checkable deposits that are money, not the paper check or the debit card. Although you can make a purchase with a credit card, it is not considered money but rather a short term loan from the credit card company to you.

When you make a purchase with a credit card, the credit card company immediately transfers money from its checking account to the seller, and at the end of the month, the credit card company sends you a bill for what you have charged that month. Until you pay the credit card bill, you have effectively borrowed money from the credit card company. With a smart card, you can store a certain value of money on the card and then use the card to make purchases. Some “smart cards” used for specific purposes, like long-distance phone calls or making purchases at a campus bookstore and cafeteria, are not really all that smart, because they can only be used for certain purchases or in certain places.

In short, credit cards, debit cards, and smart cards are different ways to move money when a purchase is made. But having more credit cards or debit cards does not change the quantity of money in the economy, any more than having more checks printed increases the amount of money in your checking account.

? Practice Question

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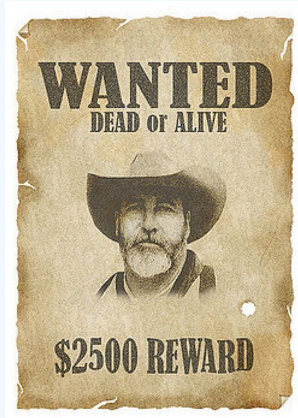
One key message here is that counting and tracking the money in a modern economy doesn’t just involve paper bills and coins; instead, money is closely linked to bank accounts. Indeed, the macroeconomic policies concerning money are largely conducted through the banking system. The next section explains how banks function as an intermediary to financial transactions.

1. Source: Board of Governors of the Federal Reserve System. https://www.federalreserve.gov/releases/h6/20190221/↵

11.7: Banks As Financial Intermediaries

Learning Objectives

- Explain how banks act as intermediaries between savers and borrowers



The late bank robber named Willie Sutton was once asked why he robbed banks. He answered: "That's where the money is." While this may have been true at one time, from the perspective of modern economists, Sutton is both right and wrong. He is wrong because the overwhelming majority of money in the economy is not in the form of currency sitting in vaults or drawers at banks, waiting for a robber to appear. Most money is in the form of bank accounts, which exist only as electronic records on computers. From a broader perspective, however, the bank robber was more right than he may have known. Banking is intimately interconnected with money and, consequently, with the broader economy.

Banks make it far easier for a complex economy to carry out the extraordinary range of transactions that occur in goods, labor, and financial capital markets. Imagine for a moment what the economy would be like if all payments had to be made in cash. When shopping for a large purchase or going on vacation, you might need to carry hundreds of dollars in a pocket or purse. Even small businesses would need stockpiles of cash to pay workers and to purchase supplies. A bank allows people and businesses to store this money in either a checking account or savings account, for example, and then withdraw this money as needed through the use of a direct withdrawal, writing a check, or using a debit card.

Banks are a critical intermediary in what is called the payment system, which helps an economy exchange goods and services for money or other financial assets. Also, people with extra money that they'd like to save can store their money in a bank rather than look for an individual who is willing to borrow it from them and then repay them at a later date. Those who want to borrow money can go directly to a bank rather than trying to find someone to lend them cash. Thus, banks act as financial intermediaries—they bring savers and borrowers together.

An **intermediary** is one who stands between two other parties. Banks are a **financial intermediary**—that is, an institution that operates between a saver who deposits money in a bank and a borrower who receives a loan from that bank. All the funds deposited are mingled in one big pool, which is then loaned out. Figure 1 illustrates the position of banks as financial intermediaries, with deposits flowing into a bank and loans flowing out.

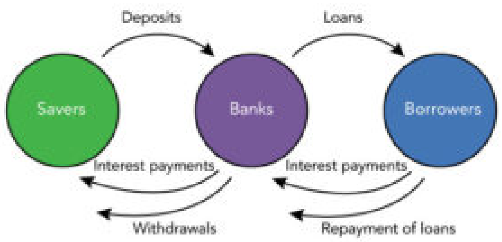


Figure 11.7.1: Banks As Financial Intermediaries.

Practice Question

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For some concrete examples of what banks do, watch the following video from Paul Solman's *Making Sense of Financial News.*

You can view the transcript for "Move Your Money" (opens in new window).

Contributors and Attributions

11.8: The Federal Reserve System

Learning Objectives

- Explain the structure and key functions of the Federal Reserve

Figure 11.8.1: **Marriner S. Eccles Federal Reserve Headquarters, Washington, DC**. Some of the most influential decisions regarding monetary policy in the United States are made behind these doors.

Money, loans, and banks are all tied together. Money is deposited in bank accounts, which is then loaned to businesses, individuals, and other banks. When the interlocking system of money, loans, and banks works well, economic transactions in goods and labor markets happen smoothly, and savers are connected with borrowers. If the money and banking system does not operate smoothly, the economy can either fall into recession or suffer prolonged inflation.

The government of every country has public policies that support the system of money, loans, and banking. But these policies do not always work perfectly. In this section we will explore how monetary policy works and what may prevent it from working perfectly.

In making decisions about the money supply—that is, the total amount of monetary assets available in an economy at a specific time—a central bank decides whether to raise or lower interest rates and, in this way, to influence macroeconomic policy, whose goal is low unemployment and low inflation. The central bank is also responsible for regulating all or part of the nation's banking system to protect bank depositors and insure the health of the bank's finances.

The organization responsible for conducting monetary policy and ensuring that a nation's financial system operates smoothly is called the **central bank**. Most nations have central banks or currency boards. Some prominent central banks around the world include the European Central Bank, the Bank of Japan, and the Bank of England. In the United States, the central bank is called the **Federal Reserve**—often abbreviated as "the Fed." This section explains the organization of the U.S. Federal Reserve and identifies the major responsibilities of a central bank.

Structure/Organization of the Federal Reserve

Unlike most central banks, the Federal Reserve is semi-decentralized, mixing government appointees with representation from private-sector banks. At the national level, it is run by a board of governors, consisting of seven members appointed by the president of the United States and confirmed by the Senate. Appointments are for fourteen-year terms and they are arranged so that one term expires January 31 of every even-numbered year. The purpose of the long and staggered terms is to insulate the board of governors as much as possible from political pressure so that policy decisions can be made based only on their economic merits. In addition, except when filling an unfinished term, each member only serves one term, further insulating decision-making from politics. Policy decisions of the Fed do not require congressional approval, and the president cannot ask for the resignation of a Federal Reserve governor as the president can with cabinet positions.

One member of the Board of Governors is designated as the Chair. For example, from 1987 until early 2006, the Chair was Alan Greenspan. From 2006 until 2014, Ben Bernanke held the post. Janet Yellen, who served as Chair from 2014–2018, was the first woman to hold the post and was generally considered to be the most qualified and perhaps the most successful Fed chair in history. President Trump broke with tradition in not re-appointing Ms. Yellen as chair, nominating instead Federal Reserve Governor Jerome Powell.

? Try It

President Trump remarked that he was “greatly impressed” with Yellen but, given her 5’3″ height, he felt she was too short to do the job (aside: that she’s been doing exceptionally well for 4 years). In reporting on the situation, Washington Post economic affairs reporter Matt O’Brien quipped “you might say this was the height of a bad decision.”[1]

As with most of his interactions with appointments and agencies, Trump’s relationship with Mr. Powell and the Fed has become strained. In a departure from protocol (and good judgement), Trump has repeatedly gone on record trying to bully the Board of Governors and/or undermine monetary policy decisions. One of the more recent headlines, pulled from a CNBC interview with Fed Chair Powell: “The law is clear, Trump can’t fire me.”[2] The rebuttal, from conservative commentator Stephen Moore—Trump’s nominee for the Fed—”Trump should fire Fed chair Powell ‘for cause;’ he’s ‘wrecking our economy.’”[3]

In response to Trump’s appointment of Moore to be a Fed governor, Republican economist and Harvard professor Greg Mankiw wrote: “[Stephen Moore] does not have the intellectual gravitas for this important job. It is time for senators to do their job. Mr. Moore should not be confirmed.” In a recent Vanity Fair interview, Ms. Yellen stated that she doesn’t believe the President has a grasp of macroeconomic policy and, further, that he doesn’t understand the independent nature of the Federal Reserve or how critical it is in economic terms for American’s to have confidence in the central bank.[4]

Regardless of one’s political position, it appears the current Administration will test the effectiveness of the structures put in place to maintain the integrity of economic policy. As well as the confidence of business and consumers in the government and our central bank.

Who Has the Most Immediate Economic Power in the World?

\Figure 11.8.2: **Former Chair of the Federal Reserve Board**. Janet L. Yellen was the first woman to hold the position of chair of the Federal Reserve Board of Governors.

What individual can make the financial market crash or soar just by making a public statement? It’s not Bill Gates or Warren Buffett. It’s not even the president of the United States. The answer is the chair of the Federal Reserve Board of Governors. In early 2014, Janet L. Yellen, shown in Figure 2, became the first woman to hold this post. Yellen has been described in the media as “perhaps the most qualified Fed chair in history.”

With a PhD in economics from Yale University, Yellen has taught macroeconomics at Harvard, the London School of Economics, and most recently at the University of California at Berkeley. From 2004–2010, Yellen was president of the Federal Reserve Bank of San Francisco.

Not an ivory-tower economist, Yellen became one of the few economists who warned about a possible bubble in the housing market, more than two years before the financial crisis occurred. Yellen served on the board of governors of the Federal Reserve twice, most recently as vice chair. She also spent two years as chair of the President’s Council of Economic Advisors. If experience and credentials mean anything, Yellen is likely to be an effective Fed chair.

The Fed chair is first among equals on the board of governors. While he or she has only one vote, the chair controls the agenda, and is the public voice of the Fed, so he or she has more power and influence than one might expect.

The Federal Reserve is more than the board of governors. The Fed also includes twelve regional **Federal Reserve banks**, each of which is responsible for supporting the commercial banks and economy generally in its district. The Federal Reserve districts and the cities where their regional headquarters are located are shown in Figure 3. The commercial banks in each district elect a board of directors for each regional Federal Reserve bank, and that board chooses a president for each regional Federal Reserve district. Thus, the Federal Reserve System includes both federally and private-sector appointed leaders.

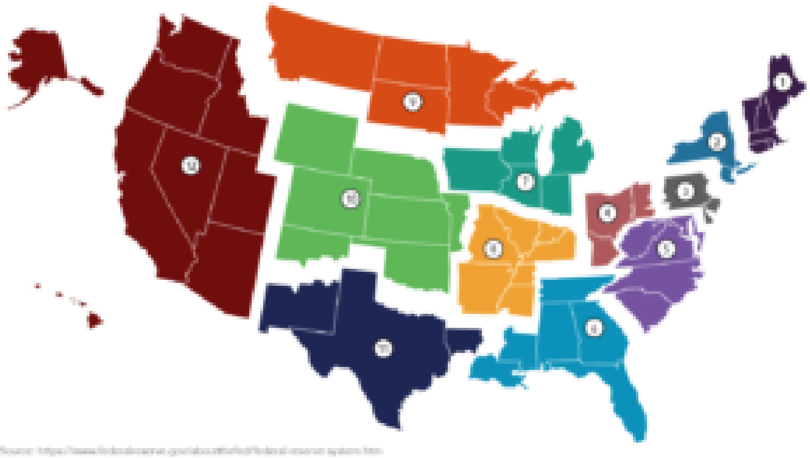

Figure 11.8.1: **The Twelve Federal Reserve Districts**. There are twelve regional Federal Reserve banks, each with its own district.

The Federal Reserve Districts and Their Territories

District Number	Head Office Location	Territories Covered
1	Boston, Massachusetts	The state of Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont; and all but Fairfield County in Connecticut.
2	New York, New York	The state of New York; Fairfield County in Connecticut; and 12 counties in northern New Jersey, and serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands.
3	Philadelphia, Pennsylvania	The state of Delaware; nine counties in southern New Jersey; and 48 counties in the eastern two-thirds of Pennsylvania.
4	Cleveland, Ohio	The state of Ohio; 56 counties in eastern Kentucky; 19 counties in western Pennsylvania; and 6 counties in northern West Virginia.
5	Richmond, Virginia.	The states of Maryland, Virginia, North Carolina, and South Carolina; 49 counties constituting most of West Virginia; and the District of Columbia.
6	Atlanta, Georgia	The states of Alabama, Florida, and Georgia; 74 counties in the eastern two-thirds of Tennessee; 38 parishes of southern Louisiana; and 43 counties of southern Mississippi.
7	Chicago, Illinois	The state of Iowa; 68 counties of northern Indiana; 50 counties of northern Illinois; 68 counties of southern Michigan; and 46 counties of southern Wisconsin.
8	St. Louis, Missouri	The states of Minnesota, Montana, North Dakota, and South Dakota; the Upper Peninsula of Michigan; and 26 counties in northern Wisconsin.

9	Minneapolis, Minnesota.	The states of Minnesota, Montana, North Dakota, and South Dakota; the Upper Peninsula of Michigan; and 26 counties in northern Wisconsin.
10	Kansas City, Missouri	The states of Colorado, Kansas, Nebraska, Oklahoma, and Wyoming; 43 counties in western Missouri; and 14 counties in northern New Mexico.
11	Dallas, Texas	The state of Texas; 26 parishes in northern Louisiana; and 18 counties in southern New Mexico
12	San Francisco, California	The states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington, and serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands

What Does a Central Bank Do?

The Federal Reserve, like most central banks, is designed to perform the following three important functions:

1. To conduct monetary policy
2. To promote stability of the financial system
3. To provide banking services to commercial banks and other depository institutions, and to provide banking services to the federal government

The Federal Reserve provides many of the same services to banks as banks provide to their customers. For example, all commercial banks have an account at the Fed where they deposit reserves, and they can obtain loans from the Fed through the "discount window," which will be discussed in the next reading. The Fed is also responsible for check processing. When you write a check to buy groceries, for example, the grocery store deposits the check in its bank account. Then, the physical check (or an image of that actual check) is returned to your bank, after which funds are transferred from your bank account to the account of the grocery store. The Fed is responsible for how these transactions are handled once the check leaves the cash register and is deposited into the store's bank account. Does that mean that your check to the grocery store goes all the way to Washington, DC.? No. Instead the regulations that govern how banks handle checks, deposits, withdrawals are regulated by The Federal Reserve Act. This act is the reason that a bank must start paying you interest on a savings deposit the day it is received. It's also the reason that if you deposit a large check, your bank may tell you that the funds will not be available for three to five business days.

On a more mundane level, the Federal Reserve ensures that enough currency and coins are circulating through the financial system to meet public demands. For example, each year the Fed increases the amount of currency available in banks around the Christmas shopping season and reduces it again in January.

Finally, the Fed is responsible for assuring that banks are in compliance with a wide variety of consumer protection laws. For example, banks are forbidden from discriminating on the basis of age, race, sex, or marital status. Banks are also required to publicly disclose information about the loans they make for buying houses and how those loans are distributed geographically, as well as by sex and race of the loan applicants.

? Practice Question

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Contributors and Attributions

11.9: How a Central Bank Executes Monetary Policy

Learning Objectives

- Explain how the Federal Reserve System implements monetary policy

The most important function of the Federal Reserve is to conduct the nation's monetary policy. Article I, Section 8 of the U.S. Constitution gives Congress the power "to coin money" and "to regulate the value thereof." As part of the 1913 legislation that created the Federal Reserve, Congress delegated these powers to the Fed. Monetary policy involves managing interest rates and credit conditions, which influence the level of economic activity, as described in more detail below.

A central bank has the following three traditional tools to implement monetary policy in the economy:

1. Open market operations
2. Changing reserve requirements
3. Changing the discount rate

In discussing how these three tools work, it is useful to think of the central bank as a "bank for banks"—that is, each private-sector bank has its own account at the central bank. We will discuss each of these monetary policy tools in the sections below.

Open Market Operations

The most commonly used tool of monetary policy in the U.S. is open market operations. **Open market operations** take place when the central bank sells or buys U.S. Treasury bonds in order to influence the quantity of bank reserves and the level of interest rates. The specific interest rate targeted in open market operations is the federal funds rate. The name is a bit of a misnomer since the federal funds rate is the interest rate charged by commercial banks making overnight loans to other banks. As such, it is a very short-term interest rate, but one that reflects credit conditions in financial markets very well.

The **Federal Open Market Committee (FOMC)** makes the decisions regarding these open market operations. The FOMC is made up of the seven members of the Federal Reserve's board of governors. It also includes five voting members who are drawn, on a rotating basis, from the regional Federal Reserve Banks. The New York district president is a permanent voting member of the FOMC and the other four spots are filled on a rotating, annual basis, from the other eleven districts. The FOMC typically meets every six weeks, but it can meet more frequently if necessary. The FOMC tries to act by consensus; however, the chairman of the Federal Reserve has traditionally played a very powerful role in defining and shaping that consensus. For the Federal Reserve, and for most central banks, open market operations have, over the last few decades, been the most commonly used tool of monetary policy. The following video explains how these operations work.

You can view the transcript for "Segment 406: Open Market Operations" (opens in new window).

Is it a sale of bonds by the central bank that increases bank reserves and lowers interest rates, ***or*** is it a purchase of bonds by the central bank? The easy way to keep track of this is to treat the central bank as being *outside* the banking system. When a central bank buys bonds, money is flowing from the central bank to individual banks in the economy, increasing the supply of money in circulation. When a central bank sells bonds, then money from individual banks in the economy is flowing into the central bank—reducing the quantity of money in the economy.

Changing Reserve Requirements

A second method of conducting monetary policy is for the central bank to raise or lower the **reserve requirement**, which is the percentage of each bank's deposits that it is legally required to hold either as cash in their vault or on deposit with the central bank. If banks are required to hold a greater amount in reserves, they have less money available to lend out. If banks are allowed to hold a smaller amount in reserves, they will have a greater amount of money available to lend out. The following video will explain how changing the reserve requirement alters the money supply.

You can view the transcript for "Segment 409: Reserve Requirements" (opens in new window).

In early 2015, the Federal Reserve required banks to hold reserves equal to 0% of the first $14.5 million in deposits, then to hold reserves equal to 3% of the deposits up to $103.6 million, and 10% of any amount above $103.6 million. Small changes in the reserve requirements are made almost every year. For example, the $103.6 million dividing line is sometimes bumped up or down by a few million dollars. In practice, large changes in reserve requirements are rarely used to execute monetary policy. A sudden demand that all banks increase their reserves would be extremely disruptive and difficult to comply with, while loosening requirements too much would create a danger of banks being unable to meet the demand for withdrawals.

Changing the Discount Rate

The Federal Reserve was founded in the aftermath of the Financial Panic of 1907 when many banks failed as a result of bank runs. As mentioned earlier, since banks make profits by lending out their deposits, no bank, can withstand a bank run. As a result of the Panic, the Federal Reserve was founded to be the "lender of last resort." In the event of a bank run, sound banks could borrow as much cash as they needed from the Fed's discount "window" to cover the bank run. The interest rate banks pay for such loans is called the **discount rate.** They are so named because loans are made against the bank's outstanding loans "at a discount" of their face value. Once depositors became convinced that the bank would be able to honor their withdrawals, they no longer had a reason to make a run on the bank. In short, the Federal Reserve was originally intended to provide credit passively, but in the years since its founding, the Fed has taken on a more active role with monetary policy.

So, the third traditional method for conducting monetary policy is to raise or lower the discount rate. If the central bank raises the discount rate, then commercial banks will reduce their borrowing of reserves from the Fed, and instead call in loans to replace those reserves. Since fewer loans are available, the money supply falls and market interest rates rise. If the central bank lowers the discount rate it charges to banks, the process works in reverse.

The following video explains the impact of changes to the Fed's discount rate.

You can view the transcript for "Investopedia Video: Fed's Discount Rate" (opens in new window).

In recent decades, the Federal Reserve has made relatively few discount loans. Before a bank borrows from the Federal Reserve to fill out its required reserves, the bank is expected to first borrow from other available sources, like other banks. This is encouraged by the Fed charging a higher discount rate than the federal funds rate. Given that most banks borrow little at the discount rate, changing the discount rate up or down has little impact on their behavior. More important, the Fed has found from experience that open market operations are a more precise and powerful means of executing any desired monetary policy.

? Practice Question

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11.10: Chair the Fed

Learning Objectives

- Explain the structure and key functions of the Federal Reserve
- Explain how the Federal Reserve System implements monetary policy

We have now seen that the Fed has three primary goals and a set of tools at its disposal to help it achieve these goals. If *you* were the chairperson of the Federal Reserve, do you think that you could accomplish these goals? Let's find out!

After reading the following information, click on the Chair the Fed link below, which will take you to the Federal Reserve Bank of San Francisco Web site, where YOU will act as the Chair of the Fed. By manipulating the fed funds rate, you will try to keep inflation and unemployment at target rates.

Instructions for Playing the Game

The game puts the player in the role of setting monetary policy as Chair of the Fed. The goals are as follows: inflation (2 percent) and unemployment (5 percent). Remember that the fed funds rate is the primary tool for monetary policy and is shown on the game screen (green line in the chart area is initially set at 4 percent rate).

Record the starting levels for inflation, unemployment, and the fed funds rate (2.11 percent, 4.68 percent, and 4.00 percent, respectively) in your notes by making a small table with four columns labeled: Quarters Remaining, Inflation, Unemployment, and Fed Funds Rate.

Review the "rules" and functions of the simulation by clicking on "**YOUR JOB.**" Once you have familiarized yourself with the way the simulation works, you are ready to "GO."

Start the game by clicking on the **"Go"** button. Once the first quarter is completed (fifteen quarters remaining), record all three rates. Using the "raise" and "cut" buttons, make adjustments to the fed funds rate. The information in the headline reflects changes in the levels of inflation and unemployment.

Work through the remaining fifteen quarters, pausing to review each headline and record the new values of inflation and unemployment.

The game ends on an announcement screen indicating "Congratulations" if the Chair has kept the economy on track (close to the goals for inflation and unemployment) or "Sorry" if the goals have not been met.

Good Luck!

Play the Chair the Fed Simulation

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11.11: Introduction to Financial Markets and Business

What you'll learn to do: describe common ways in which businesses obtain financial capital (money) to fund operations

In this section, we will discuss the options businesses have for obtaining financial capital to fund growth and other initiatives at different business stages and given different business structures and objectives. In the process, we'll distinguish between bonds and bank loans and private and public companies and discuss tradeoffs between debt and equity financing and stock issuance as a source of financing. We'll conclude with a discussion of how businesses decide which option is best.

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11.12: Financial Markets

Learning Objectives

- Distinguish between bonds and bank loans as methods of borrowing
- Distinguish between private and public companies
- Define “stock”

In 2006, housing equity in the United States peaked at $13 trillion. That means that the market prices of homes, less what was still owed on the loans used to buy these houses, equaled $13 trillion. This was a very good number, since the equity represented the value of the financial asset most U.S. citizens owned.

However, by 2008 this number had gone down to $8.8 trillion, and it declined further still in 2009. Combined with the decline in value of other financial assets held by U.S. citizens, by 2010, U.S. homeowners’ wealth had declined by $14 trillion! This is a staggering loss, and it affected millions of lives: people had to alter their retirement decisions, housing decisions, and other important consumption decisions. Just about every other large economy in the world suffered a decline in the market value of financial assets, as a result of the global financial crisis of 2008–2009.

This section will explain why people buy houses (other than as a place to live), why they buy other types of financial assets, and why businesses sell those financial assets in the first place. The section will also give us insight into why financial markets and assets go through boom-and-bust cycles like the one described here.

When a firm needs to buy new equipment or build a new facility, it often must go to the financial market to raise funds. Usually firms will add capacity during an economic expansion when profits are on the rise and consumer demand is high. Business investment is one of the critical ingredients needed to sustain economic growth. Even in the sluggish economy of 2009, U.S. firms invested $1.4 trillion in new equipment and structures, in the hope that those investments would generate profits in the years ahead.

Between the end of the recession in 2009 through the second quarter 2013, profits for the S&P 500 companies grew to 9.7 percent despite the weak economy, with much of that amount driven by cost cutting and reductions in input costs, according to the *Wall Street Journal*. Figure 1, below, shows corporate profits after taxes (adjusted for inventory and capital consumption). Despite the steep decline in quarterly net profit in 2008, profits have recovered and surpassed pre-Recession levels.

Figure 11.12.1: **Corporate Profits after Tax (Adjusted for Inventory and Capital Consumption)**. Until 2008, corporate profits after tax have generally continued to increase each year. There was a significant drop in profits during 2008 and into 2009. The profit trend has since continued to increase each year, though at a less steady or consistent rate. (Source: Federal Reserve Economic Data (FRED) https://research.stlouisfed.org/fred2/series/CPATAX)

Many firms, from huge companies like General Motors to start-up firms writing computer software, do not have the financial resources within the firm to make all the investments they want. These firms need financial capital from outside investors, and they are willing to pay interest for the opportunity to get a rate of return on the investment for that financial capital.

On the other side of the financial capital market, suppliers of financial capital, like households, wish to use their savings in a way that will provide a return. Individuals cannot, however, take the few thousand dollars that they save in any given year, write a letter to General Motors or some other firm, and negotiate to invest their money with that firm. Financial capital markets bridge this gap: That is, they find ways to take the inflow of funds from many separate suppliers of financial capital and transform it into the funds desired by demanders of financial capital. Such financial markets include stocks, bonds, bank loans, and other financial investments.

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11.13: How Businesses Raise Financial Capital

Learning Objectives

- Distinguish between bonds and bank loans as methods of borrowing
- Distinguish between private and public companies
- Define “stock”
- Discuss how firms choose between sources of financial capital

Firms often make decisions that involve spending money in the present and expecting to earn profits in the future. Some examples are: when a firm buys a machine that will last ten years, or builds a new plant that will last for thirty years, or starts a research and development project. They need economic resources—also known as **financial capital**—to do this. Firms can raise the financial capital they need to pay for such projects in four main ways: (1) from early-stage investors; (2) by reinvesting profits; (3) by borrowing through banks or bonds; and (4) by selling stock. As you’ll see, each financial option has different implications for the business in terms of operations and profits.

Early-Stage Financial Capital

Firms that are just beginning often have an idea or a prototype for a product or service to sell, but they have few customers, or even no customers at all, and thus are not earning profits. Banks are often unwilling to loan money to start-up businesses because they’re seen as too risky. Such firms face a difficult problem when it comes to raising financial capital: How can a firm that has not yet demonstrated any ability to earn profits pay a rate of return to financial investors?

For many small businesses, the original source of money is the owner of the business. Someone who decides to start a restaurant or a gas station, for instance, might cover the start-up costs by dipping into his or her own bank account or by borrowing money (perhaps using a home as collateral). Alternatively, many cities have a network of well-to-do individuals, known as “angel investors,” who will put their own money into small new companies at an early stage of development, in exchange for owning some portion of the firm.

Venture capital firms make financial investments in new companies that are still relatively small in size but have substantial growth potential. These firms gather money from a variety of individual or institutional investors, including banks, institutions like college endowments, insurance companies that hold financial reserves, and corporate pension funds. Venture capital firms do more than just supply money to small start-ups. They also provide advice on potential products, customers, and key employees. Typically, a venture capital fund invests in a number of firms, and then investors in that fund receive returns according to how the fund performs as a whole.

The amount of money invested in venture capital fluctuates substantially from year to year: As one example, venture capital firms invested more than $48.3 billion in 2014, according to the National Venture Capital Association. All early-stage investors realize that the majority of small start-up businesses will never hit it big; indeed, many of them will go out of business within a few months or years. They also know that getting in on the ground floor of a few huge successes like a Netflix or an Amazon.com can make up for a lot of failures. Early-stage investors are therefore willing to take large risks in order to be in a position to gain substantial returns on their investment.

Profits As a Source of Financial Capital

If firms are earning profits (their revenues are greater than costs), they can choose to reinvest some of these profits in equipment, structures, and research and development. For many established companies, reinvesting their own profits is one primary source of financial capital. Companies and firms just getting started may have numerous attractive investment opportunities but few current profits to invest. Even large firms can experience a year or two of earning low profits or even suffering losses, but unless the firm can find a steady and reliable source of financial capital so that it can continue making real investments in tough times, the firm may not survive until better times arrive. Firms often need to find sources of financial capital other than profits.

Borrowing: Banks and Bonds

When a firm has a record of at least earning significant revenues or, better still, of earning profits, the firm can make a credible promise to pay interest, and so it becomes possible for the firm to borrow money. Firms have two main methods of borrowing: banks and bonds.

A bank loan for a firm works in much the same way as a loan for an individual who is buying a car or a house. The firm borrows an amount of money and then promises to repay it, including some rate of interest, over a predetermined period of time. If the firm fails to make its loan payments, the bank (or banks) can often take the firm to court and require it to sell its buildings or equipment to make the loan payments.

Another source of financial capital is a bond. A **bond** is a financial contract: A borrower agrees to repay the amount that was borrowed and also a rate of interest over a period of time in the future. A **corporate bond** is issued by firms, but bonds are also issued by various levels of government. For example, a municipal bond is issued by cities, a state bond by U.S. states, and a Treasury bond (T-bond) by the federal government through the U.S. Department of the Treasury. A bond specifies an amount that will be borrowed, the interest rate that will be paid, and the time until repayment.

A large company, for example, might issue bonds for $10 million; the firm promises to make interest payments at an annual rate of 8 percent ($800,000 per year), and then, after ten years, it will repay the $10 million it originally borrowed. When a firm issues bonds, the total amount that is borrowed is divided up. A firm that seeks to borrow $50 million by issuing bonds might actually issue 10,000 bonds of $5,000 each. In this way, an individual investor could, in effect, loan the firm $5,000, or any multiple of that amount. Anyone who owns a bond and receives the interest payments is called a **bondholder**. If a firm issues bonds and fails to make the promised interest payments, the bondholders can take the firm to court and require it to pay, even if the firm needs to raise the money by selling buildings or equipment. However, there is no guarantee that the firm will have sufficient assets to pay off the bonds. The bondholders may get back only a portion of what they loaned the firm.

Two significant downsides to bank debt versus bonds are pricing and operating restrictions. The cost of capital tends to be higher and/or more variable than that on a bond. In an article for Investopedia, Nick Lioudis notes that "many chief financial officers (CFOs) view banks as lenders of last resort because of the restrictive debt covenants that banks place on direct corporate loans."[1] Restrictions that are designed to reduce the bank's debt risk may restrict the ability of the borrowing company to respond to changes in leadership or market conditions and represent a greater risk.

Bank borrowing is more customized than issuing bonds, so it often works better for relatively small firms. The bank can get to know the firm extremely well—often because the bank can monitor sales and expenses quite accurately by looking at deposits and withdrawals. Relatively large and well-known firms often issue bonds instead. They use bonds to raise new financial capital that pays for investments, or to raise capital to pay off old bonds, or to buy other firms. However, the idea that banks are usually used for relatively smaller loans and bonds for larger loans is not an ironclad rule: Sometimes groups of banks make large loans, and sometimes relatively small and lesser-known firms issue bonds.

PRactice Question

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Corporate Stock and Public Companies

A corporation is a business that "incorporates"—it is owned by shareholders that have limited liability for the debt of the company but share in its profits (and losses). Corporations may be private or public and may or may not have stock that is publicly traded. They may raise funds to finance their operations or new investments by raising capital through the sale of stock or the issuance of bonds.

Those who buy the stock become the owners, or shareholders, of the firm. **Stock** represents ownership of a firm; that is, a person who owns 100 percent of a company's stock, by definition, owns the entire company. The stock of a company is divided into shares. Corporate giants like IBM, AT&T, Ford, General Electric, Microsoft, Merck, and Exxon all have millions of shares of stock. In most large and well-known firms, no individual owns a majority of the shares of the stock. Instead, large numbers of shareholders—even those who hold thousands of shares—each have only a small slice of the overall ownership of the firm.

When a company is owned by a large number of shareholders, three important questions emerge:

1. How and when does the company get money from the sale of its stock?
2. What rate of return does the company promise to pay when it sells stock?
3. Who makes decisions in a company owned by a large number of shareholders?

First, a firm receives money from the sale of its stock only when the company sells its own stock to the public (the public includes individuals, mutual funds, insurance companies, and pension funds). A firm's first sale of stock to the public is called an initial public offering (**IPO**). The IPO is important for two reasons. For one, the IPO, and any stock issued thereafter, such as stock held as treasury stock (shares that a company keeps in their own treasury) or new stock issued later as a secondary offering, provides the funds to repay the early-stage investors, like the angel investors and the venture capital firms. A venture capital firm may have a 40 percent ownership in the firm. When the firm sells stock, the venture capital firm sells its part ownership of the firm to the public. A second reason for the importance of the IPO is that it provides the established company with financial capital for a substantial expansion of its operations.

Most of the time when corporate stock is bought and sold, however, the firm receives no financial return at all. If you buy shares of stock in General Motors, you almost certainly buy them from the current owner of those shares, and General Motors does not receive any of your money. This pattern should not seem particularly odd. After all, if you buy a house, the current owner gets your money, not the original builder of the house. Similarly, when you buy shares of stock, you are buying a small slice of ownership of the firm from the existing owner—and the firm that originally issued the stock is not a part of this transaction.

Second, when a firm decides to issue stock, it must recognize that investors will expect to receive a rate of return. That rate of return can come in two forms. A firm can make a direct payment to its shareholders, called a **dividend**. Alternatively, a financial investor might buy a share of stock in Walmart for $45 and then later sell that share of stock to someone else for $60, for a gain of $15. The increase in the value of the stock (or of any asset) between when it is bought and when it is sold is called a **capital gain**.

Third: Who makes the decisions about when a firm will issue stock, or pay dividends, or reinvest profits? To understand the answers to these questions, it is useful to separate firms into two groups: private and public.

A **private company** is owned by the people who run it on a day-to-day basis. A private company can be run by a single individual, in which case it is called a **sole proprietorship**, or it can be run by a group, in which case it is a **partnership**. A private company can also be a corporation or a limited liability corporation or LLC. A private company's stock is transferred privately, and is not for sale on a public stock exchange. For example, a private corporation may issue stock to employees as part of the compensation plan or incentive program. LLCs do not issue stock. A small law firm owned by one person, even if it employs additional lawyers, would be a sole proprietorship. A group of lawyers might create a LLC and share in ownership and profits. Most private companies are relatively small, but there are some large private corporations, with tens of billions of dollars in annual sales, that do not have publicly issued stock, such as farm-products dealer Cargill, the Mars candy company, and the Bechtel engineering and construction firm.

When a firm decides to sell stock, which in turn can be bought and sold by financial investors, it is called a **public company**. Shareholders own a public company. Since the shareholders are a very broad group, often consisting of thousands or even millions of investors, the shareholders vote for a board of directors, who in turn hire top executives to run the firm on a day-to-day basis. The more shares of stock a shareholder owns, the more votes that shareholder is entitled to cast for the company's board of directors.

In theory, the board of directors helps to ensure that the firm is run in the interests of the true owners—the shareholders. However, the top executives who run the firm have a strong voice in choosing the candidates who will be on their board of directors. After all, few shareholders are knowledgeable enough or have enough of a personal incentive to spend energy and money nominating alternative members of the board.

? Practice Question

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How Firms Choose between Sources of Financial Capital

There are clear patterns in how businesses raise financial capital. These patterns can be explained partly by the fact that buyers and sellers in a market do not both have complete and identical information. Those who are actually running a firm will almost always have more information about whether the firm is likely to earn profits in the future than outside investors who provide financial capital.

Any young start-up firm is a risk; indeed, some start-up firms are only a little more than an idea on paper. The firm's founders inevitably have better information about how hard they are willing to work, and whether the firm is likely to succeed, than anyone else. When the founders put their own money into the firm, they demonstrate a belief in its prospects. At this early stage, angel investors and venture capitalists try to get all the information they need, partly by getting to know the managers and their business plan personally and by giving them advice.

As a firm becomes at least somewhat established and its strategy appears likely to lead to profits in the near future, knowing the individual managers and their business plans on a personal basis becomes less important, because information has become more widely available regarding the company's products, revenues, costs, and profits. As a result, other outside investors who do not know the managers personally, like bondholders and shareholders, are more willing to provide financial capital to the firm.

At this point, a firm must often choose how to access financial capital. It may choose to borrow from a bank, issue bonds, or issue stock. The great disadvantage of borrowing money from a bank or issuing bonds is that the firm commits to scheduled interest payments, whether or not it has sufficient income. The great advantage of borrowing money is that the firm maintains control of its operations and is not subject to shareholders. Issuing stock involves selling off ownership of the company to the public and becoming responsible to a board of directors and the shareholders.

The benefit of issuing stock is that a small and growing firm increases its visibility in the financial markets and can access large amounts of financial capital for expansion, without worrying about paying this money back. If the firm is successful and profitable, the board of directors will need to decide upon a dividend payout or how to reinvest profits to further grow the company. Issuing and placing stock is expensive, requires the expertise of investment bankers and attorneys, and entails compliance with reporting requirements to shareholders and government agencies, such as the federal Securities and Exchange Commission.

? Practice Question

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11.14: Putting It Together- Financial Markets and System

Synthesis

Still have that dollar bill handy that you pulled out earlier when you learned about the Federal Reserve System? Do you think about it the same way you did before you completed this module? Perhaps you do, but now you should have a better understanding of what that dollar bill represents, how it came into existence, and where its value comes from. Money will always exist in some form, whether it's based on NFC technology in your iPhone or we go back to a barter system where we trade seashells for bread. It will still motivate people to work, study, achieve, and unfortunately even break the law. But, as you consider everything you have read and heard in this module, is it the money itself that is the motivator or the "store of value" that we work to obtain? In fact, you can look at that dollar bill and, really, it's just a piece of paper with a picture of a dead president on its face—it has no intrinsic value. So where is the value in the dollar bill you're holding? Is it that our society recognizes it as having value, and business and individuals are willing to "trade" your dollars for shoes, cars, houses, food, and the other things that you need or want in your day-to-day life? Yes, we could go back to trading chickens for shoes, but technology is pushing us further and further away from that model, and as the monetary system evolves, it's unlikely that it will become less complex. That's one big reason you've spent all this time understanding this thing that "makes the world go 'round."

Summary

This module covered the financial markets and system. Below is a summary of the topics covered in this module.

Money

Money serves three basic functions:

- **Medium of exchange**: because you can use it to buy the goods and services you want, everyone's willing to trade things for money.
- **Measure of value**: it simplifies the exchange process because it's a means of indicating how much something costs.
- **Store of value**: people are willing to hold on to it because they're confident that it will keep its value over time.
- Virtual currencies, such as BitCoin, are using the traditional concept of "money" but as an alternative to the established Federal Reserve System. Although gaining in popularity, these virtual currencies are unregulated and pose some serious risks to those using this medium of exchange.
- Cashless payment systems such as Google Wallet and ApplePay allow consumers to carry their "cash" in their mobile devices. As more retailers move to "tap to pay" or scanning QR codes to complete transactions, the need to carry conventional paper money and coin diminishes. The question raised by this technology is not whether it will lead to a cashless society, but rather which mobile payment service will rise to the top and capture the market.

Role of Banks

- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.
- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
- A bank holds on to only a fraction of the money that it takes in—an amount called its **reserves**—and lends out the rest to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The **money multiplier** effect ensures that the cycle expands the money supply.

- Most large banks are members of the central banking system called the **Federal Reserve System** (commonly known as "the Fed").
- The Fed's goals include price stability, sustainable economic growth, and full employment. It uses *monetary policy* to regulate the money supply and the level of interest rates.
- To achieve these goals, the Fed has three tools:
  - it can raise or lower **reserve requirements**—the percentage of its funds that banks must set aside and can't lend out;
  - it can raise or lower the **discount rate**—the rate of interest that the Fed charges member banks to borrow "reserve" funds;
  - it can conduct **open market operations**—buying or selling government securities on the open market.

Financial Markets and Business

The four main ways that businesses raise financial capital are:

- **Early-stage capital**: business owner uses his/her own money or seeks money from an angel investor or venture capital firm
- **Profits**: profits from the business are reinvested in equipment, structures, research and development, etc.
- **Bonds:** a way to raise capital through borrowing, used by corporations and governments; an investment for the bondholder that creates return through regular, fixed, or floating interest payments on the debt and the repayment of principal at maturity; traded on bond exchanges through brokers.
- **Stocks:** a way to raise capital by selling ownership or equity; an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value; traded on stock exchanges through member brokers.

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11.15: Discussion- Why Wanda Cares About the Federal Reserve—or Does She?

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Jamie picks Wanda up from the mall. When Wanda gets into the car, Jamie has the radio tuned to Public Radio. When Wanda reaches to change the station, Jamie stops her, explaining that she is listening to a report about a meeting of the Federal Reserve earlier that day. The reporter is talking about how the Federal Reserve is considering a potential increase in interest rates. Several economists are giving their opinions regarding the announcement. When the segment ends, Jamie changes the station. After thinking about what she has heard, Wanda asks Jamie, "Why do you and I care what the Federal Reserve does?"

For Discussion

- In this discussion forum, *you* need to answer Wanda's question. When putting together your response, consider the possible impact that increases/decreases in interest rates and the tightening/loosening of the money supply might have on Salty Pawz. Moreover, how might such decisions affect Wanda personally and as a business owner?

After considering the impact of the actions of the Federal Reserve on Wanda and Salty Pawz, do you believe that the decisions of the Federal Reserve affect *you?* If so, in what ways might you experience this impact? If you do not believe the actions of the Federal Reserve affect you, then why not?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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11.16: Discussion- Do You Have Change for a $20?

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Quick—how much cash do you have on you right now? Check your wallet, purse, and pockets, and see what you have. Do you have enough to make change for a twenty-dollar bill? Not so long ago, you could ask a roomful of people that question, and most folks would have the cash on hand to make change. These days, it's less common. Think about the last five or six purchases you made. Did you pay with cash? Chances are good that you used a debit card or a credit card instead. Consider the possibility that someday debit and credit cards will disappear, too.

Technology has had a profound impact on our view of the necessity of cash. As we move towards a "cashless" society, the banking system is also challenged to adapt its processes and the services it provides.

Go beyond what you learned in the course module, and research some of the forms of "virtual currency" or cash alternatives that are currently available to consumers. Some of these include digital currencies, EFT, ACH transactions, iPay, Google Wallet, ePayments, direct draft.

For Discussion

1. Briefly explain the alternative form of payment that you researched and how it works as an alternative to traditional cash.
2. What are the advantages of this form of payment?
3. Are there disadvantages or risks associated with the form of payment that you researched?
4. As a consumer yourself, do you use any forms of cash alternatives? Which ones? Do you have concerns about the security of this payment method, and if so, what can you do to mitigate these?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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11.17: Assignment- Show Wanda the Money

Scenario

Salty Pawz was established using Wanda's personal funds, since she initially sold her products only to friends and family and was able to pay for everything as she went along. Now that the business is growing, she knows she cannot finance the expansion out of her own pocket, so she is considering taking out a loan. She has no experience with financial institutions, other than the basics such as managing her personal bank accounts, a credit card, a mortgage and a car loan, all of which are with the local credit union.

Your Task

Explain to Wanda how the monetary system works. In particular, describe the various financial institutions options she has for raising capital for her business. Be certain to explain the advantages and potential disadvantages of each funding method. could approach to seek funding.

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain the financial institutions and markets appropriate for Salty Pawz needs.	0 points	16.5 points	24 points	30 points	30%
Describe available loan options and processes required for Salty Pawz to obtain funds to expand.	0 points	16.5 points	24 points	30 points	30%
Identify your recommendation for the best loan option based on Salty Pawz needs and goals.	0 points	11 points	16 points	20 points	20%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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11.18: Assignment- The Most Powerful Person in the World

Preparation

You could make a very convincing argument that the person who serves as chair of the Federal Reserve is the most powerful person in the world, since he/she directs the monetary policy of the United States. Considering that most of the world's countries rely on the value of the U.S. dollar to conduct international trade and value their own currency, what the U.S. does with its fiscal policy has a ripple effect around the globe. This is what you will explore this week.

1. Follow the link to read a condensed version of an interview on National Public Radio that gives a great overview of the power of the Fed.
2. Watch the following video about the U.S. Federal Reserve:

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "The U.S. Federal Reserve Bank" (opens in a new window).

Having gotten a good idea of what the Federal Reserve System is and what it does, now it's your turn to do some research.

Your Task

1. Using the Internet, research one of the powers, policies, or people involved in the Federal Reserve System. Some suggestions: quantitative easing, selection of the new Fed chair, Fed policies in response to financial crisis.
2. Locate an article from a *credible* source regarding *recent* Federal Reserve activities. (Source must not be more than twelve months old.)
3. Summarize the article, and make sure to include the link to it.
4. In addition, answer the following questions:

- Does your article support the idea that the chair of the Federal Reserve is one of the most powerful positions in the U.S. (and possibly the world)?
- If so, in what way(s)?
- If not, in what way(s)?

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CHAPTER OVERVIEW

12: Module 4 Readings - Entrepreneurship

12.1: Reading- The Importance of Small Business to the U.S. Economy

What Is a "Small Business"?

To assess the value of small businesses to the U.S. economy, first we need to know what constitutes a small business. Let's start by looking at the criteria used by the Small Business Administration. According to the SBA, a small business is one that is independently owned and operated, exerts little influence in its industry, and (with a few exceptions) has fewer than five hundred employees ("What is SBAs Definition of a Small Business Concern?," U.S. Small Business Administration, accessed August 28, 2011).

Why Are Small Businesses Important?

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

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

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

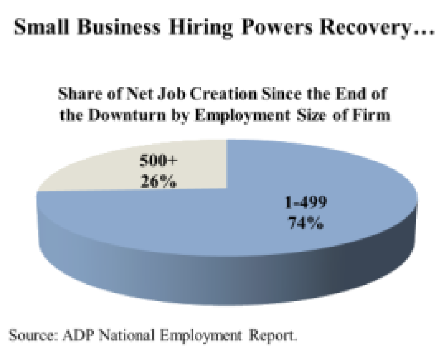
In addition, they complement the economic activity of large organizations by providing them with components, services, and distribution of their products.

Let's take a closer look at each of these contributions.

Job Creation

The majority of U.S. workers first entered the business world working for small businesses. According to the U.S. Small Business Administration:

"The United States' 28.4 million small businesses play a vital role in our economy," said Christine Kymn, Advocacy's chief economist and director of economic research. "Small businesses represent 99.7 percent of all U.S. businesses with employees and employ about 56 million members of the nation's private-sector workforce. The Office of Advocacy notes that this year's state profiles signal improving conditions for small businesses and in turn, their respective state economies. We hope to see further improvements in 2015" (SBA, Small Business Advocate, February, 2015 Vol. 34 Issue 2).



On January 15,2015 **Maria Contreras-Sweet**, SBA Administrator reported the following in regard to job creation and small business:

American businesses added back 252,000 jobs and the unemployment rate fell to its lowest level since June 2008. We're in the midst of 58 month of consecutive job growth—the longest streak on record since the mid-1990s. Once again, it was not large corporations driving this train, but entrepreneurs and small businesses powering us out of the greatest economic crisis since the Great Depression. Small businesses created nearly 2 million of the roughly 3 million private-sector jobs generated in 2014. More than 7 million of the 11 million jobs created during our recovery have been generated by startups and small enterprises. . . . Entrepreneurs have been our life preserver in this economic storm, because of their resilience in budgeting wisely and effectively deploying their capital.

Innovation

Given the financial resources available to large businesses, you'd expect them to introduce virtually all the new products that hit the market. According to the SBA, small companies develop more patents per employee than do larger companies. During a recent four-year period, large firms generated 1.7 patents per hundred employees, whereas small firms generated an impressive 26.5 patents per employee (Anthony Breitzman and Diana Hicks, "An Analysis of Small Business Patents by Industry and Firm Size, Office of Advocacy, Small Business Administration," U.S. Small Business Administration, accessed August 30, 2011). Over the years, the list of important innovations by small firms has included the airplane and air-conditioning, the defibrillator and DNA fingerprinting, oral contraceptives and overnight national delivery, the safety razor, strobe lights, and the zipper (William J. Baumol, "Small Firms: Why Market-Driven Innovation Can't Get Along without Them," U.S. Small Business Administration, Office of Advocacy, December 2005, table 8.1, 186, accessed October 10, 2008).

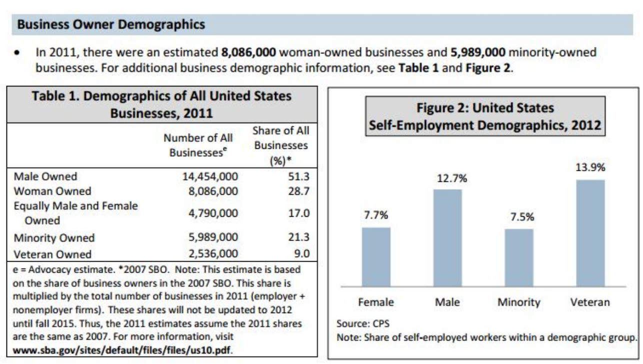
Small business owners are also particularly adept at finding new ways of doing old things. In 1994, for example, a young computer-science graduate working on Wall Street came up with the novel idea of selling books over the Internet. During the first year of operations, sales at Jeff Bezos's new company—Amazon.com—reached half a million dollars. In less than twenty years, annual sales had topped $34 billion

Why are small businesses so innovative? For one thing, they tend to offer environments that appeal to individuals with the talent to invent new products or improve the way things are done. Fast decision making is encouraged, their research programs tend to be focused, and their compensation structures typically reward top performers. According to one SBA study, the supportive environments of small firms are roughly thirteen times more innovative per employee than the less innovation-friendly environments in which large firms traditionally operate (William J. Baumol, "Small Firms: Why Market-Driven Innovation Can't Get Along without Them," U.S. Small Business Administration, Office of Advocacy, December 2005, accessed October 10, 2008, p 187).

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

Opportunities for Women and Minorities

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



Business Owner Demographics

- In 2011, there were an estimated **8,086,000** woman-owned businesses and **5,989,000** minority-owned businesses. For additional business demographic information, see **Table 1** and **Figure 2**.

Table 1. Demographics of All United States Businesses, 2011

	Number of All Businesses[e]	Share of All Businesses (%)*
Male Owned	14,454,000	51.3
Woman Owned	8,086,000	28.7
Equally Male and Female Owned	4,790,000	17.0
Minority Owned	5,989,000	21.3
Veteran Owned	2,536,000	9.0

e = Advocacy estimate. *2007 SBO. Note: This estimate is based on the share of business owners in the 2007 SBO. This share is multiplied by the total number of businesses in 2011 (employer + nonemployer firms). These shares will not be updated to 2012 until fall 2015. Thus, the 2011 estimates assume the 2011 shares are the same as 2007. For more information, visit **www.sba.gov/sites/default/files/files/us10.pdf**.

Figure 12.1.2: Business Owner Demographics. Source: US SBA, June 2014. http://www.sba.gov/advocacy/848. Public domain

What Small Businesses Do for Big Businesses

Small firms complement large firms in a number of ways. They supply many of the components needed by big companies. For example, the U.S. automakers depend on more than 1,700 suppliers to provide them with the parts needed to make their cars. While many of the suppliers are large, there are hundreds of smaller companies that provide a substantial portion of the 8,000 to 12,000 parts that go into each vehicle (Bill Canis and Brent D. Yacobucci, "The U.S. Motor Vehicle Industry: Confronting a New Dynamic in the Global Economy, Congressional Research Service," Federation of American Scientists, accessed August 30, 2011). Small firms also provide large ones with such services as accounting, legal, and insurance. Many small firms provide *outsourcing* services to large firms—that is, they hire themselves out to help with special projects or handle certain business functions. A large firm, for example, might hire a small one to handle its billing or collection services or to manage its health care benefits. A large company might contract with a small information technology firm to manage its Web site or oversee software upgrades.

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

KEY TAKEAWAYS

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/191

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12.2: Reading- What Is an Entrepreneur?

What Is an Entrepreneur?

We are going to start our discussion of what an entrepreneur is by taking a look at one: David Fox. As you will see, for this schoolteacher, board games aren't just a hobby—they're a way of life. David Fox travels to toy fairs pitching his ideas in hopes of landing a deal that will turn his big dreams into reality.

The Nature of Entrepreneurship

If we look a little more closely at the definition of entrepreneurship, we can identify three characteristics of entrepreneurial activity (adapted from Marc J. Dollinger, *Entrepreneurship*: *Strategies and Resources*, 3rd ed, Upper Saddle River, NJ: Prentice Hall, 2003, pp 5–7):

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

It isn't hard to recognize all three of these characteristics in the entrepreneurial experience of the Jurmains. They certainly had an *innovative* idea. But was it a *good* business idea? In a practical sense, a "good" business idea has to become something more than just an idea. If, like the Jurmains, you're interested in generating income from your idea, you'll probably need to turn it into a *product*—something that you can market because it satisfies a need. If—again, like the Jurmains—you want to develop a product, you'll need some kind of organization to coordinate the resources necessary to make it a reality (in other words, a *business*). Risk enters the equation when, like the Jurmains, you make the decision to start up a business and when you commit yourself to managing it.

A Few Things to Know About Going into Business for Yourself

So what about you? Do you ever wonder what it would be like to start your own business? Maybe you want to try your hand at entrepreneurship. You could be the next Larry Page or Sergey Brin, cofounders of Google. Or the next David Marcks, a golf course manager who came up with the idea of Geese Police—training dogs to chase geese from golf courses, corporate parks, and municipal playgrounds (Isabel M. Isidro, "Geese Police: A Real-Life Home Business Success Story," *PowerHomeBiz.com* (2008), accessed August 31, 2011). Or even the next Pierre Omidyar, the French-born software developer who built an online venue for person-to-person auctions, known as eBay. (See American Academy of Achievement, "Pierre Omidyar," *Academy of Achievement* (November 9, 2005), accessed October 8, 2008).

Figure 12.2.1: Mark Zuckerberg founded Facebook while a student at Harvard and, by age 27, has built up a personal wealth of $13.5 billion. Photo by Robert Scoble via Wikimedia Commons.

You might even turn into a "serial entrepreneur" like Marcia Kilgore (Encyclopedia of World Biography, s.v. "Marcia Kilgore: Entrepreneur and spa founder," accessed August 29, 2011). After high school, she moved from Canada to New York City to attend Columbia University. But when her financial aid was delayed, she abandoned her plans to attend college and took a job as a personal trainer (a natural occupation for a former bodybuilder and middleweight title holder). But things got boring in the summer when her wealthy clients left the city for the Hamptons. To keep busy, she took a skin-care course at a Manhattan cosmetology institute. As a teenager, she was self-conscious about her bad complexion and wanted to know how to treat it herself. She learned how to give facials and work with natural remedies. Her complexion improved, and she started giving facials to her fitness clients who were thrilled with the results. As demand for her services exploded, she started her first business—Bliss Spa—and picked up celebrity clients, including Madonna, Oprah Winfrey, and Jennifer Lopez. The business went international, and she sold it for more than $30 million (Jessica Bruder, "The Rise Of The Serial Entrepreneur," *Forbes*, August 12, 2010, accessed August 29, 2011).

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

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

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

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

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12.3: Reading- Why Start Your Own Business?

Why Start Your Own Business?

Let's say that you are interested in the idea of going into business for yourself. Not everyone, of course, has a desire to take the risks and put in the work involved in starting up a business. What sort of characteristics distinguishes those who do from those who don't want to start a business? Or, more to the point, why do some people actually follow through on the desire to start up their own businesses? According to the Small Business Administration (SBA), a government agency that provides assistance to small businesses, the most common reasons for starting a business are the following (U.S. Small Business Administration, "First Steps: How to Start a Small Business," accessed April 21, 2006):

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

The Small Business Administration points out, though, that these are likely to be advantages only "for the right person." And how do you know if you're one of the "right people"? The SBA suggests that you assess your strengths and weaknesses by asking yourself a few relevant questions (U.S. Small Business Administration, "Is Entrepreneurship for You?" accessed August 31, 2011).

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

Later we'll take up the question of why businesses fail, but since we're still talking about the pros and cons of starting a business in the first place, we should consider one more issue: in addition to the number of businesses that start and then fail, a huge number of business ideas never even make it to the grand opening. One business analyst cites four reservations (or *fears*) that prevent people from starting businesses (Shari Waters, "Top Four Reasons People Don't Start a Business," About.com, accessed October 8, 2008):

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

If you're still interested in going into business for yourself, feel free to regard these potential drawbacks as mere obstacles than can be overcome by a combination of planning and creative thinking. The following short video is an example of the entrepreneurial spirit triumphing over such challenges.

KEY TAKEAWAYS

- An **entrepreneur** is someone who identifies a business opportunity and assumes the risk of creating and running a business to take advantage of it.
- There are three characteristics of entrepreneurial activity:
  - *Innovating*. An entrepreneur offers a new product, applies a new technique or technology, opens a new market, or develops a new form of organization for the purpose of producing or enhancing a product.
  - *Running a business*. Entrepreneurship means setting up a business to make a profit from an innovative product or process.
  - *Risk taking*. Risk means that an outcome is unknown. Entrepreneurs, therefore, are always working under a certain degree of uncertainty, and they can't know the outcomes of many of the decisions that they have to make.
- According to the **SBA**, a government agency that provides assistance to small businesses, there are five advantages to starting a business—"for the right person":
  - Be your own boss.
  - Accommodate a desired lifestyle.
  - Achieve financial independence.
  - Enjoy creative freedom.
  - Use your skills and knowledge.
- To determine whether you're one of the "right people" to exploit the advantages of starting your own business, the SBA suggests that you assess your strengths and weaknesses by asking yourself the following questions:
  - Am I a self-starter?
  - How well do I get along with different personalities?
  - How good am I at making decisions?
  - Do I have the physical and emotional stamina?
  - How well do I plan and organize?
  - Is my drive strong enough?
  - How will my business affect my family?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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12.4: Reading- Advantages and Disadvantages of Business Ownership

Advantages of Small Business Ownership

Do you want to be a business owner someday? Before deciding, you might want to consider the following advantages and disadvantages of business ownership (Small Business Development Center, "Pros and Cons of Owning a Business," accessed April 21, 2006).

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

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

Disadvantages of Small Business Ownership

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

- *Financial risk*. The financial resources needed to start and grow a business can be extensive. You may need to commit most of your savings or even go into debt to get started. If things don't go well, you may face substantial financial loss. In addition, there's no guaranteed income. There might be times, especially in the first few years, when the business isn't generating enough cash for you to live on.
- *Stress*. As a business owner, you *are* the business. There's a bewildering array of things to worry about—competition, employees, bills, equipment breakdowns, customer problems. As the owner, you're also responsible for the well-being of your employees.
- *Time commitment*. People often start businesses so that they'll have more time to spend with their families. Unfortunately, running a business is extremely time-consuming. In theory, you have the freedom to take time off, but in reality, you may not be able to get away. In fact, you'll probably have less free time than you'd have working for someone else. For many entrepreneurs and small business owners, a forty-hour workweek is a myth; see Figure 1, "The Entrepreneur's Workweek." Vacations will be difficult to take and will often be interrupted. In recent years, the difficulty of getting away from the job has been compounded by cell phones, iPhones, Internet-connected laptops and iPads, and many small business owners have come to regret that they're always reachable.
- *Undesirable duties*. When you start up, you'll undoubtedly be responsible for either doing or overseeing just about everything that needs to be done. You can get bogged down in detail work that you don't enjoy. As a business owner, you'll probably have to perform some unpleasant tasks, like firing people.

In spite of these and other disadvantages, most small business owners are pleased with their decision to start a business. A survey conducted by the *Wall Street Journal* and Cicco and Associates indicates that small business owners and top-level corporate executives agree overwhelmingly that small business owners have a more satisfying business experience. Interestingly, the researchers had fully expected to find that small business owners were happy with their choices; they were, however, surprised at the number of corporate executives who believed that the grass was greener in the world of small business ownership (Cicco and Associates Inc., "Type E Personality—Happy Days—Entrepreneurs Top Satisfaction Survey," *Entrepreneur.com*, accessed April 21, 2006).

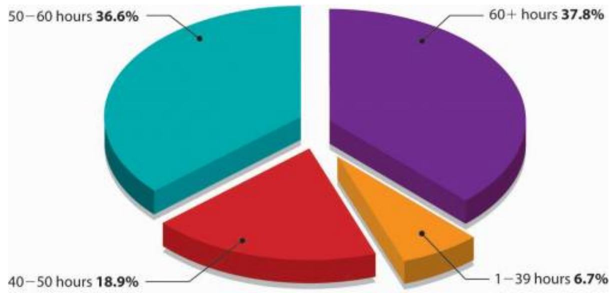

Figure 12.4.1: Copy and Paste Caption here. (Copyright; author via source)

KEY TAKEAWAYS

- There are several advantages that, generally speaking, come with success in business ownership:
  - *Independence*. As a business owner, you're your own boss.
  - *Lifestyle*. Because you're in charge, you decide when and where you want to work.
  - *Financial rewards*. In spite of high financial risk, running your own business gives you a chance to make more money than if you were employed by someone else.
  - *Learning opportunities*. As a business owner, you'll be involved in all aspects of your business.
  - *Creative freedom and personal satisfaction*. As a business owner, you'll be able to work in a field that you really enjoy, and you'll gain personal satisfaction from watching your business succeed.
- There are also a number of potential disadvantages to consider in deciding whether to start a small business:
  - *Financial risk*. The financial resources needed to start and grow a business can be extensive, and if things don't go well, you may face substantial financial loss. In addition, you'll have no guaranteed income.
  - *Stress*. You'll have a bewildering array of things to worry about—competition, employees, bills, equipment breakdowns, customer problems.
  - *Time commitment*. Running a business is extremely time-consuming. In fact, you'll probably have less free time than you'd have working for someone else.
  - *Undesirable duties*. You'll be responsible for either doing or overseeing just about everything that needs to be done, and you'll probably have to perform some unpleasant tasks, like firing people.

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12.5: Reading- Is Entrepreneurship for You?

Is Entrepreneurship for You?

Starting your own business can be an exciting and rewarding experience. It can offer numerous advantages such as being your own boss, setting your own schedule, and making a living doing something you enjoy. However, becoming a successful entrepreneur requires thorough planning, creativity, and hard work.

Consider whether you have the following characteristics and skills commonly associated with successful entrepreneurs:

- **Comfortable with taking risks:** Being your own boss also means you're the one making tough decisions. Entrepreneurship involves uncertainty. Do you avoid uncertainty in life at all costs? If yes, then entrepreneurship may not be the best fit for you. Do you enjoy the thrill of taking calculated risks? Then read on.
- **Independent:** Entrepreneurs have to make a lot of decisions on their own. If you find you can trust your instincts — and you're not afraid of rejection every now and then — you could be on your way to being an entrepreneur.
- **Persuasive:** You may have the greatest idea in the world, but if you cannot persuade customers, employees and potential lenders or partners, you may find entrepreneurship to be challenging. If you enjoy public speaking, engage new people with ease and find you make compelling arguments grounded in facts, it's likely you're poised to make your idea succeed.
- **Able to negotiate:** As a small business owner, you will need to negotiate everything from leases to contract terms to rates. Polished negotiation skills will help you save money and keep your business running smoothly.
- **Creative:** Are you able to think of new ideas? Can you imagine new ways to solve problems? Entrepreneurs must be able to think creatively. If you have insights on how to take advantage of new opportunities, entrepreneurship may be a good fit.
- **Supported by others:** Before you start a business, it's important to have a strong support system in place. You'll be forced to make many important decisions, especially in the first months of opening your business. If you do not have a support network of people to help you, consider finding a business mentor. A business mentor is someone who is experienced, successful and willing to provide advice and guidance.

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12.6: Reading- Twenty Questions Before Starting a Business

Twenty Questions Before Starting a Business

So you've got what it takes to be an entrepreneur? Now, ask yourself these twenty questions to make sure you're thinking about the key business decisions:

1. Why am I starting a business?
2. What kind of business do I want?
3. Who is my ideal customer?
4. What products or services will my business provide?
5. Am I prepared to spend the time and money needed to get my business started?
6. What differentiates my business idea and the products or services I will provide from others in the market?
7. Where will my business be located?
8. How many employees will I need?
9. What types of suppliers do I need?
10. How much money do I need to get started?
11. Will I need to get a loan?
12. How soon will it take before my products or services are available?
13. How long do I have until I start making a profit?
14. Who is my competition?
15. How will I price my product compared to my competition?
16. How will I set up the legal structure of my business?
17. What taxes do I need to pay?
18. What kind of insurance do I need?
19. How will I manage my business?
20. How will I advertise my business?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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12.7: Reading- Ten Steps to Starting a Business

Ten Steps to Starting a Business

Starting a business involves planning, making key financial decisions, and completing a series of legal activities. These ten easy steps can help you plan, prepare, and manage your business.

Step 1: Write a Business Plan

A business plan generally contains the following parts (which we will expand on later):

- Executive Summary
- Company Description
- Market Analysis
- Organization and Management
- Service or Product Line
- Marketing and Sales
- Funding Request
- Financial Projections
- Appendix

Step 2: Get Business Assistance and Training

Take advantage of free training and counseling services, from preparing a business plan and securing financing, to expanding or relocating a business.

Step 3: Choose a Business Location

Get advice on how to select a customer-friendly location and comply with zoning laws.

Choosing a business location is perhaps the most important decision a small business owner or startup will make, so it requires precise planning and research. It involves looking at demographics, assessing your supply chain, scoping the competition, staying on budget, understanding state laws and taxes, and much more.

Here are some tips to help you choose the right business location.

Determine Your Needs

Most businesses choose a location that provides exposure to customers. Additionally, there are less obvious factors and needs to consider, such as the following:

- **Brand Image**—Is the location consistent with the image you want to maintain?
- **Competition**—Are the businesses around you complementary or competing?
- **Local Labor Market—**Does the area have potential employees? What will their commute be like?
- **Plan for Future Growth**—If you anticipate further growth, look for a building that has extra space should you need it.
- **Proximity to Suppliers**—They need to be able to find you easily as well.
- **Safety**—Consider the crime rate. Will employees feel safe alone in the building or walking to their vehicles?
- **Zoning Regulations—**These determine whether you can conduct your type of business in certain properties or locations. You can find out how property is zoned by contacting your local planning agency.

Evaluate Your Finances

Besides determining what you can afford, you will need to be aware of other financial considerations:

- **Hidden Costs**—Very few spaces are business ready. Include costs like renovation, decorating, IT system upgrades, and so on.
- **Taxes—**What are the income and sales tax rates for your state? What about property taxes? Could you pay less in taxes by locating your business across a nearby state line?
- **Minimum Wage**—While the federal minimum wage is $7.25 per hour, many states have a higher minimum. View the Department of Labor's list of minimum wage rates by state.
- **Government Economic Incentives**—Your business location can determine whether you qualify for government economic business programs, such as state-specific small business loans and other financial incentives.

Is the Area Business Friendly?

Understanding laws and regulations imposed on businesses in a particular location is essential. As you look to grow your business, it can be advantageous to work with a small business specialist or counselor. Check what programs and support your state government and local community offer to small businesses. Many states offer online tools to help small business owners start up and succeed. Local community resources such as SBA Offices, Small Business Development Centers, Women's Business Centers, and other government-funded programs specifically support small businesses.

The Bottom Line

Do your research. Talk to other business owners and potential co-tenants. Consult the small business community and utilize available resources, such as free government-provided demographic data, to help in your efforts.

Step 4: Finance Your Business

SBA offers a variety of loan programs for very specific purposes. Take some time to study the programs described on this website to learn more about which types of businesses qualify for different loans.

Step 5: Determine the Legal Structure of Your Business

Decide which form of ownership is best for you: sole proprietorship, partnership, Limited Liability Company (LLC), corporation, S corporation, nonprofit or cooperative.

Determine Your Federal Tax Obligations

When starting a business, you must decide what form of business entity to establish. Your form of business (e.g., sole proprietorship, partnership, LLC) determines which income tax return form you have to file. The federal government levies four basic types of business taxes:

- Income tax
- Self-employment tax
- Taxes for employers
- Excise taxes

To learn more about these taxes, visit the Internal Revenue Service's (IRS) Guide to Business Taxes.

Federal Income Taxes

Select the form of your business below to find out which federal tax forms you need to file:

- Sole Proprietorship
- Partnership
- Corporation
- S Corporation
- Limited Liability Company (LLC)

State Income Taxes

Nearly every state levies a business or corporate income tax. Like federal taxes, your state tax requirement depends on the legal structure of your business. For example, if your business is an LLC, the LLC is taxed separately from the owners of the business, while sole proprietors report their personal and business income taxes using the same form used to report their business taxes. Consult the General Tax Information link on the State and Local Tax Guide for specific requirements.

Step 6: Register a Business Name ("Doing Business As")

Register your business name with your state government. Naming your business is an important branding exercise, but if you choose to name your business as anything other than your own personal name then you'll need to register it with the appropriate authorities.

This process is known as registering your "Doing Business As" (DBA) name.

What is a "Doing Business As" Name?

A fictitious name (or assumed name, trade name or DBA name) is a business name that is different from your personal name, the names of your partners or the officially registered name of your LLC or corporation.

It's important to note that when you form a business, the legal name of the business defaults to the name of the person or entity that owns the business, unless you choose to rename it and register it as a DBA name.

For example, consider this scenario: John Smith sets up a painting business. Rather than operate under his own name, John instead chooses to name his business: "John Smith Painting". This name is considered an assumed name and John will need to register it with the appropriate local government agency.

The legal name of your business is required on all government forms and applications, including your application for employer tax IDs, licenses and permits.

Do I Need a "Doing Business As" Name?

A DBA is needed in the following scenarios:

- **Sole Proprietors or Partnerships** – If you wish to start a business under anything other than your real name, you'll need to register a DBA so that you can do business as another name.
- **Existing Corporations or LLCs** – If your business is already set up and you want to do business under a name other than your existing corporation or LLC name, you will need to register a DBA.

Note: Not all states require the registering of fictitious business names or DBAs.

How to Register your "Doing Business As" Name

Registering your DBA is done either with your county clerk's office or with your state government, depending on where your business is located. There are a few states that do not require the registering of fictitious business names.

Step 7: Get a Tax Identification Number

Learn which tax identification number you'll need to obtain from the IRS and your state revenue agency. An Employer Identification Number (EIN) is also known as a Federal Tax Identification Number, and is used to identify a business entity. Generally, businesses need an EIN. You may apply for an EIN in various ways, and now you may apply online. You must check with your state to determine if you need a state number or charter. The following links will take you to the IRS's website for more information:

- Do You Need an EIN?
- Do You Need a ***New*** EIN?
- How to Apply for an EIN
- How Long Will it Take to Get a Number?
- Lost or Misplaced Your EIN?
- How EINs are Assigned and Valid EIN Prefixes
- Canceling an EIN—Closing Your Account
- Who is a Responsible Party?

You can apply for an EIN online.

Step 8: Register for State and Local Taxes

Register with your state to obtain a tax identification number, workers' compensation, unemployment and disability insurance.

Determine Your State Tax Obligations

In addition to business taxes required by the federal government, you will have to pay some state and local taxes. Each state and locality has its own tax laws. The links below provide access to key resources that will help you learn about your state tax obligations. Having knowledge of your state tax requirement can help you avoid problems and your business save money. The most common types of tax requirements for small business are income taxes and employment taxes.

Income Taxes

Nearly every state levies a business or corporate income tax. Your tax requirement depends on the legal structure of your business. For example, if your business is a Limited Liability Company (LLC), the LLC gets taxed separately from the owners, while sole proprietors report their personal and business income taxes using the same form. Consult the General Tax Information link under your state for specific requirements.

Employment Taxes

In addition to federal employment taxes, business owners with employees are also responsible for paying certain taxes required by the state. All states require payment of state workers' compensation insurance and unemployment insurance taxes. The following states/territories also require a business to pay for temporary disability insurance:

- California
- Hawaii
- New Jersey
- New York
- Rhode Island
- Puerto Rico
- State and Territory Tax Resources

Each state requires different steps and forms in order to register and be open for business. In general, you can look for these four things:

- Business Tax Registration
- General Tax Information and Forms
- Workers' Compensation Insurance
- Unemployment Insurance Tax

Step 9: Obtain Business Licenses and Permits

Get a list of federal, state and local licenses and permits required for your business.

Federal Licenses and Permits

If your business is involved in activities supervised and regulated by a federal agency—such as selling alcohol, firearms, commercial fishing, etc.—then you may need to obtain a federal license or permit. Here is a brief list of business activities that require these forms and information on how to apply.

In addition, you can also discover which general business permits, licenses and registrations required by your state, county or city.

Agriculture

If you import or transport animals, animal products, biologics, biotechnology or plants across state lines, you'll need to apply for a permit from the U.S. Department of Agriculture (USDA).

Alcoholic Beverages

If you manufacture, wholesale, import, or sell alcoholic beverages at a retail location, you will need to register your business and obtain certain federal permits (for tax purposes) with the U.S. Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB). The website has a number of online tools that make this process straightforward. If you are just starting a business in this trade, start by reading the TTB's New Visitors Guide which offers helpful information for small business owners.

Remember, you will also need to contact your local Alcohol Beverage Control Board for local alcohol business permit and licensing information.

Aviation

Does your business involve the operation of aircraft; the transportation of goods or people via air; or aircraft maintenance? If so, you'll need to apply for one or more of the following licenses and certificates from the Federal Aviation Administration:

- FAA Licenses and Certificates – Get licensing information for airmen, aircraft, airports, airlines and medical aviation services.
- Pilot Licenses and Training Requirements
- Aircraft Mechanic Licenses

Firearms, Ammunition, and Explosives

Businesses who manufacture, deal and import firearms, ammunitions and explosives must comply with the Gun Control Act's licensing requirements. The Act is administered by the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF). Refer to the following resources from the ATF to make sure your business is properly licensed:

- Firearms Industry Guide – Includes information on obtaining and renewing a federal firearms license, importing firearms and ammunitions, and more.

- Explosives Industry Guide – Find out how to get a federal explosives license.
- How to Become a Federal Firearms Licensee (FFL)
- How to Become a Federal Explosives Licensee (FEL)

Fish and Wildlife

If your business is engaged in any wildlife related activity, including the import/export of wildlife and derivative products, must obtain an appropriate permit from the U.S. Fish and Wildlife Service.

Commercial Fisheries

Commercial fishing businesses are required to obtain a license for fishing activities from the NOAA Fisheries Service. This guide includes quick links to permit applications and information.

Maritime Transportation

If you provide ocean transportation or facilitate the shipment of cargo by sea, you'll need to apply here for a license from the Federal Maritime Commission.

Mining and Drilling

Businesses involved in the drilling for natural gas, oil or other mineral resources on federal lands may be required to obtain a drilling permit from the Bureau of Ocean Energy Management, Regulation and Enforcement (formerly the Minerals Management Service).

Nuclear Energy

Producers of commercial nuclear energy and fuel cycle facilities as well as businesses involved in the distribution and disposal of nuclear materials must apply for a license from the U.S. Nuclear Regulatory Commission

Radio and Television Broadcasting

If your business broadcasts information by radio, television, wire, satellite and cable, you may be required to obtain a license from The Federal Communications Commission (FCC).

Transportation and Logistics

If you operate an oversize or overweight vehicle, you'll need to abide by the U.S. Department of Transportation offers guidelines on maximum weight. Permits for oversize/overweight vehicles are issued by your state government.

State Licenses and Permits

Starting a business? Confused about whether you need a business license or permit?

Virtually every business needs some form of license or permit to operate legally. However, licensing and permit requirements vary depending on the type of business you are operating, where it's located, and what government rules apply.

To help you identify the specific licenses or permits your business may need, simply select a state from the list below to learn about specific license and permit requirements in the area where your business is located.

State Business License Offices

State Business License Offices		
• Alabama • Alaska • Arizona • Arkansas • California • Colorado • Connecticut • Delaware • District of Columbia • Florida • Georgia • Guam • Hawaii • Idaho • Illinois • Indiana • Iowa • Kansas	• Kentucky • Louisiana • Maine • Maryland • Massachusetts • Michigan • Minnesota • Mississippi • Missouri • Montana • Nebraska • Nevada • New Hampshire • New Jersey • New Mexico • New York • North Carolina • North Dakota	• Ohio • Oklahoma • Oregon • Pennsylvania • Puerto Rico • Rhode Island • South Carolina • South Dakota • Tennessee • Texas • U.S. Virgin Islands • Utah • Vermont • Virginia • Washington • West Virginia • Wisconsin • Wyoming

Step 10: Understand Employer Responsibilities

Learn the legal steps you need to take to hire employees. If your business is booming, but you are struggling to keep up, perhaps it's time to hire some help.

The eight steps below can help you start the hiring process and ensure you are compliant with key federal and state regulations.

Step 1: Obtain an Employer Identification Number (EIN)

Before hiring your first employee, you need to get an employment identification number (EIN) from the U.S. Internal Revenue Service. The EIN is often referred to as an Employer Tax ID or as Form SS-4. The EIN is necessary for reporting taxes and other documents to the IRS. In addition, the EIN is necessary when reporting information about your employees to state agencies. Apply for EIN online or contact the IRS at 1-800-829-4933.

Step 2: Set up Records for Withholding Taxes

According to the IRS, you must keep records of employment taxes for at least four years. Keeping good records can also help you monitor the progress of your business, prepare financial statements, identify sources of receipts, keep track of deductible expenses, prepare your tax returns, and support items reported on tax returns.

Below are three types of withholding taxes you need for your business:

- **Federal Income Tax Withholding**—Every employee must provide an employer with a signed withholding exemption certificate (Form W-4) on or before the date of employment. The employer must then submit Form W-4 to the IRS. For specific information, read the IRS' Employer's Tax Guide [PDF].
- **Federal Wage and Tax Statement—**Every year, employers must report to the federal government wages paid and taxes withheld for each employee. This report is filed using Form W-2, wage and tax statement. Employers must complete a W-2 form for each employee who they pay a salary, wage or other compensation.

Employers must send Copy A of W-2 forms to the Social Security Administration by the last day of February to report wages and taxes of your employees for the previous calendar year. In addition, employers should send copies of W-2 forms to their employees by Jan. 31 of the year following the reporting period.

- **State Taxes—**Depending on the state where your employees are located, you may be required to withhold state income taxes.

Step 3: Employee Eligibility Verification

Federal law requires employers to verify an employee's eligibility to work in the United States. Within three days of hire, employers must complete Form I-9, employment eligibility verification, which requires employers to examine documents to confirm the employee's citizenship or eligibility to work in the U.S. Employers can only request documentation specified on the I-9 form.

Employers do not need to submit the I-9 form with the federal government but are required to keep them on file for three years after the date of hire or one year after the date of the employee's termination, whichever is later.

Employers can use information taken from the Form I-9 to electronically verify the employment eligibility of newly hired employees by registering with **E-Verify**.

Visit the U.S. Immigration and Customs Enforcement agency's I-9 website to download the form and find more information.

Step 4: Register with Your State's New Hire Reporting Program

All employers are required to report newly hired and re-hired employees to a state directory within 20 days of their hire or rehire date. Visit the New Hires Reporting Requirements page to learn more and find links to your state's New Hire Reporting System.

Step 5: Obtain Workers' Compensation Insurance

All businesses with employees are required to carry workers' compensation insurance coverage through a commercial carrier, on a self-insured basis or through their state's Workers' Compensation Insurance program.

Step 6: Post Required Notices

Employers are required to display certain posters in the workplace that inform employees of their rights and employer responsibilities under labor laws. Visit the Workplace Posters page for specific federal and state posters you'll need for your business.

Step 7: File Your Taxes

Generally, employers who pay wages subject to income tax withholding, Social Security and Medicare taxes must file IRS Form 941, Employer's Quarterly Federal Tax Return. For more information, visit IRS.gov.

New and existing employers should consult the IRS Employer's Tax Guide to understand all their federal tax filing requirements.

Visit the state and local tax page for specific tax filing requirements for employers. [1]

Step 8: Get Organized and Keep Yourself Informed

Being a good employer doesn't stop with fulfilling your various tax and reporting obligations. Maintaining a healthy and fair workplace, providing benefits and keeping employees informed about your company's policies are key to your business' success. Here are some additional steps you should take after you've hired your first employee:

Set up Recordkeeping

In addition to requirements for keeping payroll records of your employees for tax purposes, certain federal employment laws also require you to keep records about your employees. Complying with standards for employee rights in regards to equal opportunity and fair labor standards is a requirement. Following statutes and regulations for minimum wage, overtime, and child labor will help you avoid error and a lawsuit. See the Department of Labor's Employment Law Guide for up-to-date information on these statutes and regulations.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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12.8: Reading- Create Your Business Plan

Executive Summary

This written guide will help you create a business plan and map out how you will start and run your business successfully.

The executive summary is often considered the most important section of a business plan. This section briefly tells your reader where your company is, where you want to take it, and why your business idea will be successful. If you are seeking financing, the executive summary is also your first opportunity to grab a potential investor's interest.

The executive summary should highlight the strengths of your overall plan and therefore be the last section you write. However, it usually appears first in your business plan document.

Below are several key points that your executive summary should include based on the stage of your business.

If You Are an Established Business

If you are an established business, be sure to include the following information:

- **The Mission Statement—**This explains what your business is all about. It should be between several sentences and a paragraph.
- **Company Information**—Include a short statement that covers when your business was formed, the names of the founders and their roles, your number of employees, and your business location(s).
- **Growth Highlights**—Include examples of company growth, such as financial or market highlights (for example, "XYZ Firm increased profit margins and market share year-over-year since its foundation). Graphs and charts can be helpful in this section.
- **Your Products/Services**—Briefly describe the products or services you provide.
- **Financial Information—**If you are seeking financing, include any information about your current bank and investors.
- **Summarize future plans**—Explain where you would like to take your business.

With the exception of the mission statement, all of the information in the executive summary should be covered in a concise fashion and kept to one page. The executive summary is the first part of your business plan many people will see, so each word should count.

If You Are a Startup or New Business

If you are just starting a business, you won't have as much information as an established company. Instead, focus on your experience and background as well as the decisions that led you to start this particular enterprise.

Demonstrate that you have done thorough market analysis. Include information about a need or gap in your target market, and how your particular solutions can fill it. Convince the reader that you can succeed in your target market, then address your future plans.

Remember, your Executive Summary will be the last thing you write. So the first section of the business plan that you will tackle is the Company Description section.

Company Description

This section of your business plan provides a high-level review of the different elements of your business. This is akin to an extended elevator pitch and can help readers and potential investors quickly understand the goal of your business and its unique proposition.

What to Include in Your Company Description

- Describe the nature of your business and list the marketplace needs that you are trying to satisfy.
- Explain how your products and services meet these needs.
- List the specific consumers, organizations or businesses that your company serves or will serve.
- Explain the competitive advantages that you believe will make your business a success such as your location, expert personnel, efficient operations, or ability to bring value to your customers.

Next, you'll need to move on to the Market Analysis section of your plan.

Market Analysis

The market analysis section of your business plan should illustrate your industry and market knowledge as well as any of your research findings and conclusions.

What to Include in Your Market Analysis

- **Industry Description and Outlook**—Describe your industry, including its current size and historic growth rate as well as other trends and characteristics (e.g., life cycle stage, projected growth rate). Next, list the major customer groups within your industry.
- **Information About Your Target Market**—Narrow your target market to a manageable size. Many businesses make the mistake of trying to appeal to too many target markets. Research and include the following information about your market:
- **Distinguishing Characteristics—**What are the critical needs of your potential customers? Are those needs being met? What are the demographics of the group and where are they located? Are there any seasonal or cyclical purchasing trends that may impact your business?
- **Size of the Primary Target Market**—In addition to the size of your market, what data can you include about the annual purchases your market makes in your industry? What is the forecasted market growth for this group?
- **How Much Market Share Can You Gain?**—What is the market share percentage and number of customers you expect to obtain in a defined geographic area? Explain the logic behind your calculation.
- **Pricing and Gross Margin Targets**—Define your pricing structure, gross margin levels, and any discount that you plan to use.
- When you include information about any of the market tests or research studies you have completed, be sure to focus only on the results of these tests. Any other details should be included in the appendix (which we will discuss later).
- **Competitive Analysis—**Your competitive analysis should identify your competition by product line or service and market segment. Assess the following characteristics of the competitive landscape:
    - Market share
    - Strengths and weaknesses
    - How important is your target market to your competitors?
    - Are there any barriers that may hinder you as you enter the market?
    - What is your window of opportunity to enter the market?
    - Are there any indirect or secondary competitors who may impact your success?
    - What barriers to market are there (e.g., changing technology, high investment cost, lack of quality personnel)?
- **Regulatory Restrictions**—Include any customer or governmental regulatory requirements affecting your business, and how you'll comply. Also, cite any operational or cost impact the compliance process will have on your business.

Once you've completed this section, you can move on to the Organization and Management section of your business plan.

Organization and Management

This section should include: your company's organizational structure, details about the ownership of your company, profiles of your management team, and the qualifications of your board of directors.

Who does what in your business? What is their background and why are you bringing them into the business as board members or employees? What are they responsible for? These may seem like unnecessary questions to answer in a one- or two-person organization, but the people reading your business plan want to know who's in charge, so tell them. Give a detailed description of each division or department and its function.

This section should include who's on the board (if you have an advisory board) and how you intend to keep them there. What kind of salary and benefits package do you have for your people? What incentives are you offering? How about promotions? Reassure your reader that the people you have on staff are more than just names on a letterhead.

Organizational Structure

A simple but effective way to lay out the structure of your company is to create an organizational chart with a narrative description. This will prove that you're leaving nothing to chance, you've thought out exactly who is doing what, and there is someone in charge of every function of your company. Nothing will fall through the cracks, and nothing will be done three or four times over. To a potential investor or employee, that is very important.

Ownership Information

This section should also include the legal structure of your business along with the subsequent ownership information it relates to. Have you incorporated your business? If so, is it a C or S corporation? Or perhaps you have formed a partnership with someone. If so, is it a general or limited partnership? Or maybe you are a sole proprietor.

The following important ownership information should be incorporated into your business plan:

- Names of owners
- Percentage ownership
- Extent of involvement with the company
- Forms of ownership (i.e., common stock, preferred stock, general partner, limited partner)
- Outstanding equity equivalents (i.e., options, warrants, convertible debt)
- Common stock (i.e., authorized or issued)
- Management Profiles
- Experts agree that one of the strongest factors for success in any growth company is the ability and track record of its owner/management team, so let your reader know about the key people in your company and their backgrounds. Provide resumes that include the following information:
- Name
- Position (include brief position description along with primary duties)
- Primary responsibilities and authority
- Education
- Unique experience and skills
- Prior employment
- Special skills
- Past track record
- Industry recognition
- Community involvement
- Number of years with company
- Compensation basis and levels (make sure these are reasonable — not too high or too low)
- Be sure you quantify achievements (e.g. “Managed a sales force of ten people,” “Managed a department of fifteen people,” “Increased revenue by 15 percent in the first six months,” “Expanded the retail outlets at the rate of two each year,” “Improved the customer service as rated by our customers from a 60 percent to a 90 percent rating”)

Also, highlight how the people surrounding you complement your own skills. If you’re just starting out, show how each person’s unique experience will contribute to the success of your venture.

Board of Directors’ Qualifications

The major benefit of an unpaid advisory board is that it can provide expertise that your company cannot otherwise afford. A list of well-known, successful business owners/managers can go a long way toward enhancing your company’s credibility and perception of management expertise.

If you have a board of directors, be sure to gather the following information when developing the outline for your business plan:

- Names
- Positions on the board
- Extent of involvement with company
- Background
- Historical and future contribution to the company’s success

Service or Product Line

Once you’ve completed the Organizational and Management section of your plan, the next part of your business plan is where you describe your service or product, emphasizing the benefits to potential and current customers. Focus on why your particular product will fill a need for your target customers.

What to Include in Your Service or Product Line Section

- **A Description of Your Product/Service—**Include information about the specific benefits of your product or service – from your customers' perspective. You should also talk about your product or service's ability to meet consumer needs, any advantages your product has over that of the competition, and the current development stage your product is in (e.g., idea, prototype).
- **Details About Your Product's Life Cycle—**Be sure to include information about where your product or service is in its life cycle, as well as any factors that may influence its cycle in the future.
- **Intellectual Property—**If you have any existing, pending, or any anticipated copyright or patent filings, list them here. Also disclose whether any key aspects of a product may be classified as trade secrets. Last, include any information pertaining to existing legal agreements, such as nondisclosure or non-compete agreements.
- **Research and Development (R&D) Activities—**Outline any R&D activities that you are involved in or are planning. What results of future R&D activities do you expect? Be sure to analyze the R&D efforts of not only your own business, but also of others in your industry.

Marketing and Sales

Once you've completed the Service or Product Line section of your plan, the next part of your business plan should focus on your marketing and sales management strategy for your business.

Marketing is the process of creating customers, and customers are the lifeblood of your business. In this section, the first thing you want to do is define your marketing strategy. There is no single way to approach a marketing strategy; your strategy should be part of an ongoing business-evaluation process and unique to your company. However, there are common steps you can follow which will help you think through the direction and tactics you would like to use to drive sales and sustain customer loyalty.

An **overall marketing strategy** should include four different strategies:

- A market penetration strategy.
- A growth strategy. This strategy for building your business might include: an internal strategy such as how to increase your human resources, an acquisition strategy such as buying another business, a franchise strategy for branching out, a horizontal strategy where you would provide the same type of products to different users, or a vertical strategy where you would continue providing the same products but would offer them at different levels of the distribution chain.
- Channels of distribution strategy. Choices for distribution channels could include original equipment manufacturers (OEMs), an internal sales force, distributors, or retailers.
- Communication strategy. How are you going to reach your customers? Usually a combination of the following tactics works the best: promotions, advertising, public relations, personal selling, and printed materials such as brochures, catalogs, flyers, etc.

After you have developed a comprehensive marketing strategy, you can then define your sales strategy. This covers how you plan to actually sell your product.

Your **overall sales strategy** should include two primary elements:

- A sales force strategy. If you are going to have a sales force, do you plan to use internal or independent representatives? How many salespeople will you recruit for your sales force? What type of recruitment strategies will you use? How will you train your sales force? What about compensation for your sales force?
- Your sales activities. When you are defining your sales strategy, it is important that you break it down into activities. For instance, you need to identify your prospects. Once you have made a list of your prospects, you need to prioritize the contacts, selecting the leads with the highest potential to buy first. Next, identify the number of sales calls you will make over a certain period of time. From there, you need to determine the average number of sales calls you will need to make per sale, the average dollar size per sale, and the average dollar size per vendor.

Next, if you are seeking financing for your business, you'll need to complete the next part of your plan—Funding Request.

Funding Request

If you are seeking funding for your business venture, use this section to outline your requirements.

Your funding request should include the following information:

- Your current funding requirement
- Any future funding requirements over the next five years

- How you intend to use the funds you receive: Is the funding request for capital expenditures? Working capital? Debt retirement? Acquisitions? Whatever it is, be sure to list it in this section.
- Any strategic financial situational plans for the future, such as: a buyout, being acquired, debt repayment plan, or selling your business. These areas are extremely important to a future creditor, since they will directly impact your ability to repay your loan(s).

When you are outlining your funding requirements, include the amount you want now and the amount you want in the future. Also include the time period that each request will cover, the type of funding you would like to have (e.g., equity, debt), and the terms that you would like to have applied.

To support your funding request you'll also need to provide historical and prospective financial information. Once you have completed your funding request, move on to the next part of your plan—Financial Projections.

Financial Projections

You should develop the Financial Projections section after you've analyzed the market and set clear objectives. That's when you can allocate resources efficiently. The following is a list of the critical financial statements to include in your business plan packet.

Historical Financial Data

If you own an established business, you will be requested to supply historical data related to your company's performance. Most creditors request data for the last three to five years, depending on the length of time you have been in business.

The historical financial data to include are your company's income statements, balance sheets, and cash flow statements for each year you have been in business (usually for up to three to five years). Often, creditors are also interested in any collateral that you may have that could be used to ensure your loan, regardless of the stage of your business.

Prospective Financial Data

All businesses, whether startup or growing, will be required to supply prospective financial data. Most of the time, creditors will want to see what you expect your company to be able to do within the next five years. Each year's documents should include forecasted income statements, balance sheets, cash flow statements, and capital expenditure budgets. For the first year, you should supply monthly or quarterly projections. After that, you can stretch it to quarterly and/or yearly projections for years two through five.

Make sure that your projections match your funding requests; creditors will be on the lookout for inconsistencies. It's much better if you catch mistakes before they do. If you have made assumptions in your projections, be sure to summarize what you have assumed. This way, the reader will not be left guessing.

Finally, include a short analysis of your financial information. Include a ratio and trend analysis for all of your financial statements (both historical and prospective). Since pictures speak louder than words, you may want to add graphs of your trend analysis (especially if they are positive).

Next, you may want to include an Appendix to your plan. This can include items such as your credit history, resumes, letters of reference, and any additional information that a lender may request.

Appendix

The Appendix should be provided to readers on an as-needed basis. In other words, it should not be included with the main body of your business plan. Your plan is your communication tool; as such, it will be seen by a lot of people. Some of the information in the business section you will not want everyone to see, but specific individuals (such as creditors) may want access to this information to make lending decisions. Therefore, it is important to have the appendix within easy reach.

The appendix would include:

- Credit history (personal and business)
- Resumes of key managers
- Product pictures
- Letters of reference
- Details of market studies
- Relevant magazine articles or book references

- Licenses, permits or patents
- Legal documents
- Copies of leases
- Building permits
- Contracts
- List of business consultants, including attorney and accountant

Any copies of your business plan should be controlled; keep a distribution record. This will allow you to update and maintain your business plan on an as-needed basis. Remember, too, that you should include a private placement disclaimer with your business plan if you plan to use it to raise capital.

How to Make Your Business Plan Stand Out

One of the first steps to business planning is determining your target market and why they would want to buy from you.

For example, is the market you serve the best one for your product or service? Are the benefits of dealing with your business clear and are they aligned with customer needs? If you're unsure about the answers to any of these questions, take a step back and revisit the foundation of your business plan.

The following tips can help you clarify what your business has to offer, identify the right target market for it and build a niche for yourself.

Be Clear About What You Have to Offer

Ask yourself: Beyond basic products or services, what are you really selling? Consider this example: Your town probably has several restaurants all selling one fundamental product—food. But each is targeted at a different need or clientele.

One might be a drive-thru fast food restaurant, perhaps another sells pizza in a rustic Italian kitchen, and maybe there's a fine dining seafood restaurant that specializes in wood-grilled fare. All these restaurants sell meals, but they sell them to targeted clientele looking for the unique qualities each has to offer. What they are *really* selling is a combination of product, value, ambience and brand experience.

When starting a business, be sure to understand what makes your business unique. What needs does your product or service fulfill? What benefits and differentiators will help your business stand out from the crowd?

Don't Become a Jack of All Trades—Learn to Strategize

It's important to clearly define what you're selling. You do not want to become a jack-of-all trades and master of none because this can have a negative impact on business growth. As a smaller business, it's often a better strategy to divide your products or services into manageable market niches. Small operations can then offer specialized goods and services that are attractive to a specific group of prospective buyers.

Identify Your Niche

Creating a niche for your business is essential to success. Often, business owners can identify a niche based on their own market knowledge, but it can also be helpful to conduct a market survey with potential customers to uncover untapped needs. During your research process, identify the following:

- Which areas your competitors are already well established
- Which areas are being ignored by your competitors
- Potential opportunities for your business

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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12.9: Reading- Why Do So Many Small Business Startups Fail?

Valuable Lessons

With four out of five small business startups ending up in failure, the odds are stacked against small business owners and would-be entrepreneurs. That's why it's so important to understand how and where things go wrong—such information offers valuable lessons on what to avoid. There are six main causes of small business startup failure:

Lack of Planning

We've said it before: starting a business without planning where you want to go is like starting a car journey with no idea of your final destination or a map to get there; you're bound to get lost. To avoid this mistake, set a clear goal of where you want to be and how you plan to get there.

Failure to Delegate

Within every business someone needs to keep an eye on the bigger picture; and have an overview of everything happening internally and externally around the company. That person should be you and if you have your head buried in the accounts you won't. So delegate and outsource all the tasks that can be done by others and free yourself to focus on the bigger picture.

Unwillingness to Change

As a small business you cannot afford to remain motionless as your market and the world around you drives forward. Adapt and develop your small business so it is forward-thinking and innovative, not behind the times.

Forgetting That Cash is King!

A small business needs to keep its eye firmly focused on cashflow. As soon as it loses sight of this, it's prone to failure. Plot and analyze your incomings and outgoings to make sure your small business stays on the right track. Don't expect massive profits from the outset, but don't accept a loss.

Lack of Objective Targets

Not measuring the success of campaigns, products, or services can be disastrous for a small business. Is that PR campaign your running really worth the money? Does Twitter really bring traffic to your website? Know what to measure, and you'll know how successful you are.

Failure to Ask the Right Questions

When you're a small business start-up, knowing which questions (and whom) to ask is difficult. There are numerous resources, such as the SBA, local economic development agencies, and chambers of commerce, that are a great place to start. Part of the process is "knowing what you don't know," and such organizations can help you figure that out.

While avoiding these pitfalls won't guarantee small business success, knowing *what not to do* can help you to be proactive and focus on the things you should do.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in the previous section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

13: Module 5- Legal Environment

13.1: Why It Matters- Legal Environment

Why summarize the role of the legal system in governing and shaping the climate for business?

Imagine yourself in the following story: When you were in high school, you sometimes worked for your father, a house painter. Now that you're in college, you've decided to take advantage of that experience to earn some extra money during your summer vacation. You've set yourself up as a house-painting business and hired your college roommate to help you out.

One fine summer day, the two of you were putting a coat of Misty Meadow acrylic latex on the exterior of a two-story Colonial. You were working on the ground floor around the door of the house while your roommate was working from scaffolding over the garage. Looking up, you noticed that—despite several warnings—your roommate had placed his can of paint at his feet rather than having fixed it to the ladder bracing the platform. You were about to say something yet again, but it was too late: He accidentally kicked the bucket (so to speak), which then bounced off the homeowner's red sports car, denting the hood, and splattering it with Misty Meadow.

As luck would have it, the whole episode was witnessed by the homeowner's neighbor, who approached the scene of the disaster just as your roommate climbed down from the scaffold. "Man, you must be dumber than a bag of hammers," the neighbor said to your roommate, who was in no mood for unsolicited opinions—and before you knew what was happening, he broke the neighbor's nose with a single well-placed punch.

The homeowner sues you and your roommate for negligence, and the neighbor sues you and your roommate for assault and battery.

In this module, we will discuss how our legal system shapes the business environment. We will explore how legal situations like this and others could impact your business.

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13.2: Introduction to the Meaning and Purpose of Law

What you'll learn to do: explain the meaning and purpose of law

This section is an introduction to the meaning and purpose of law, including historical bases and the implications of law for businesses and society. Key terms and concepts covered include law, how the term law is used, examples of foundational laws and the "rule of law."

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13.3: Understanding Law

Learning Objectives

- Define law

Lawyer and educator Lloyd Duhaime defines law as “conduct approved and enforced by the government of and over a certain territory.”[1] Distilling the concept to its essence, McGill University law professor and author Wendy Adams defines law as “a mechanism for facilitating and regulating interaction between autonomous entities.” What’s fascinating is the essential role of law in society. In*Essentials of Business Law*, the authors note that “every society of which we have any historical record has had some system of laws.”[2]

Note that the term “law” is used to refer to legislation—for example, the Civil Rights Act of 1964 and other anti-discrimination legislation discussed in Module 15: Human Resource Management—as well as common law, described as “judge-made law” since it’s based on precedent or prior court rulings.

Although intended to protect the fundamental rights and liberties of U.S. citizens, the legal system and its laws are not always readily understood by the average citizen. At what point do we cross that fine line between legal and illegal, and on what basis is that line even drawn in the first place? Most people understand (and accept) laws prohibiting acts of murder, thievery, physical harm, and financial malfeasance, but there are plenty of other laws that might give us pause. For example, in Minnesota, any game in which participants attempt to capture a greased or oiled pig is illegal. The same laws also prohibits turkey scrambles.[3] Don’t attempt to substitute a ferret for a hunting dog in West Virginia. Anyone who hunts, catches, takes, kills, injures, or pursues a wild animal or bird with a ferret will face a fine of no less than $100 (but no more than $500) and no fewer than 10 (but no more than 100) days in jail. [4]

While you may never have considered taking part in a turkey scramble or hunting with a ferret, chances are good that you have broken some law at some time—perhaps even in the last twenty-four hours. Did you exceed a speed limit while driving? Roll through a stop sign at an empty intersection while riding your bike? Drive to the minimart without wearing your seatbelt? Although unlikely that you will be prosecuted and jailed for these minor traffic offenses, the fact is that you broke the law. Why do we have so many laws? Let’s take a closer look at the role of law in society and why laws are created in the first place.

Practice Question

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U.S. law is based primarily on English law, with influences from other societies as well as our colonial/revolutionary experience. Most notably, our Constitution, with it’s division of power between the state and federal governments, was inspired by the League of the Iroquois, a Native American League or Confederacy governance structure. As documented by the Milwaukee Public Museum, the structure was designed to unite the five major nations—the Cayuga, Mohawk, Oneida, Onondaga and Seneca—with “one mind, one heart, one law.”[5] Intra-tribal issues were handled at the individual nation level. Each nation elected representatives to the Council, which was charged with managing relations between the tribes and the Confederacy and other entities – for example, relations with the United States Government.

1. "Law Definition." Accessed June 12, 2019. http://www.duhaime.org/LegalDictionary/L/Law.aspx. ↵
2. Beatty, Jeffrey F., and Susan S. Samuelson. *Essentials of Business Law*, 5th ed., p. 3. Stamford, CT: Cengage Learning, 2015. ↵
3. "2013 Minnesota Statutes Section 343.36." Accessed June 11, 2019. www.revisor.mn.gov/statutes/2013/cite/343.36. ↵

4. "West Virginia Code 20 - 2 - 5." Accessed June 11, 2019. www.legis.state.wv.us/legisdocs/code/20/WVC%2020%20%20-%20%202%20%20-%20%20%205%20%20.htm. ↵
5. "The League of the Iroquois." Milwaukee Public Museum. Accessed June 12, 2019. www.mpm.edu/content/wirp/ICW-155.html. ↵

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13.4: Purposes of Law

Learning Objectives

- Explain the purposes of law

As alluded to in the prior section, there are four primary purposes of law:

1. maintaining order
2. establishing standards
3. resolving disputes
4. protecting individual rights and liberties.

These purposes are not separate but entwined.

In a civil society, law is required to maintain order and to establish what personal behavior and business practices are right or wrong based on a society's values and circumstances. For example, the Bill of Rights, which constitutes the first 10 amendments to the Constitution, guarantees a number of individual rights and liberties including freedom of speech, freedom of the press and freedom of religion. Businesses are held accountable for a range of employee actions; the Department of Labor alone administers 180 federal laws.

As citizens, we also have an obligation to comply with laws and expectations regarding the development and enforcement of those laws—points we'll expand on in the next section. Law is also, somewhat paradoxically, a requirement for freedom. To quote former President Ronald Reagan: "Law and freedom must be indivisible partners. For without law, there can be no freedom, only chaos and disorder; and without freedom, law is but a cynical veneer for injustice and oppression." Former Supreme Court Associate Justice Benjamin Cardozo's statement is an apt summary: "the final cause of law is the welfare of society."

Practice Question

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13.5: Rule of Law

Learning Objectives

- Explain “rule of law”

The United States Federal Courts defines the rule of law as a principle under which all persons, institutions, and entities are accountable to laws that are:[1]

- Publicly promulgated
- Equally enforced
- Independently adjudicated
- And consistent with international human rights principles.

In an educational publication, the American Bar Association uses quotes to highlight four aspects of the rule of law: due process, separation of powers, an open and transparent system of making laws, and predictable and uniform application of the laws.[2] To quote U.S. Court of Appeals Judge Diane Wood: “Neither laws nor the procedures used to create or implement them should be secret; and . . . the laws must not be arbitrary.”

An American Bar Association publication puts that framework in context, noting that the rule of law is effective because the majority of citizens recognize the importance of adhering to the law. That is, we see obeying the law as a fundamental requirement of our social contract and essential to maintaining social order. In short: “in return for the benefits of social order, we agree to live according to certain laws and rules.”[3]

Practice Question

https://assessments.lumenlearning.co...essments/14331

1. "Overview - Rule of Law." United States Courts. Accessed June 12, 2019. https://www.uscourts.gov/educational-resources/educational-activities/overview-rule-law. ↵
2. "What Is the Rule of Law." ABA Division for Public Education. Accessed June 12, 2019. www.americanbar.org/content/dam/aba/migrated/publiced/features/Part1DialogueROL.authcheckdam.pdf. ↵
3. Ibid. ↵

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13.6: Introduction to Statutory and Common Law

What you'll learn to do: differentiate between statutory and common law

In this section, we'll define and differentiate between statutory and common law, explain how statutory and common law is developed and present related statistics and perspective. We'll also introduce the principle of "stare decisis" and discuss the limitations and implications of the doctrine of precedence.

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13.7: Statutory vs. Common Law

Learning Objectives

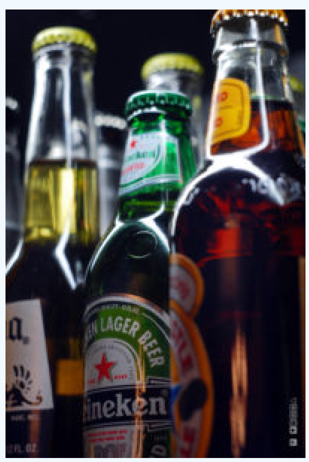
- Define statutory law
- Define common law

Statutory Law

Statutory law are laws passed by Congress and represent one of the primary sources of law in the United States. This legislative power was established in the Constitution, which granted Congress the power to pass laws or statutes on any subject not prohibited in that document. The White House website summarizes the composition, powers and process of the legislative branch of government. To excerpt: “Established by Article I of the Constitution, the Legislative Branch consists of the House of Representatives and the Senate, which together form the United States Congress. The Constitution grants Congress the sole authority to enact legislation.”[1]

A new statute generally starts as a proposal or “bill.” According to the GovTrack website, Congress considers around 5,000 bills and resolutions annually; only a fraction—approximately 7% or 350—become law.[2] For perspective on current bills, see GovTrack.us, an independent website tracking the status of legislation in the United States Congress. In order to advance, a bill must win a simple majority vote in both the House and Senate. A bill that is approved by Congress is submitted to the President for consideration. At this point, the bill is either signed and becomes a new statute—law—or is vetoed. If the President vetoes the bill, a two-thirds majority vote in both the House and Senate is required to override the veto and pass the bill. If the votes garners that support, the bill becomes law without the President’s signature.

Statutory Law In North Carolina



Suppose you are headed over to a friend’s house to watch football on Sunday, and on your way you stop in at the local supermarket to buy some beer and pretzels for the gang. You carry your six-pack and snacks up to the counter to pay, and the clerk tells you that she’s sorry, but she can’t sell you the beer. At first you think it’s because she suspects you’re underage, but before you can show her your ID, she explains that she can’t sell alcohol before noon because (1) it’s Sunday and (2) you are in the State of North Carolina.

Shocked, you think she’s joking until she refers you to the following NC Statute: N.C. General Statute 18B-1004(c) states,

> “It shall be unlawful to sell or consume alcoholic beverages on any licensed premises from the time at which sale or consumption must cease on Sunday morning until 12:00 noon on that day.”

No amount of begging or pleading will get you the beer, because the owner of the supermarket knows that if she violates N.C. General Statute 18B-1004(c), the store’s ABC license could be revoked and its alcohol sales ended *permanently*. This is an example of statutory law.

Common Law

Common law is based on the concept of precedence, which requires judges to decide a case based on prior rulings or, at a minimum, consider the reasoning of prior judges when deciding a case with similar facts. The constraints precedence impose on a judge depend on court hierarchy, case relevance and jurisdiction. As outlined by the Indiana Court System, "When a decision is made by a higher court, the lower courts must follow it. Once a case is decided, it establishes a precedent, or a judicial decision that should be followed when a similar case comes to court. To serve as precedent for a pending case, a prior decision must have almost the same question of law and almost the same facts. If the precedent is from another area, such as another state's Supreme Court, it can be considered, but it does not have to be followed." In this way, new decisions can become a legal precedent. A binding precedent is referred to by the Latin phrase *stare decisis* or "let the decision stand."

The upside of this doctrine of precedence is predictability. Melbourne Law School professor Matthew Harding summarizes the logic of this practice: "The moral value of the doctrine of precedent is in the way it serves the political ideal of the rule of law; according to that ideal, institutions of the state, like courts, should strive to ensure that the law is developed and applied in a consistent and predictable manner, so that citizens may order their affairs with confidence as to their rights and duties."[3]

? Practice Questions

https://assessments.lumenlearning.co...essments/14332

https://assessments.lumenlearning.co...essments/14333

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Contributors and Attributions

13.8: Introduction to Tort Law

What you'll learn to do: define tort law, and explain the role of product liability in tort law

In this section, we'll explore tort law as it relates to product liability. Key terms and concepts covered include tort, negligence, strict liability, compensatory and punitive damages and the single recovery principle. We'll also discuss the three major bases for product liability claims and responsibilities, liability and remedies under tort law.

Contributors and Attributions

13.9: Tort Law

Learning Objectives

- Define tort law
- Explain the concept of negligence as it relates to tort law
- Explain the concept of strict liability under tort law

The word “tort” is a legal term derived from the French word meaning to harm or to be in the wrong.[1] In a legal context, a tort is a violation of civil law that causes harm or injury to a person or property and an associated legal liability on the part of the person who commits a tortious act.

Tort lawsuits have a lower burden of proof than in criminal law. In a criminal case, the fault of the defendant must be proved beyond a reasonable doubt. However, in tort law, the plaintiff must only prove a preponderance of the evidence—that is, that there is more than a 50 percent chance, given the evidence, that the plaintiff’s claims are true.

In tort law, it is the responsibility of the plaintiff to file a lawsuit to seek damages for the wrong. There are a number of types of tort, broadly categorized as either intentional or unintentional. Intentional torts include defamation, false imprisonment, infliction of emotional distress, assault and battery and trespass, conversion and fraud. In the business environment, intentional torts include interference with business relations: for example, a contract or economic relationship. We’ll discuss unintentional torts in the next section.

PRactice Question

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Negligence

Negligence falls under the unintentional category of a tort; that is, it involves harm that arises from unintentional action. The standard used to determine negligence is that of a reasonable person under the circumstances. Specifically, the law assumes that individuals have a duty to behave as a reasonable person under the circumstances. There are five elements to a negligence case, as outlined below. In order to prevail, a plaintiff must prove all five elements.

1. **Duty of due care:** The question posed by this point is whether the defendant has a legal responsibility or duty of care to the plaintiff. The key test for proving this element is “foreseeability;” that is, whether the defendant could have foreseen that the plaintiff would be harmed by his or her action.
2. **Breach:** The question posed by this point is whether the defendant failed to meet (breached) his or her duty of due care. See exception below.
3. **Factual causation:** The question posed by this point is whether the defendants failure to meet his or her duty of due care caused the harm.
4. **Proximate causation:** This element requires the plaintiff to prove that the defendant could reasonably foresee the general type of harm. For example, it’s reasonable for a mechanic to foresee that failure to fix a customer’s brakes would result in an accident. If the court determines that an event leading to the harm is not foreseeable, the event is termed a “superseding” cause and the defendant is not liable.

5. **Damage:** The final element is proof of harm—an injury and/or other measurable loss. These can include emotional, economic, or reputational damages. Note that courts decide to award damages based on the single recovery principle; that is, they must factor in present and future damages.

A state legislature can pass statutes that override the "reasonable person" standard, setting a minimum standard of care relative to a particular activity in order to protect the public or a particular group of people that are considered to be at risk. Violation of speed limits or building codes and driving under the influence are common bases for a negligence per se claim. When a plaintiff is relying on negligence per se, there is no need to prove the defendant's conduct was negligent. If the law was violated, the question is simply whether the violation was the proximate cause of damage. That is, negligence per se eliminates the duty of due care and breach elements of a negligence claim.

? Practice Question

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Strict Liability

Most states have evolved product liability negligence into strict liability tort law. Strict liability acknowledges that some products are inherently dangerous; thus strict liability is a significantly higher level of liability that applies when a tort or harm results from ultrahazardous activity or defective products. In a strict liability case, elements of proof such as duty of due care, breach, and proximate causation are irrelevant. Ultrahazardous activities are those that introduce an exceptional level of danger into the community; examples drawn from cases include the manufacture, storage or use of hazardous chemicals or explosives and the transport and possession of dangerous animals.

As emphasized in *Business Law and the Legal Environment*, "a defendant engaging in an ultrahazardous activity is almost always liable for any harm that results." Given the significantly higher probability of being found liable, the question of whether a defendant is, in fact, engaged in an ultrahazardous activity is pivotal in tort cases. Strict liability as it pertains to product liability is addressed in the next section.

? Practice Question

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1. "English Translation of 'tort'."Collins French-English Dictionary. Accessed June 12, 2019. https://www.collinsdictionary.com/us/dictionary/french-english/tort. ↵

Contributors and Attributions

13.10: Product Liability

Learning Objectives

- Explain the three major bases for product liability claims

When a tort or harm is caused by a product, the legal question is whether there is a product defect and, therefore, product liability. Manufacturers have a responsibility to produce products that are reasonably safe in both their intended and anticipated uses.

In pursuing a product liability case based on negligence, plaintiffs generally claim one of the following:

1. **Design defects,** In this case, the buyer/plaintiff claims the manufacturer's design is inherently dangerous or defective.
2. **Manufacturing defects.** In this situation, the defect is not the design, but rather a failure in the manufacturing and/or quality control process.
3. **Failure-to-warn defects.** In this case, the plaintiff is claiming "failure to warn"; that is, the manufacturer failed to provide adequate instructions regarding the product's use or warn the buyer of potential danger of misuse.

As an alternative (or in addition to) filing a claim based on negligence, an injured party can file a tort claim against the product manufacturer or retailer based on strict liability. The key difference between the two bases is that in a strict product liability case, the buyer doesn't need to prove that the manufacturer or seller's conduct was unreasonable. The plaintiff only needs to demonstrate that the defendant manufactured or sold a product that was defective and that the defect caused him or her harm. Three key points to note:

- The seller of a defective product is only subject to liability for harm if normally engaged in the business of selling this type of project.
- The defendant (manufacturer or seller) is liable only if the product is defective; that is, the product was defective when purchased by the consumer and the defect wasn't caused by a buyer's misuse of or substantial change to the product.
- In a strict liability case, "privity"—a contractual relationship—is not required. That is, a consumer can sue the manufacturer, distributor and retail store, even though privity only exists between the buyer and the entity that he or she actually purchased the product from.

To reinforce, whether a manufacturer or seller exercised due care is irrelevant. If the product is defective and injures the consumer, the seller is liable regardless of whether reasonable care was taken in the design, manufacture and throughout the distribution process.

? Practice Question

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13.11: Compensatory and Punitive Damages

Learning Objectives

- Differentiate between compensatory and punitive damages

The way a court remedies a wrong is by awarding monetary payment, referred to as “damages.” There are two categories of damages: compensatory and punitive. As the term suggests, compensatory damages are intended to compensate for the wrong and restore the plaintiff to his or her pre-incident position (e.g., physically, economically, or mentally). In contrast, punitive damages are awarded in extreme cases where behavior is considered to be so socially unacceptable that the court needs to make an example of the defendant. In these cases, the court generally awards significant punitive damages intended to punish the defendant and deter similar behavior in the future.

In setting compensatory damages, courts are governed by the single recovery principle mentioned previously. Briefly, this principle requires the court to award a single lump sum of money that accounts for past and future expenses, lost wages and pain and suffering. The latter is based on the courts estimate of lingering impacts, including physical and emotional injury and mental anguish.

Practice Question

https://assessments.lumenlearning.co...essments/14338

The following videos also explain compensatory and punitive damages.

You can view the transcript for “Compensatory Damages” (opens in new window) or the text alternative for “Compensatory Damages” (opens in new window).

You can view the transcript for “What are Punitive Damages?

Contributors and Attributions

13.12: Introduction to Intellectual Property

What you'll learn to do: explain the purpose and characteristics of intellectual property law

This section is an introduction to intellectual property law, including the principles as established in the Constitution, significant changes and issues and the implications for business, society and the economy. We'll discuss the purpose of intellectual property law, define and differentiate between types of assets and property rights and outline the associated statutory criteria, rights, terms and duration of protection. Terms presented include intangible asset, intellectual property, patents, copyrights and trademarks.

Intellectual Property underpins nearly every aspect of our economy – it supports good paying jobs, it supports the arts, sciences and technology, and it creates a framework that allows new industries and innovations to flourish.

— Article I, Section 8, Clause 8 of the Constitution

Contributors and Attributions

13.13: Intellectual Property

Learning Objectives

- Explain the purpose and characteristics of intellectual property law
- Explain patents
- Explain copyrights
- Explain trademarks

Property rights are one of the factors that economists refer to as "rules of the game" or the institutions that give individuals and businesses an incentive to not only develop, but continuously improve, the goods and services they invent. And, as our discussion will illustrate, the ongoing development aspect is embedded in intellectual property law.

Property rights establish ownership of land and other productive assets and allow owners to earn a profit from the enterprise using those assets. Property rights include not only land and other physical assets, but also intangible assets—new ideas and inventions ranging from clothing or product design to software and musical scores.

Intellectual property (IP) is an idea— an intangible asset—and patents, copyrights and trademarks are statutory forms of IP. That is, types of intellectual property that meet the statutory criteria may be granted protection under the law. Be it physical or intangible property, the key to value creation is the ability to control access or use. The purpose of intellectual property law is to create a framework that incentivizes value creation—specifically, development of new ideas and inventions—while also providing for public access to the good or service. As we will cover in this section, patents, copyrights, and trademarks protect different types of intellectual property. The abbreviated version: a patent protects an invention; a copyright protects an original work of art or authorship and a trademark typically protects brand names and logos.[1]

With the evolution of the United States into a services-dominant economy, the relative importance of ideas or intellectual versus physical assets has changed and establishing ownership and protecting and enforcing intellectual property rights is a priority at the nation level as well as in the private sector. For example, the Trump Administration considers the protection of intellectual property vital to the nation's security and prosperity. In the business realm, it's standard procedure for employee contracts and independent contractor agreements to include language the addresses the ownership of intellectual property created in the scope of the position or engagement.

In an article for the World Intellectual Property Organization, valuation consultant Kelvin King states "intellectual capital is recognized as the most important asset of many of the world's largest and most powerful companies; it is the foundation for the market dominance and continuing profitability of leading corporations [and] is often the key objective in mergers and acquisitions."

Intellectual property also has a significant impact on human health (medical inventions) and quality of life, so there's a tension and tradeoff built into intellectual property law. Thomas Jefferson captured this dynamic when he referred to intellectual property law as "the difficulty of drawing a line between the things which are worth to the public the embarrassment of an exclusive patent, and those which are not."

According to Cornell University Law School, "intellectual property is any product of the human intellect that the law protects from unauthorized use by others." Take a look at the following video to learn more about what intellectual property is and why it matters.

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for “What Is Intellectual Property & Why Do I Care?” (opens in new window) or the text alternative for “What is Intellectual Property & Why Do I Care?” (opens in new window).

Practice Question

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Patent

Figure 13.13.1: Patent pending: Solar Puff is a solar-powered inflatable light that was designed to provide an affordable and renewable light source to disaster-relief victims. The light uses the principles of origami and foldable design to “pop” open from a flat envelope into a cube.

The United States Patent and Trademark Office (USPTO) describes patents as a property right granted to an inventor for an invention or, in the words of the Constitution, “writings and discoveries.” A patent granted by the USPTO is generally in force for a 20 year term from the date of filing the patent application and is effective only within the United States and its territories—e.g., Puerto Rico and the U.S. Virgin Islands. (The World Intellectual Property Organization is a resource for inventors researching patent protection on a global scale.) Patent term extensions are available for products such as pharmaceuticals, food additives, and medical devices that require regulatory approval prior to sale or use.

The term extension is intended to adjust for time the product was undergoing clinical trials and regulatory review.[2] Note that the USPTO is not a regulatory institution; it is the patentee’s responsibility to enforce his or her patent.

A patent grants an inventor “the right to exclude others from making, using, offering for sale, or selling the invention in the United States or importing the invention into the United States”[3] for the patent term. However, patent protection is a trade-off: an inventor trades statutory protection—in effect, a time-limited monopoly—in exchange for disclosure of the invention. A patent application must disclose the invention in specific enough detail to prove invention and to allow a person with relevant expertise to replicate the invention. To quote the statute: “The specification shall contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains, or with which it is most nearly connected, to make and use the same, and shall set forth the best mode contemplated by the inventor or joint inventor of carrying out the invention.”[4] Thus, the written description requirement serves as proof of invention and to “promote the Progress of Science and useful Arts” as called for in the Constitution.

In order to be patentable, an invention must be novel, non-obvious and useful. The three patent categories are: design, with a 14 year term; utility, with a 20 year term; and plant, with a 20 year term.

As the title suggests, design patents are based on an article's appearance and prevent unauthorized use of a product design or design element. A design patent protects the appearance of an article, not it's functional elements, which would be covered by a utility patent. If an invention is new in both its appearance and utility aspects, it can seek both design and utility patents. Design patents run the gambit from Oakley sunglasses and Michael Jackson's Anti-Gravity shoes to LollyZip TSA Approved Travel Squeeze Bottles. The requirement for granting a design patent is that it is a "new, original and ornamental design for an article of manufacture."[5]

Utility patents protect how inventions work. They are what the USPTO characterizes as "the inventor's patent," and represent over 90% of patents issued. To quote the USPTO: "Utility patents may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or composition of matter, or any new and useful improvement thereof." Apple unsurprisingly has a number of utility (and design) patents and a USPTO chart—Apple Finances by Utility Patent—notes the correlation between Apple's patent numbers and financial performance. Apple has also been successful in defending it's patents, including a $119.6 million dollar ruling against Samsung for violation of Apple's slide-to-unlock, text prediction, and other utility patents. [6]

Plant patents, "granted to anyone who invents or discovers and asexually reproduces any distinct and new variety of plant,"[7] are relatively rare—representing less that 1% of all patent applications in 2017.[8] However, in the case of genetically "engineered" or modified seeds, patents are controversial and the value of those patents is significant. A pro-"biotechnology agriculture" website rationalized aggressive enforcement of seed patent rights, stating that "it costs an average of $135 million to develop a new trait and seven years to move it through the regulatory process."[9] According to multiple sources, Monsanto has collected more than $23 million in seed patent judgements since 1997.

Practice Question

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Copyrights

Unlike patents and trademarks, that are administered by the USPTO, copyrights are administered by the Library of Congress. However, like patents and trademarks, a copyright gives its creator the exclusive right to his or her original work for a limited time. Georgia Tech Library provides a more accessible explanation than the Library of Congress site, noting that "a copyright is a form of protection provided to the authors of 'original works of authorship' including literary, dramatic, musical, artistic, and certain other intellectual works, both published and unpublished." Specifically, a copyright gives an owner "the exclusive right to reproduce the copyrighted work, to prepare derivative works, to distribute copies or phonorecords of the copyrighted work, to perform the copyrighted work publicly, or to display the copyrighted work publicly."[10] For the full text of title 17 of the United States Code, including the Copyright Act of 1976 and all amendments enacted by Congress through June 30, 2016, visit Copyright Law of the United States.

The duration of copyrights, which was originally 28 years with an option for the author to renew for one additional 28-year term, has changed radically over the years. Copyright durations can now exceed 100 years. Some blame/credit Mickey Mouse (or, rather, the Walt Disney Company) for the change. Concerned about the pending (2003) expiration of its copyright to Mickey Mouse, The Walt Disney Company began lobbying Congress for an extension of existing copyrights in the 1990s. Congress granted a 20-year extension to all copyrights in 1998. The 1998 extension was challenged in a federal lawsuit, claiming that the 20-year extension violated Article I, Section 8, Clause 8 of the Constitution, which, if you recall, states that Congress has the power "To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries" (emphasis added). In a 2003 ruling, the Supreme Court upheld the copyright term extension, finding that the extension did not exceed Congress's power under the Copyright Clause and did not violate the First Amendment.[11]

As it currently stands, "the law automatically protects a work that is created and fixed in a tangible medium of expression on or after January 1, 1978, from the moment of its creation and gives it a term lasting for the author's life plus an additional 70 years." The copyright duration for works owned by a corporation ("works made for hire") is 95 years from first publication or 120 years from creation, whichever is shorter.[12] Technically, once a copyright expires, the work is referred to as being in the public domain;

that is, the material can be used without obtaining permission or paying a fee. However, as a result of this change in duration, existing copyrights have effectively stopped passing into the public domain.

? Practice Question

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Trademarks

The USPTO defines a trademark as “a word, phrase, symbol, or design, or a combination thereof, that identifies and distinguishes the source of the goods of one party from those of others.” The term “service mark” is synonymous with trademark; the distinction is that a service mark refers to the source of a service rather than a product. In order to be registrable, a trademark/service mark must be perceived as unique. According to the USPTO, the most common reason for a registration application to be denied is a “likelihood of confusion” with a registered or previously filed mark application. A likelihood of confusion exists when trademarks are similar and the goods and/or services of the parties are related in such a way that consumers may mistakenly believe that they are from the same source.

Note that a similar or even identical mark may be registrable as long as the goods and services are not related. In evaluating the likelihood of confusion, three factors are considered: visual appearance, sound, and meaning, including meaning in translation. The key question is whether a proposed mark “create[s] the same general commercial impression in the consuming public’s mind.” As is true with patents, the mark owner is solely responsible for trademark enforcement. The USPTO is only responsible for registering trademarks.

✔ Dove: Chocolate or Soap?

Imagine your friend has just told you that they’ve gotten a job working in the marketing department of Dove. Do you think your friend is working for a chocolate company? Or a soap and beauty product company?

Both companies were able to trademark the brand name Dove because chocolate and beauty products are unrelated goods.

? Practice Question

https://assessments.lumenlearning.co...essments/14342

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Contributors and Attributions

13.14: Introduction to Warranties

What you'll learn to do: describe warranties

In this section, we'll define warranties and describe and differentiate between types of warranties including express warranties, implied warranties and subcategories: warranties of merchantability and fitness for purpose. We also discuss how a warranty is created, how to prove a warranty claim and exceptions to or disclaimers of warranties.

Contributors and Attributions

13.15: Warranties

Learning Objectives

- Define “warranty”
- Explain express warranties
- Explain implied warranties
- Explain the warranties provided by the Uniform Commercial Code

A **warranty** is a promise that goods sold will meet stated standards of performance. A contractual obligation (and associated legal liability) is created when a manufacturer or seller provides a warranty and a buyer relies on the warranty in making his or her purchase decision. A warranty can be either in writing or oral. Another category is when the law imposes a warranty, requiring the manufacturer to meet certain standards of merchantability or fitness. We’ll drill down into each of these scenarios below.

Practice Question

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Types of Warranties

Express Warranties

An express warranty is created based on a seller’s words or actions (i.e., something that has been expressly stated). According to Uniform Commercial Code 2-313, a seller can create an express warranty in three ways:

1. with an affirmation of fact or promise
2. with a description of the goods
3. with a sample or model

In all three cases, the code requires that the seller’s words or actions “become part of the basis of the bargain.” In Business Law and the Legal Environment, the authors explain the “basis of the bargain” clause as follows: “To prove an express warranty, a buyer must demonstrate that the two parties included the statements or acts in their bargain.” Courts generally interpret “basis of bargain” in one of two ways, either requiring a buyer to demonstrate that he or she relied on the seller’s promises in making a purchase decision or assuming that a seller who makes a claim or promise—in advertising, for example—should be held liable for breach of warranty unless he or she can prove otherwise.

Note that it’s not necessary for a seller to use a term such as “warrant” or “guarantee” to create an express warranty. However, if a seller is simply expressing his or her opinion of the goods, there is no promise or warranty.

Implied Warranties

Implied warranties are those created by the Uniform Commercial Code rather than a particular manufacturer or seller. There are two categories of implied warranty: warranty of merchantability and warranty of fitness.

Unless excluded or modified (if allowed, addressed below), a sales contract includes an implied warranty of “merchantability,” defined as “fit for the ordinary purpose for which such goods are used.” Unlike express warranties, this warranty does not need to be in writing or otherwise communicated to the buyer—it is an obligation imposed by the code. An implied warranty of merchantability does not apply to all sales. For it to apply, the seller must be “a merchant with respect to goods of that kind.” That is, the seller must be a person who regularly deals in such goods or, due to his or her occupation or use of an agent, broker or other intermediary to whom knowledge or skill may be attributed, may be considered an expert or someone with “knowledge or skill peculiar to the practices or goods involved in the transaction.”

An implied warranty of fitness is created when a seller, at the time of contracting, has reason to know about a particular purpose for which the goods are required and that the buyer is relying on the seller’s skill or judgment to select or furnish suitable goods. Indeed, the full title of the relevant code (UCC 2-315) is “Implied Warranty: Fitness for Particular Purpose.” In brief, unless excluded or modified, the seller’s knowledge of the particular use of the goods creates an implied warranty that the goods shall be fit for that purpose. As above and detailed below, a seller can exclude or modify a warranty of fitness as allowed by law.

? Practice Question

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https://assessments.lumenlearning.co...essments/14345

https://assessments.lumenlearning.co...essments/14346

The following video explains one’s legal rights under implied warranties. Pay close attention to the examples of “implied warranty” by state law and “implied warranty of fitness.”

You can view the transcript for “Legal Rights Under Implied Warranties” (opens in new window) or the text alternative for “Legal Rights Under Implied Warranties” (opens in new window).

? Try It

Within limits, the Uniform Commercial Code (UCC) allows sellers to disclaim or negate both express and implied warranties on goods they sell. A seller can disclaim an oral express warranty—for example, statements made by a salesperson—by including language in the contract that specifically states that the written contract represents the full extent of the warranty and that any statements made by company representatives are disclaimed and are not part of the contract. Written express warranties generally cannot be disclaimed. In particular, if warranty language is included in a sales contract, it cannot be disclaimed.

Note that the UCC does not allow a seller to take contradictory positions in a document. For example, a sales contract can’t include a description that creates a warranty in one section and disclaim warranties in another section. If the description and disclaimer are in two separate documents—a brochure and sales contract, for example—the disclaimer will be ruled void if a buyer would be “unfairly surprised.” That is, if a buyer read and relied on information in a brochure in making his or her purchase, the seller’s attempt to disclaim the written warranty would most likely fail.

A seller can generally disclaim an implied warranty by stating that a good has no warranty or that it is being sold “as is.” However, there are conditions and exceptions. In order to disclaim an implied warranty of merchantability, a seller must specifically use the word merchantability in the disclaimer and the disclaimer must be conspicuous. For example, the disclaimer could be in bold or red type or the contract could require the buyer to initial the disclaimer section. To disclaim or modify an implied warranty of fitness, the exclusion must be in writing and conspicuous. According to Cornell Law School,

> “Language to exclude all implied warranties of fitness is sufficient if it states, for example, that ‘There are no warranties which extend beyond the description on the face hereof.’”[1]
>
> Note that some states prohibit disclaimers of warranties on consumer goods. According to Consumer Reports, eleven states and the District of Columbia prohibit consumer products from being sold ‘as is.’”[2] In some cases, selling a good as a factory second is a way to circumvent that restriction.

1. "§ 2-316. Exclusion or Modification of Warranties." Legal Information Institute. Accessed June 12, 2019. https://www.law.cornell.edu/ucc/2/2-316. ↵
2. "What You Need to Know about Warranty Laws." Consumer Reports. May 2013. Accessed June 12, 2019. https://www.consumerreports.org/cro/magazine/2013/05/the-word-on-warranty-protection/index.htm. ↵

Contributors and Attributions

13.16: Introduction to 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

This section is an introduction to contract law, legislation that governs the majority of our business and professional dealings. We will define and discuss contracts, including the four required elements of a valid or legally enforceable contract, and highlight exceptions and the related statute. We'll also define "breach of contract" and discuss the remedies for a breach, how damages are calculated and what's required to prevail under different scenarios. Key terms and concepts presented include contract, consideration, capacity, legality, breach of contract, expectation interest, reliance interest, restitution interest and specific performance.

Contributors and Attributions

13.17: What Is a Contract?

Learning Objectives

- Define "contract"
- Identify the four elements of a legally enforceable contract

The Business Law and the Legal Environment authors define contract as "a legally enforceable agreement," noting that while we make a number of casual promises (e.g., "I'll call you later") and formal commitments in the course of a day, these agreements do not necessarily constitute a valid contract. The details of what each party is committing to in a contract are referred to as covenants. As we will discuss in the next section, there are several elements to a valid—read: legally enforceable—contract.

There are four required elements to an enforceable contract, outlined below:

1. **Offer & Acceptance.** A contract begins with an offer, where one party proposes an agreement that includes specific terms. An offer can be accepted in writing, in person, over the phone or by performance that clearly communicates the accepting party agrees to the buyer's terms. Under the "Mailbox Rule" used in most states, an offer is deemed accepted when the accepting party places it in a mailbox or sends an email, even if the offering party never actually receives it.
2. **Consideration.** Consideration is the exchange of value. Value can be an exchange of money for property or services or an exchange of property and/or services as long as both parties receive a measurable benefit.
3. **Legal Capacity.** The parties must be at least 18 years old and of sound mind. A minor who signs a contract has the right to cancel it. A person with mental illness or disability or who is under the influence of drugs or alcohol or who signs under duress does not have the mental capacity to enter into a contract.
4. **Legality.** The contract must be for an activity that is legal. Courts will not enforce a contract to commit a crime—to commit murder or sell drugs, for example.

If any one of these elements is missing, a contract may be voided, releasing the parties from any associated obligations.

Note that the Statute of Frauds requires certain transactions to be contracted for in writing, including the lease or sale of a home, marriage, assumption of debt and any transaction that extends beyond one year from the date of signing.[1]

Practice Question

https://assessments.lumenlearning.co...essments/14348

https://assessments.lumenlearning.co...essments/14349

The following video explains these requirements in greater detail.

You can view the transcript for “Requirements for a Valid Contract” (opens in new window) or the text alternative for “Requirements for a Valid Contract (opens in new window).

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1. Safrath, Bernadette A. "7 Required Elements of an Enforceable Contract." Sapling. Accessed June 12, 2019. https://www.sapling.com/11368503/7-required-elements-enforceable-contract. ↵

Contributors and Attributions

13.18: Breaches of Contracts

Learning Objectives

- Define "breach of contract"
- Explain the legal remedies for breach of contract

The University of New Mexico's Judicial Education Center defines breach of contract as "a failure, without legal excuse, to perform any promise that forms all or part of the contract. This includes failure to perform in a manner that meets the standards of the industry or the requirements of any express warranty or implied warranty, including the implied warranty of merchantability."[1]

When a breach is material, the non-breaching party is released from performing his or her obligations under the contract. That is, the party is "discharged" and has the right to all remedies for breach of contract. If the breach is not material, the non-breaching party is held to the contract but may sue for damages resulting from the breach. For example, a minor delay in receiving goods or services when time is not "of the essence" is an immaterial breach. The buyer is required to pay for the goods or services as contracted and may sue to recover any damages caused by the delay.

PRactice Question

https://assessments.lumenlearning.co...essments/14350

As discussed above, a breach of contract occurs when a party (or parties) to a contract fails to perform their duties without a valid excuse. The method a court uses to compensate an injured party is referred to as a "remedy." Damages for breach of contract are based on three interests: expectation, reliance, and restitution.

Expectation interest—described as "benefit of the bargain"—is designed to put the plaintiff in the position he or she would have been in had the contract been fully executed.[2] This is the most common remedy for a breach of contract. In this scenario, damages are calculated to take into account all reasonably expected gains, expenses or losses. Monetary awards based on expectation interest may include direct damages, consequential damages and/or incidental damages. Direct damages are the direct costs incurred due to the breach of contract. In addition to direct damages, a plaintiff may seek consequential or "special" damages.

Consequential damages are awarded only if the breaching party should have foreseen the consequences when the contract was negotiated. Incidental damages are the costs an injured party incurs responding to the breach. The caveat: expectation damages must be able to be quantified with reasonable certainty. If that's not the case, an injured party may want to pursue damages based on reliance interest instead.

Reliance interest is designed to put the plaintiff in the position he or she would have been in if the contract had never been made. In this case, the remedy is based on the time and money the injured party invested in performance of the contract.

If an injured party cannot prove expectation damages or reliance damages, the final option is restitution. Restitution may also arise in a situation where there is a discharge of duties. To quote from the contract language: "A party whose duty of performance does not arise or is discharged as a result of nonoccurrence of a condition is entitled to restitution for any benefit that he has conferred on the other party by way of part performance or reliance."

When monetary damages are insufficient to compensate the plaintiff for the breach, a court can order specific performance, which compels one party to perform, as nearly as practicable, his or her duties specified in the contract. Specific performance is generally used in cases where the object transferred is considered to be rare or unique—for example, art or land.

Practice Question

https://assessments.lumenlearning.co...essments/14351

1. "Breach of Contract." Judicial Education Center. Accessed June 12, 2019. http://jec.unm.edu/education/online-training/contract-law-tutorial/breach-of-contract. ↵
2. "Damages for Breach of Contract." NYU Law. Accessed June 12, 2019. https://www.law.nyu.edu/sites/default/files/ECM_PRO_063763.pdf. ↵

Contributors and Attributions

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13.19: Introduction to Consumer Protection and Antitrust Laws

What you'll learn to do: summarize consumer protection and antitrust laws

This module concludes with coverage of consumer protection and antitrust laws. We'll consider consumer protection legislation from from both economic and business ethics standpoints, citing statistics to put the need for consumer protection in perspective. We'll highlight representative consumer protection legislation and summarize the key provisions of the three primary antitrust laws: the Sherman Act, The Federal Trade Commission Act and the Clayton Act. Note that these two categories of legislation serve both businesses and consumers, supporting ethical business practices fair competition that tends to yield price, quality and innovation benefits.

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13.20: Consumer Protection

Learning Objectives

- Explain why consumer protection legislation is needed
- Summarize several consumer protection laws

Importance of Consumer Protection Law

Accounting for roughly 70% of GDP in 2018, consumer spending is essential to the health of the U.S. economy and the country's relative political stability, prosperity and quality of life. What would happen if the American consumer lost faith in manufacturers . . . in retailers . . . in providers of goods and services ranging from aircraft and automobiles to a broad range of agricultural and consumer packaged goods? That would put the $13 trillion consumers spent in 2018 at risk.

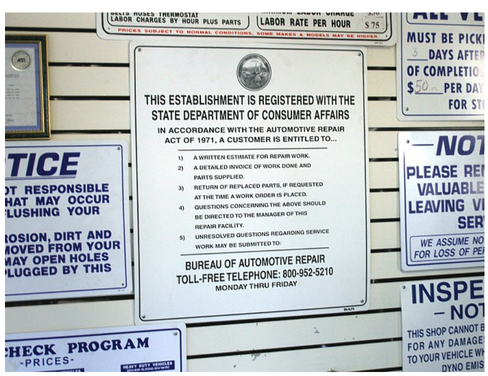
For perspective, that dollar figure dwarfs the (albeit substantial) $700 billion the Treasury spent on the 2008 bank bailout. The lack of ethics, ineffective standards and outright fraud that contributed to the economic crisis isn't limited to the financial sector. The U.S. Food and Drug Administration and the U.S. Department of Agriculture's Food Safety and Inspection Service reported 456 food recalls in 2017.[1] In the consumer durables category, The National Highway Traffic Safety Administration reported 30.7 million motor vehicle recalls in 2017. Forbes contributor Jim Gorzelany puts that in perspective, noting that with 17.6 million new vehicles sold in 2017, the industry recalled approximately 74% more cars and truck than it delivered.[2]

Clearly, *caveat emptor*, a Latin term translated as "let the buyer beware," applies as much to modern commerce as it did when it first emerged as a legal principle in a 1603 case that drew a distinction between warranties and affirmations. However, this phrase is insufficient for consumer safety, and consumer protections are essential to maintain consumer confidence and the health of the economy and society.

Practice Question

https://assessments.lumenlearning.co...essments/14352

Consumer Protection Laws



There are several consumer protection laws. In the United States, these laws are mainly enforced by The Federal Trade Commission, Consumer Financial Protection Bureau, FDA & US Department of Justice. Consumer protection legislation includes statutes that address the following:

- Product Safety

- Consumer Credit
- Automotive Safety

Product Safety

The federal Consumer Product Safety Act (CPSA) established the Consumer Product Safety Commission and authorized the agency to develop and enforce standards, including the right to ban products.[3]

The federal Food and Drug Act (FDA) mandates regulation of food, drugs, cosmetics, biologics, medical products and tobacco. The FDA's authority includes public education, investigation and enforcement.

Consumer Credit

The federal Fair Credit Reporting Act (FCRA) promotes the accuracy, fairness, and privacy of information in the files of consumer reporting agencies. The act requires credit reporting agencies such as Experian and Transunion to allow consumers to review their credit data on file and to verify any information disputed by a consumer. Here are some excerpts from the FTC's summary of rights under the act:

- You must be told if information in your file has been used against you.
- You have the right to know what is in your file.
- You have the right to dispute incomplete or inaccurate information.

An amendment to the law, the Fair and Accurate Credit Transactions Act, allows consumers to obtain one free credit report (not to be confused with your credit score) annually. To request your free report, visit www.annualcreditreport.com.

Automotive Safety

The Highway Safety Act established the National Highway Traffic Safety Administration (NHTSA), an organization charged with "promoting vehicle safety innovations, addressing vehicle defects, setting safety standards for cars and trucks, and educating Americans to help them make safer choices when driving, riding, or walking."[4]

Although deceptive trade practices are addressed under antitrust legislation, it's worth highlighting California's Consumers Legal Remedies Act, which identifies a broad range of unfair methods of competition and unfair or deceptive acts or practices used in the sale or lease of consumer goods or services and allows consumers to sue to recover damages and stop the prohibited practices.[5]

? Practice Question

https://assessments.lumenlearning.co...essments/14353

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1. Maberry, Tiffany. "A Look Back at 2017 Food Recalls." Food Safety Magazine. February 6, 2018. Accessed June 12, 2019. www.foodsafetymagazine.com/enewsletter/a-look-back-at-2017-food-recalls/. ↵
2. Gorzelany, Jim. "Auto Recalls Hit A Four-Year Low Last Year, But Still Exceed Units Sold." Forbes. March 13, 2018. Accessed June 12, 2019. https://www.forbes.com/sites/jimgorzelany/2018/03/13/auto-recalls-hit-a-four-year-low-last-year-still-exceed-units-sold/. ↵
3. "Consumer Product Safety Act." Consumer Product Safety Commission. August 12, 2011. Accessed June 12, 2019. https://www.cpsc.gov/PageFiles/105435/cpsa.pdf. ↵
4. "Understanding the National Highway Traffic Safety Administration (NHTSA)." US Department of Transportation. January 26, 2017. Accessed June 12, 2019. https://www.transportation.gov/transition/understanding-national-highway-traffic-safety-administration-nhtsa. ↵
5. "Civil Code CIV - Division 3 - Part 4 - Title 1.5 - Chapter 3." California Legislative Information. Accessed June 12, 2019. https://leginfo.legislature.ca.gov/faces/codes_displayText.xhtml?lawCode=CIV&division=3.&title=1.5.&part=4.&chapter=3.&article=. ↵

Contributors and Attributions

13.21: Antitrust Legislation

Learning Objectives

- Explain the goal of antitrust legislation
- Summarize the provisions of the Sherman Act
- Summarize the provisions of the Federal Trade Commission Act
- Summarize the provisions of the Clayton Act

The Federal Trade Commission's website explains the intended outcome of antitrust legislation as follows:

Free and open markets are the foundation of a vibrant economy. Aggressive competition among sellers in an open marketplace gives consumers — both individuals and businesses — the benefits of lower prices, higher quality products and services, more choices, and greater innovation.[1]

The goal of antitrust legislation is to create and maintain a competitive market that yields the price, quality, choice and innovation benefits mentioned. The mission of the FTC and related agencies such as the U.S. Department of Justice (DOJ) Antitrust Division is to enforce the antitrust laws and, by extension, the rules of the competitive marketplace.

Practice Question

https://assessments.lumenlearning.co...essments/14354

Here is an overview of the three core federal antitrust laws.

Sherman Act

As summarized on the Ourdocuments site, the Sherman Antitrust Act of 1890 was the first federal act to outlaw monopolistic business practices.[2] As stated on the Federal Trade Commission website, "The Sherman Act outlaws 'every contract, combination, or conspiracy in restraint of trade,' and any 'monopolization, attempted monopolization, or conspiracy or combination to monopolize.'"[3]

For example, the act authorized the federal government to dissolve trusts that concentrated ownership in the hands of a few trustees and effectively restrained trade or commerce. A 1895 Supreme Court decision limited the extent of the law, ruling that the law prohibited only unreasonable restraints of trade. This limitation did not deter the government from pursuing and winning a number of high-profile cases based on the Sherman Act, including a prosecution of Microsoft pursued by the Justice Department and 19 states. In an opinion reported in The New York Times, Judge Jackson wrote "the court concludes that Microsoft maintained its monopoly power by anticompetitive means and attempted to monopolize the Web browser market . . . unlawfully tying its Web browser to its operating system."[4]

Practice Question

https://assessments.lumenlearning.co...essments/14355

Federal Trade Commission Act

The Federal Trade Commission Act is a federal consumer protection statute that created the Federal Trade Commision (FTC), an agency charged with developing and enforcing standards for commerce. To elaborate, the Commission has the authority to:

- Prevent unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce
- Seek monetary redress and other relief for conduct injurious to consumers
- Prescribe rules defining with specificity acts or practices that are unfair or deceptive and establish requirements designed to prevent such acts or practices
- Gather and compile information and conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce.

The FTC's Bureau of Consumer Protection educates consumers and businesses about their rights and responsibilities, investigates consumer complaints and litigates cases involving deceptive trade practices and other violations of consumer protection statutes.[5]

? Practice Question

https://assessments.lumenlearning.co...essments/14356

Clayton Act

Passed by Congress and signed into law in 1914, the Clayton Antitrust Act was designed to clarify and strengthen the Sherman Act. Further, the FTC site notes that the Act "addresses specific practices that the Sherman Act does not clearly prohibit, such as mergers and interlocking directorates (that is, the same person making business decisions for competing companies)."[6] In addition to banning price discrimination and anti-competitive mergers and acquisitions, the Clayton Act established the legality of strikes, boycotts and labor unions.[7]

In addition to these federal statutes, most states have antitrust laws that are enforced by state attorneys general or private plaintiffs. Many of these statutes are based on the federal antitrust laws.

? Practice Question

https://assessments.lumenlearning.co...essments/14357

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1. "Guide to Antitrust Laws." Federal Trade Commission. April 08, 2019. Accessed June 12, 2019. https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws. ↵
2. "Sherman Anti-Trust Act (1890)." Our Documents. Accessed June 12, 2019. https://www.ourdocuments.gov/doc.php?flash=false&doc=51. ↵
3. "Guide to Antitrust Laws." Federal Trade Commission. April 08, 2019. Accessed June 12, 2019. https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws. ↵
4. Brinkley, Joel. "U.S. Judge Says Microsoft Violated Antitrust Laws with Predatory Behavior." The New York Times. April 04, 2000. Accessed June 12, 2019. https://www.nytimes.com/2000/04/04/business/us-vs-microsoft-overview-us-judge-says-microsoft-violated-antitrust-laws-with.html. ↵
5. "Bureau of Consumer Protection." Federal Trade Commission. September 23, 2016. Accessed June 12, 2019. https://www.ftc.gov/about-ftc/bureaus-offices/bureau-consumer-protection. ↵
6. "Guide to Antitrust Laws." Federal Trade Commission. April 08, 2019. Accessed June 12, 2019. https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws. ↵
7. "The Clayton Antitrust Act." US House of Representatives: History, Art & Archives. Accessed June 12, 2019. https://history.house.gov/HistoricalHighlight/Detail/15032424979. ↵

Contributors and Attributions

13.22: Putting It Together- Legal Environment

Synthesis

Now that you have studied the legal environment of business, let's go back and check on your roommate. What do you think the outcome of the lawsuit was?

You probably won't be surprised to learn that your roommate was liable for negligence in kicking over the paint bucket, but you may be dismayed to learn that you were, too. When it comes to the claim of assault and battery, your roommate was also liable for that, but you may be protected from liability. As for the damages that you'll have to pay in order to settle the homeowner's negligence suit, you'll be happy to know that you can indeed write them off as "ordinary" business expenses (unless they're paid by your insurance company).

After working through this module you should be aware that even after paying damages, you still fared better than your roommate, because assault and battery violates statutes established by two different types of law—criminal and civil.

It is incumbent on each business professional to become familiar with the legal environment in his or her profession. Employers may provide training regarding legal environment issues, such as anti-sexual-harassment training or anti-insider-trading training, but ultimately, becoming familiar with the legal environment is each person's individual responsibility. Remember that a defense of "I didn't know the law!" is no defense at all.

Summary

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

The Meaning and Purpose of Law

The law as we defined it is a set of rules of conduct or procedureestablished by custom,agreement, or authority. It refers to the entire thebody of rulesandprinciplesgoverningtheaffairs of a communityandenforced by a politicalauthority. The main purposes of the law are to establish standards, maintain order, resolve disputes, and protect liberties and rights.

Statutory and Common Law

There are different sources of law in the U.S. legal system. The U.S. Constitution is foundational; U.S. statutory and common law must be consistent with its provisions. Congress creates statutory law (with the signature of the president), and the courts interpret both statutory and constitutional law. Where there is neither constitutional law nor statutory law, the courts function in the realm of common law.

Tort Law

In common law jurisdictions, a tort is a civil wrong that unfairly causes someone else to suffer loss or harm, resulting in legal liability for the person who commits the tortious act. Torts may result from negligent as well as intentional or criminal actions.

Product liability is the area of law in which product manufacturers, distributors, and sellers are held responsible for the injuries caused by their products.

When someone pursues a claim under a tort, the goal (or legal remedy) is usually the award of damages. Damages are an award, typically of money, to be paid to a person as compensation for loss or injury.

Intellectual Property

Intellectual property refers to creations of the mind—creative works or ideas embodied in a form that can be shared or enable others to recreate, emulate, or manufacture them. There are three main ways to protect intellectual property: patents, trademarks, and copyrights.

Warranties

A first basis of recovery in products-liability theory is breach of warranty. There are two types of warranties: express and implied. Under the implied category are three major subtypes: the implied warranty of merchantability (only given by merchants), the implied warranty of fitness for a particular purpose, and the implied warranty of title. Under warranty law there must have been a sale of the goods; the plaintiff must bring the action within the statute of limitations; and the plaintiff must notify the seller within a reasonable time. The seller may limit or exclude express warranties or limit or exclude implied warranties.

Contracts

Every transaction in business creates a contract (agreement) between the parties. In order to determine whether a valid, enforceable contract exists, the following questions must be answered: (1) Did the parties reach an agreement? (2) Was consideration present? (3) Was the agreement legal? (4) Did the parties have capacity to make a contract? (5) Was the agreement in the proper form? Remedies available against someone who breaches a contract include damages, specific performance, and restitution. Frequently the party who is not in breach must choose between tort and contract remedies.

Consumer Protection and Antitrust Laws

A range of laws regulate consumer affairs, and their aim is to protect consumers from unscrupulous business practices or potentially dangerous products. Some of the most far-reaching consumer protection laws are the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Federal Food, Drug, and Cosmetics Act, and the Uniform Deceptive Trade Practices Act.

Antitrust legislation is another kind of consumer protection that aims to prevent unfair business practices that limit competition or control prices. The three core federal antitrust laws are the Sherman Act, the Federal Trade Commission Act, and the Clayton Act.

Contributors and Attributions

13.23: Discussion- They Don’t Sue Dog-Treat Companies, Do They?

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document “Salty Pawz Background.”

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda is horrified when she sees a news report that some dog treats have been recalled because they have caused some dogs to get sick and even die. Wanda is very careful about her ingredients and uses only chicken, lamb, and bison that come from sustainable farms. Still, these headlines make her nervous. What if her dog treats make someone’s dog sick? What if a batch of her Chicken Cuties is somehow contaminated and a dog dies from eating them?

For Discussion

Wanda comes to you for advice, not as an attorney, but as someone who knows about the legal environment in business regarding her potential liability.

- What kind of legal exposure does Wanda have, and how can she protect herself against lawsuits?
- How much responsibility do *you* believe companies should have for the safety of their products?

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

Contributors and Attributions

13.24: Discussion- The Product-Liability Debate

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Consider the following:

- A woman sued McDonald’s because she was burned by hot coffee;
- A man sued a motor home manufacturer after the vehicle crashed when he left the driver’s seat to fix himself a sandwich (he had the vehicle on cruise control);
- A woman sued a department store after she was injured by a falling display (pushed over by her own child);
- Millions of families lose loved ones to mesothelioma caused by prolonged exposure to asbestos.

These are all examples of product liability lawsuits that have made headlines in recent years. Non-attorney spokespeople advertise on behalf of law firms, seeking participants for class-action lawsuits. This is today’s product liability climate.

Research an instance of product liability that has resulted in a court decision within the last twelve to twenty-four months. It doesn’t matter if the decision was in favor of the plaintiff or the defendant; just be certain that you are able to report on the outcome of the lawsuit. Make sure to get a link and URL for case facts so that your classmates can follow up and read more about what you bring to the discussion. After you have read about the case and completed your research, post to the discussion as required below.

For Discussion

1. Provide a brief synopsis of the case you read in preparation for this discussion. Be sure to include a URL and/or Web link in your post.
2. Based on the case you read about, should the consumer bear more responsibility for product injuries, or should manufacturers bear more responsibility?
3. How does product liability impact business operations and decisions?
4. Do you believe that the current product-liability legal system is broken? Why or why not?
    1. If you believe it is broken, how would you fix it?
    2. If you believe it is working well, defend the system.

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

Contributors and Attributions

13.25: Assignment- Your Dog Treats Made Fluffy Sick!

Scenario

Wanda is horrified when she sees a news report that some dog treats have been recalled because they have made some dogs get sick and even die. Wanda is very careful about her ingredients and only uses chicken, lamb, and bison that come from sustainable farms. Still, these headlines make her nervous. What if her dog treats make someone's dog sick? What if a batch of her Chicken Cuties is somehow contaminated and a dog dies from eating them?

Your Task

Wanda comes to you for advice, not because you are an attorney, but because you know something about the legal environment of business and are concerned about her potential liability. In order to give Wanda as much help as possible, you will need to conduct research on the legal and regulatory environment for the dog treat industry. Once you have completed that research and have reviewed your course materials, you will be prepared to answer the following questions for Wanda.

- What kind of legal exposure does Wanda have selling dog treats?
- What are some of the legal consequences that Wanda and the business could experience if a dog did get sick or even die from a Salty Pawz treat?
- How can Wanda protect herself and the business against lawsuits?

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain Salty Pawz potential liability concerns if a batch of treats is contaminated.	0 points	16.5 points	24 points	30 points	30%
Describe the kinds of legal exposure associated with potential contamination of a batch of treats.	0 points	16.5 points	24 points	30 points	30%
Recommend strategies Salty Pawz can take to protect against lawsuits related to contamination.	0 points	16.5 points	24points	30 points	30%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	5.5 points	8 points	10 points	10%

Total points possible: 100.

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13.26: Assignment- Who Is Suing Whom?

Preparation

Most people are familiar with the lawsuit in which a woman sued McDonald's after being burned by their hot coffee, but did you know that Uber drivers may be owed millions of dollars in back pay or that a judge recently blocked 100 million WhatsApp users? Lawsuits against businesses or between businesses (Microsoft vs. Oracle) fill court dockets around the world. The issues in these cases range from patent infringement to product liability, and many of them are decided or settled without the public knowing about it. However, these lawsuits can have an impact on customers (higher prices), the availability of new products (fewer, in cases of patent infringement), and even national economies (Facebook banned in Korea).

Your Task

1. Use the link provided below to access *Entrepreneur* magazine's "Court Case" section: Entrepreneur: Court Cases. There you will find a wide range of court cases that involve some of the biggest names in business.
2. Select one of the cases on the site as the basis for your written assignment. You may get your preliminary information from the *Entrepreneur* magazine site, but don't limit yourself to this one source. Google the case and see if there are additional facts or developments that you need to consider before completing this assignment.
3. Write a case summary that includes the following information:
    1. Parties to the case and names of defendants and plaintiffs.
    2. The primary issue at the heart of the lawsuit (e.g., copyright, labor law, unfair competition) and the reasons or events that caused the plaintiff to file the lawsuit.
    3. Provide a brief summary of the keys facts in the case from the perspective of all parties. Generally, these will be the claims of the plaintiff and the defenses of the defendant.
    4. If a decision has been made in the case, what was it? If damages were awarded, how much were they? If the damages were not monetary, what did the court order the parties to do or not do because of the lawsuit?
    5. If the case has not been decided, then what is the plaintiff asking the court to do if it prevails?
    6. Regardless of whether the case is decided or not, what are the implications or potential implications for the businesses involved and the stakeholders of those businesses?

Note: Please remember to provide proper citations for all sources using APA style.

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CHAPTER OVERVIEW

14: Module 5 Readings - Global Environment

14.1: Reading- What Is International Business?

The Definition of International Business

International business relates to any situation where the production or distribution of goods or services crosses country borders. Globalization—the shift toward a more interdependent and integrated global economy—creates greater opportunities for international business. Such globalization can take place in terms of markets, where trade barriers are falling and buyer preferences are changing. It can also be seen in terms of production, where a company can source goods and services easily from other countries. Some managers consider the definition of international business to relate purely to "business." However, a broader definition of international business may serve you better both personally and professionally in a world that has moved beyond simple industrial production.

International business encompasses a full range of cross-border exchanges of goods, services, or resources between two or more nations. These exchanges can go beyond the exchange of money for physical goods to include international transfers of other resources, such as people, intellectual property (e.g., patents, copyrights, brand trademarks, and data), and contractual assets or liabilities (e.g., the right to use some foreign asset, provide some future service to foreign customers, or execute a complex financial instrument). The entities involved in international business range from large multinational firms with thousands of employees doing business in many countries around the world to a small one-person company acting as an importer or exporter. This broader definition of international business also encompasses for-profit border-crossing transactions as well as transactions motivated by nonfinancial gains (e.g., triple bottom line, corporate social responsibility, and political favor) that affect a business's future.

Strategic Management and Entrepreneurship

A knowledge of both strategic management and entrepreneurship will enhance your understanding of international business.

Strategic Management

Strategic management is the body of knowledge that answers questions about the development and implementation of good strategies and is mainly concerned with the determinants of firm performance. A strategy, in turn, is the central, integrated, and externally oriented concept of how an organization will achieve its performance objectives. One of the basic tools of strategy is a SWOT (strengths, weaknesses, opportunities, threats) assessment. The SWOT tool helps you take stock of an organization's internal characteristics—its strengths and weaknesses—to formulate an action plan that builds on what it does well while overcoming or working around weaknesses. Similarly, the external part of SWOT—the opportunities and threats—helps you assess those environmental conditions that favor or threaten the organization's strategy. Because strategic management is concerned with organizational performance—be that social, environmental, or economic—your understanding of a company's SWOT will help you better assess how international business factors should be accounted for in the firm's strategy.

Entrepreneurship

Entrepreneurship, in contrast, is defined as the recognition of opportunities (i.e., needs, wants, problems, and challenges) and the use or creation of resources to implement innovative ideas for new, thoughtfully planned ventures. An entrepreneur is a person who engages in entrepreneurship. Entrepreneurship, like strategic management, will help you to think about the opportunities available when you connect new ideas with new markets. For instance, given Google's current global presence, it's difficult to imagine that the company started out slightly more than a decade ago as the entrepreneurial venture of two college students. Google was founded by Larry Page and Sergey Brin, students at Stanford University. It was first incorporated as a privately held company on September 4, 1998. Increasingly, as the Google case study demonstrates, international businesses have an opportunity to create positive social, environmental, and economic values across borders. An entrepreneurial perspective will serve you well in this regard.

Spotlight on International Strategy and Entrepreneurship

Hemali Thakkar and three of her fellow classmates at Harvard found a way to mesh the power of play with electrical power. The foursome invented "a soccer ball with the ability to generate electricity," Thakkar said. Every kick of the ball creates a current that's captured for future use. Fifteen minutes of play lights a lamp for three hours.

Called the sOccket, the soccer ball can bring off-grid electricity to developing countries. Even better, the soccer ball can replace kerosene lamps. Burning kerosene is not only bad for the environment because of carbon dioxide emissions but it's also a health hazard: according to the World Bank, breathing kerosene fumes indoors has the same effects as smoking two packs of cigarettes per day.

How did the idea of sOccket emerge? All four students (Jessica Lin, Jessica Matthews, Julia Silverman, and Hemali Thakkar) had experience with developing countries, so they knew that kids love playing soccer (it's the world's most popular sport). They also knew that most of these kids lived in homes that had no reliable energy.

As of November 2010, the sOccket prototype cost $70 to manufacture, but the team hopes to bring the cost down to $10 when production is scaled up. One ingenious way to bring costs down is to set up facilities where developing-world entrepreneurs assemble and sell the balls themselves.

KEY TAKEAWAYS

International business encompasses a full range of cross-border exchanges of goods, services, or resources between two or more nations. These exchanges can go beyond the exchange of money for physical goods to include international transfers of other resources, such as people, intellectual property (e.g., patents, copyrights, brand trademarks, and data), and contractual assets or liabilities (e.g., the right to use some foreign asset, provide some future service to foreign customers, or execute a complex financial instrument).

Strategic management is the body of knowledge that answers questions about the development and implementation of good strategies and is mainly concerned with the determinants of firm performance. Because strategic management is concerned with organizational performance, your understanding of a company's SWOT (strengths, weaknesses, opportunities, threats) helps you better assess how international business factors should be accounted for in the firm's strategy.

Entrepreneurship is the recognition of opportunities (i.e., needs, wants, problems, and challenges) and the use or creation of resources to implement innovative ideas. Entrepreneurship helps you think about the opportunities available when you connect new ideas with new markets.

Reflection Questions

- How do Harvard-educated students benefit from doing business in lesser-developed countries?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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14.2: Reading- The Balance of Trade

Why Nations Trade

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

- Countries are *importers* when they buy goods and services from other countries;
- When they sell products to other nations, they're *exporters*.

The monetary value of international trade is enormous. In 2014, the total value of worldwide trade in merchandise and commercial services was $22.5 *trillion*.

How Do We Measure Trade between Nations?

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

Balance of trade = Value of exports – Value of imports

For many years, the United States has had a trade deficit: we buy far more goods from the rest of the world than we sell overseas. This fact shouldn't be surprising. With high income levels, we not only consume a sizable portion of our own domestically produced goods but enthusiastically buy imported goods. Other countries, such as China and Taiwan, which manufacture primarily for export, have large trade surpluses because they sell far more goods overseas than they buy.

Managing the National Credit Card

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

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

Balance of Payments

The second key measure of the effectiveness of international trade is **balance of payments**: the difference, over a period of time, between the total flow of money coming into a country and the total flow of money going out.

Balance of Payments = Total flow of money coming into a country – Total flow of money going out

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

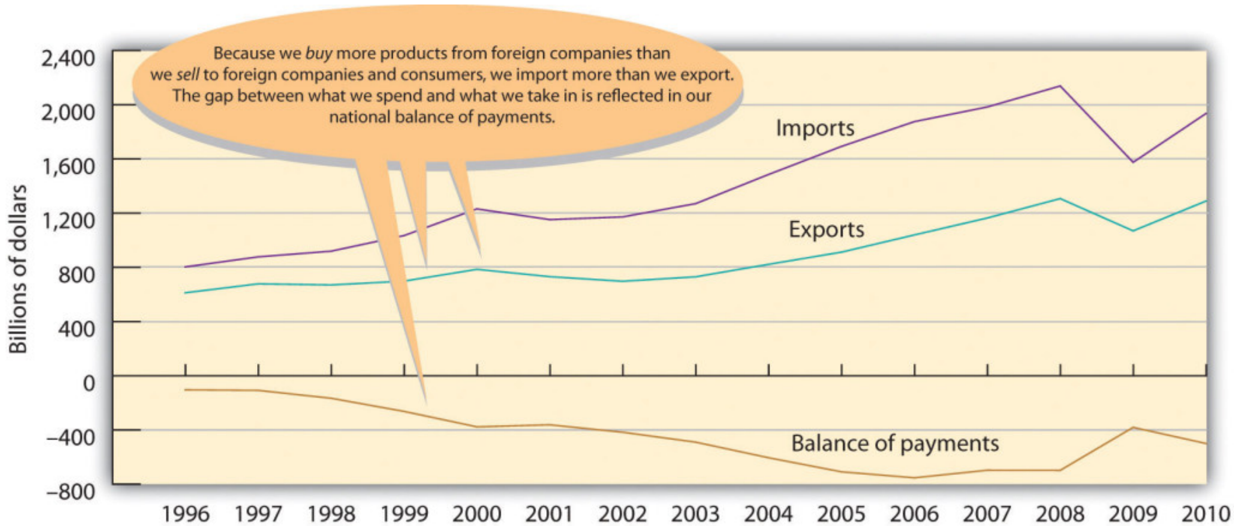

Figure 14.2.1: U.S. Imports, Exports, and Balance of Payments, 1994–2010

Note: Figures are for "goods" only, not "goods and services." Source: U.S. Census Bureau, Foreign Trade Division.

KEY TAKEAWAYS

- Nations trade because they don't produce all the products that their inhabitants need.
  - They import those that they need but don't produce and export those that are needed elsewhere.
  - To understand why certain countries import or export certain products, you need to realize that not all countries are good at producing or are able to produce the same products.
  - The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world.
- To evaluate the impact of its international trade, a nation looks at two key indicators: balance of trade and balance of payments.
- We determine a country's **balance of trade** by subtracting the value of its imports from the value of its exports.
  - If a country sells more products than it buys, it has a favorable balance, called a **trade surplus**.
  - If it buys more than it sells, it has an unfavorable balance, or a **trade deficit**.
- The **balance of payments** is the difference, over a period of time, between the total flow coming into a country and the total flow going out.
  - As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of exports and imports.
  - But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid.

Reflection Questions

- Should the U.S. buy fewer foreign goods and seek to improve its balance of trade?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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14.3: Reading- Absolute and Comparative Advantage

Absolute and Comparative Advantage

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

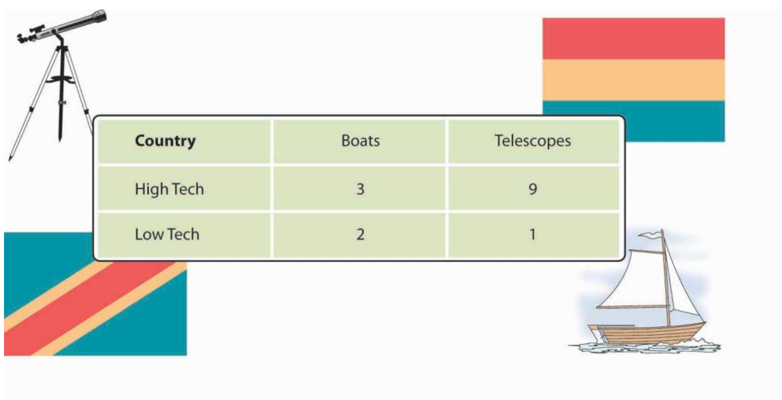
Absolute Advantage

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

Comparative Advantage

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

Let's simplify things by imagining a world with only two countries—the Republic of High Tech and the Kingdom of Low Tech. We'll pretend that each country knows how to make two and only two products: wooden boats and telescopes. Each country spends half its resources (labor and capital) on each good. Figure 14.3.1 shows the daily output for both countries: High Tech makes three boats and nine telescopes while Low Tech makes two boats and one telescope. (They're not highly productive, as we've imagined two *very* small countries.)



Country	Boats	Telescopes
High Tech	3	9
Low Tech	2	1

Figure 14.3.1: Comparative Advantage in the Techs

When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make nine telescopes (see Figure 14.3.1). If it gives up the opportunity to make the nine telescopes, it can use the time gained by not making the telescopes to make three more boats (the number of boats it can make with half of its time). Because High Tech could make three more boats by giving up the opportunity to make the nine telescopes, the opportunity cost of making each boat is three telescopes (9 telescopes ÷ by 3 boats = 3 telescopes). First, note that High Tech has an *absolute* advantage (relative to Low Tech) in both boats and telescopes: it can make more boats (three versus two) and more telescopes (nine versus one) than Low Tech can with the same resources. So, why doesn't High Tech make *all* the boats and *all* the telescopes needed for *both* countries? Because it lacks sufficient resources to make all the boats and all the telescopes, High Tech must, therefore, decide how much of its resources to devote to each of the two goods. Let's assume that each country could devote 100 percent of its resources on *either* of the two goods. We'll pick boats as a start. If both countries spend *all* their resources on boats (and make no telescopes), here's what happens:

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

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

- When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make three boats (Figure 1). If it gives up the opportunity to make the three boats, it can use the time gained by not making the boats to make nine more telescopes. Because High Tech could make nine more telescopes by giving up the opportunity to make three boats, the opportunity cost of making each telescope is one-third of a boat (3 boats ÷ 9 telescopes = 1/3 of a boat).
- When Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make two boats. If it gives up the opportunity to make the two boats, it can use the time to make one more telescope. Thus, if Low Tech wants to make only telescopes, it could make one more telescope by giving up the opportunity to make two boats. Thus, the opportunity cost of making each telescope is two boats (2 boats ÷ 1 telescope = 2 boats).
- In this case, High Tech has the *lower opportunity cost*: Because it had to give up less to make the extra telescopes (1/3 of a boat vs. 2 boats), it enjoys a comparative advantage for telescopes. And because it's better—more efficient—at making telescopes than at making boats, it should specialize in telescope making.

Each country will specialize in making the good for which it has a comparative advantage—that is, the good that it can make most efficiently, relative to the other country. High Tech will devote its resources to telescopes (which it's good at making), and Low Tech will put its resources into boat making (which it does well). High Tech will export its excess telescopes to Low Tech, which will pay for the telescopes with the money it earns by selling its excess boats to High Tech. Both countries will be better off.

Things are a lot more complex in the real world, but, generally speaking, nations trade to exploit their advantages. They benefit from specialization, focusing on what they do best, and trading the output to other countries for what *they* do best. The United States, for instance, is increasingly an exporter of knowledge-based products, such as software, movies, music, and professional services (management consulting, financial services, and so forth). America's colleges and universities, therefore, are a source of comparative advantage, and students from all over the world come to the United States for the world's best higher-education system.

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

KEY TAKEAWAYS

- To explain how countries decide what products to import and export, economists use the concepts of *absolute* and *comparative advantage*.
  - A nation has an **absolute advantage** if it's the only source of a particular product or can make more of a product with the same amount of or fewer resources than other countries.
  - A **comparative advantage** exists when a country can produce a product at a lower *opportunity cost* than other nations.
- Nations trade to exploit their advantages: they benefit from specialization, focusing on what they do best and trading the output to other countries for what *they* do best.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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14.4: Reading- The Global Business Environment

The Global Business Environment

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

The Cultural Environment

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

Language

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

In many countries, only members of the educated classes speak English. The larger population—which is usually the market you want to tap—speaks the local tongue. Advertising messages and sales appeals must take this fact into account. More than one English translation of an advertising slogan have resulted in a humorous (and perhaps serious) blunder. Some classics are listed in Table $14.4.1$ below.

Table $14.4.1$. Lost in Translation
In Belgium, the translation of the slogan of an American auto-body company, "Body by Fisher," came out as "Corpse by Fisher."
Translated into German, the slogan "Come Alive with Pepsi" became "Come out of the Grave with Pepsi."
A U.S. computer company in Indonesia translated "software" as "underwear."
A German chocolate product called "Zit" didn't sell well in the United States.
An English-speaking car-wash company in Francophone Quebec advertised itself as a "*lavement d'auto*" ("car enema") instead of the correct "*lavage d'auto*."
A proposed new soap called "Dainty" in English came out as "aloof" in Flemish (Belgium), "dimwitted" in Farsi (Iran), and "crazy person" in Korea; the product was shelved.
One false word in a Mexican commercial for an American shirt maker changed "When I used this shirt, I felt good" to "Until I used this shirt, I felt good."
In the 1970s, GM's Chevy Nova didn't get on the road in Puerto Rico, in part because *Nova* in Spanish means "It doesn't go."
A U.S. appliance ad fizzled in the Middle East because it showed a well-stocked refrigerator featuring a large ham, thus offending the sensibilities of Muslim consumers, who don't eat pork.

Furthermore, relying on translators and interpreters puts you as an international businessperson at a disadvantage. You're privy only to *interpretations* of the messages that you're getting, and this handicap can result in a real competitive problem. Maybe you'll misread the subtler intentions of the person with whom you're trying to conduct business. The best way to combat this problem is to study foreign languages. Most people appreciate some effort to communicate in their local language, even on the most basic level. They even appreciate mistakes you make resulting from a desire to demonstrate your genuine interest in the language of your counterparts in foreign countries. The same principle goes doubly when you're introducing yourself to non-English speakers in the United States. Few things work faster to encourage a friendly atmosphere than a native speaker's willingness to greet a foreign guest in the guest's native language.

Time and Sociability

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

High- and Low-Context Cultures

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

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

By contrast, in low-context cultures, such as those of the United States, Germany, Switzerland, and the Scandinavian countries, personal and work relationships are more compartmentalized: you don't necessarily need to know much about the personal context of a person's life to deal with him or her in the business arena.

Intercultural Communication

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

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

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

In summary, learn about a country's culture and use your knowledge to help improve the quality of your business dealings. Learn to value the subtle differences among cultures, but don't allow cultural stereotypes to dictate how you interact with people from *any* culture. Treat each person as an individual and spend time getting to know what he or she is about.

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14.5: Reading- The Global Economic and Regulatory Environment

The Economic Environment

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

Economic Development

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

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

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

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

The Legal and Regulatory Environment

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

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

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

Foreign Corrupt Practices Act

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

Where are American businesspeople most likely and least likely to encounter bribe requests and related forms of corruption? Transparency International, an independent German-based organization, annually rates nations according to "perceived corruption," which it defines as "the abuse of public office for private gain." Table 14.5.1, "Corruptibility Around the World, 2010," reports a sampling of the 2010 rankings.

Table 14.5.1. Corruptibility Around the World, 2010

Rank	Country	CPI Score*
1	Denmark	9.3
1	New Zealand	9.3
1	Singapore	9.3
4	Finland	9.2
4	Sweden	9.2
6	Canada	8.9
15	Germany	7.9
17	Japan	7.8
20	United Kingdom	7.6
22	United States	7.1
98	Mexico	3.1
175	Iraq	1.6
176	Afghanistan	1.4
178	Somalia	1.1

*A score of 10 means that a country is squeaky clean. Anything under 3 means that corruption is rampant.

Source: "Corruption Perceptions Index 2010 Results," Transparency International, Corruption Perceptions Index 2010 Results, www.transparency.org/policy_research/surveys_indices/cpi/2010/results (accessed September 20, 2011).

KEY TAKEAWAYS

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/164

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14.6: Reading- Global Business Ethics

Global Business Ethics

The field of ethics is a branch of philosophy that explores the nature of virtue and morality, addressing questions about "right" and "wrong" in secular (as opposed to religious) terms; essentially, ethics tries to set standards for how human beings ought to act. The study of ethics comes from a variety of sources—religion, philosophy, the laws of nature, political and social theory, and science—and its ideas have an impact on many fields besides business—medicine, government, and science, to name a few.

The text below is organized in the way that people tend to think about ethics: first they consider where ethical principles come from; then they consider how people ought to apply those principles to specific tasks or issues. Though global business ethics is the focus of the discussion, you won't find a tangible list of dos and don'ts here. Instead, the material is meant to help you understand some of the critical issues that global managers must deal with on an operational and strategic basis.

Where Do Our Values Come From?

Just as people look to history to understand political, technical, and social changes, so, too, do they look to history to understand changes in thinking and philosophy. Believe it or not, there is a history of thought and belief. What may or may not have been acceptable just a hundred years ago may be very different today—from how people present themselves and how they act and interact to customs, values, and beliefs.

Ethics can be defined as a system of moral standards or values. Cultural beliefs and programming influence our values. A sense of ethics is determined by a number of social, cultural, and religious factors; this sense influences us beginning early in childhood. People are taught how to behave by their families, exposure to education and thinking, and the society in which they live. Ethical behavior also refers to behavior that is generally accepted within a specific culture. Some behaviors are universally accepted—for example, people shouldn't physically hurt other people. Other actions are less clear, such as discrimination based on age, race, gender, or ethnicity.

Culture impacts how local values influence global business ethics. There are differences in how much importance cultures place on specific ethical behaviors. For example, bribery remains widespread in many countries, and while people may not approve of it, they accept it as a necessity of daily life. Each professional is influenced by the values, social programming, and experiences encountered from childhood on. These collective factors affect how a person perceives an issue and the related correct or incorrect behaviors. Even within a specific culture, individuals have different ideas of what constitutes ethical or unethical behavior. Judgments may differ greatly depending on an individual's social or economic standing, education, and experiences with other cultures and beliefs. Just as in the example of bribery, it should be noted that there is a difference between ethical behavior and normal practice. It may be acceptable to discriminate in certain cultures, even if the people in that society know that it is not right or fair. In global business ethics, people try to understand what the ethical action is and what the normal practice might be. If these are not consistent, the focus is placed on how to encourage ethical actions.

While it's clear that ethics is not religion, values based on religious teachings have influenced our understanding of ethical behavior. Given the influence of Western thought and philosophy over the world in the last few centuries, many would say that global business has been heavily influenced by the ideas and values of the Reformation and Enlightenment, which emphasize equality and individual rights. As a result, it has become accepted that all people in any country and of any background are equal and should have equal opportunity. Companies incorporate this principle in their employment, management, and operational guidelines. However, enforcing it in global operations can be both tricky and inconsistent.

It's important to understand the impact and influence of these two critical historical periods on our modern sense of global business ethics. The prevailing corporate values—including those of institutional and individual equality; the right of every employee to work hard and reap the rewards (both financial and non-financial); corporate social responsibility; and the application of science and reason to all management and operational processes—have their roots in the thoughts and values of those historical periods.

Impact of Ethics on Global Business

At first, it may seem relatively easy to identify unethical behavior. When the topic of business ethics is raised, most people immediately focus on corruption and bribery. While this is a critical result of unethical behavior, the concept of business ethics and global business ethics is much broader. It impacts human resources, social responsibility, and the environment. The areas of business impacted by global perceptions of ethical, moral, and socially responsible behavior include the following:

- Ethics and management
- Ethics and corruption
- Corporate social responsibility

Ethics and Management Practices

Ethics affects various aspects of management and operations, including human resources, marketing, research and development, and even the corporate mission.

The role of ethics in management practices, particularly those practices involving human resources and employment, differs from culture to culture. Local culture affects the way people view the employee-employer relationship. In many cultures, there are no clear social rules preventing discrimination against people based on age, race, gender, sexual preference, handicap, and so on. Even when there are formal rules or laws against discrimination, they may not be enforced, as normal practice may allow people and companies to act in accordance with local cultural and social practices.

Culture can influence the way people view one another in the workplace, and local views—of, say, women—can be at odds with a company's ethics. So how do companies handle local customs and values for the treatment of women in the workplace? If you're a senior officer of an American company, do you send a woman to Saudi Arabia or Afghanistan to negotiate with government officials or manage the local office? Does it matter what your industry is or whether your firm is the seller or buyer? *In theory*, most global firms have clear guidelines articulating anti-discrimination policies. *In reality*, global businesses routinely self-censor. Companies often determine whether a person—based on their gender, ethnicity, or race—can be effective in a specific culture based on the prevailing values of that culture. The largest and most respected global companies, typically the *Fortune* Global 500, can often make management and employment decisions regardless of local practices. Most people in each country will want to deal with these large and well-respected companies. The person representing the larger company brings the clout of their company to any business interaction. In contrast, lesser-known, midsize, and smaller companies may find that *who* their representative is will be more important. Often lacking business recognition in the marketplace, these smaller and midsize companies have to rely on their corporate representatives to create the professional image and bond with their in-country counterparts.

Cultural norms may make life difficult for the company as well as the employee. In some cultures, companies are seen as "guardians" or paternal figures. Any efforts to lay off or fire employees may be perceived as culturally unethical. In Japan, where lifelong loyalty to the company was expected in return for lifelong employment, the decade-long recession beginning in the 1990s triggered a change in attitude. Japanese companies finally began to alter this ethical perception and lay off workers without being perceived as unethical.

Global corporations are increasingly trying to market their products based not only on the desirability of the goods but also on their social and environmental merits. Companies whose practices are considered unethical may find their global performance impacted when people boycott their products. Most corporations understand this risk. However, ethical questions have grown increasingly complicated, and the "correct" or ethical choice has, in some cases, become difficult to define.

For example, the pharmaceutical industry is involved in a number of issues that have medical ethicists squirming. First, there's the well-publicized issue of cloning. No matter *what* choice the companies make about cloning, they are sure to offend a great many consumers. At the same time, pharmaceutical companies must decide whether to forfeit profits and give away free drugs or cheaper medicines to impoverished African nations. Pharmaceutical companies that *do* donate medicines often promote this practice in their corporate marketing campaigns in hopes that consumers see the companies in a favorable light.

Tobacco companies are similarly embroiled in a long-term ethical debate. Health advocates around the world agree that smoking is bad for a person's long-term health. Yet in many countries, smoking is not only acceptable but can even confer social status. The United States has banned tobacco companies from adopting marketing practices that target young consumers by exploiting tobacco's social caché. However, many other countries don't have such regulations. Should tobacco companies be held responsible for knowingly marketing harmful products to younger audiences in other countries?

Corporate Social Responsibility

Corporate social responsibility (CSR) is defined in Wikipedia as "the corporate conscience, citizenship, social performance, or sustainable responsible business, and is a form of corporate self-regulation integrated into a business model. CSR policy functions as a built-in, self-regulating mechanism whereby business monitors and ensures its active compliance with the spirit of the law, ethical standards, and international norms."

CSR emerged more than three decades ago, and it has gained increasing strength over time as companies seek to generate goodwill with their employees, customers, and stakeholders. “Corporate social responsibility encompasses not only what companies do with their profits, but also how they make them. It goes beyond philanthropy and compliance and addresses how companies manage their economic, social, and environmental impacts, as well as their relationships in all key spheres of influence: the workplace, the marketplace, the supply chain, the community, and the public policy realm.”[1]

Companies may support nonprofit causes and organizations, global initiatives, and prevailing themes. Promoting environmentally friendly and green initiatives is an example of a current prevailing theme.

Coca-Cola is an example of global corporation with a long-term commitment to CSR. In many developing countries, Coca-Cola promotes local economic development through a combination of philanthropy and social and economic development. Whether by using environmentally friendly containers or supporting local education initiatives through its foundation, Coca-Cola is only one of many global companies that seek to increase their commitment to local markets while enhancing their brand, corporate image, and reputation by engaging in socially responsible business practices.

Companies use a wide range of strategies to communicate their socially responsible strategies and programs. Under the auspices of the United Nations, the Global Compact “is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anticorruption.”

Enforcement of Ethical Guidelines and Standards

The concept of culture impacting the perception of ethics is one that many businesspeople debate. While culture does impact business ethics, international companies operate in multiple countries and need a standard set of global operating guidelines. Professionals engage in unethical behavior primarily as a result of their own personal ethical values, the corporate culture within a company, or from unrealistic performance expectations

In the interest of expediency, many governments—the U.S. government included—may not strictly enforce the rules governing corporate ethics. The practice of gift giving is one aspect of business that many governments don’t examine too closely. Many companies have routinely used gifts to win favor from their customers, without engaging in direct bribery. American companies frequently invite prospective buyers to visit their U.S. facilities or attend company conferences in exotic locales with all expenses paid. These trips often have perks included. Should such spending be considered sales and marketing expenses, as they are often booked, or are these companies engaging in questionable behavior? It’s much harder to answer this question when you consider that most of the company’s global competitors are likely to engage in similarly aggressive marketing and sales behavior.

Governments often do not enforce laws until it’s politically expedient to do so. Take child labor, for example. Technically, companies operating in India or Pakistan are not permitted to use child labor in factories, mines, and other areas of hazardous employment. However, child labor is widespread in these countries due to deep-rooted social and economic challenges. Local governments are often unable and unwilling to enforce national rules and regulations. Companies and consumers who purchase goods made by children are often unaware that these practices remain unchecked.

The Evolution of Ethics

Ethics evolves over time. It is difficult for both companies and professionals to operate within one set of accepted standards or guidelines only to see them gradually evolve or change. For example, bribery has been an accepted business practice for centuries in Japan and Korea. When these nations adjusted their practices in order to enter the global system, the questionable practices became illegal. Hence a Korean businessman who engaged in bribery ten or twenty years ago may not do so today without finding himself on the other side of the law. Even in the United States, discrimination and business-regulation laws have changed tremendously over the last several decades. And who can know what the future holds? Some of the business practices that are commonly accepted today may be frowned on tomorrow.

It’s clear that changing values, as influenced by global media, and changing perceptions and cultures will impact global ethics. The most challenging aspect is that global business does not have a single definition of “fair” or “ethical.” While culture influences the definitions of those ideas, many companies are forced to navigate this sensitive area very carefully, as it impacts both their bottom line and their reputations.

KEY TAKEAWAYS

- Culture impacts how local values influence the concept of global business ethics. Each professional is influenced by the values, social programming, and experiences he or she has absorbed since childhood. These collective factors impact how a person perceives an issue and the related correct or incorrect behavior. For some cultures, the evolution of international business and culture sometimes creates a conflict, such as what is seen in gift-giving practices or views on women in the workplace.
- Ethics impacts global business in the areas of management, corruption, and corporate social responsibility.

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1. *Source:* "Defining Corporate Social Responsibility," *Corporate Social Responsibility Initiative*, Harvard Kennedy School, last modified 2008, accessed March 26, 2011. ↵

Contributors and Attributions

14.7: Reading- Ethics and Corruption

Ethics and Corruption

To begin our discussion of corruption, let's first define it in a business context. Corruption is "giving or obtaining advantage through means which are illegitimate, immoral, and/or inconsistent with one's duty or the rights of others."

Our modern understanding of business ethics notes that following culturally accepted norms is not always the ethical choice. What may be acceptable at certain points in history, such as racism or sexism, became unacceptable with the further development of society's mind-set. What happens when cultures change but business practices don't? Does that behavior become unethical, and is the person engaged in the behavior unethical? In some cultures, there may be conflicts with global business practices, such as in the area of gift giving, which has evolved into bribery—a form of corruption.

Paying bribes is relatively common in many countries, and bribes often take the form of *grease payments*, which are small inducements intended to expedite decisions and transactions. In India and Mexico, for example, a grease payment may help get your phones installed faster—at home or at work. Transparency International tracks illicit behavior, such as bribery and embezzlement, in the public sector in 180 countries by surveying international business executives. It assigns a CPI (Corruption Perceptions Index) rating to each country. New Zealand, Denmark, Singapore, and Sweden have the lowest levels of corruption, while the highest levels of corruption are seen in most African nations, Russia, Myanmar, and Afghanistan.

Even the most respected of global companies has found itself on the wrong side of the ethics issue and the law. In 2008, after years of investigation, Siemens agreed to pay more than 1.34 billion euros in fines to American and European authorities to settle charges that it routinely used bribes and slush funds to secure huge public-works contracts around the world. "Officials said that Siemens, beginning in the mid-1990s, used bribes and kickbacks to foreign officials to secure government contracts for projects like a national identity card project in Argentina, mass transit work in Venezuela, a nationwide cell phone network in Bangladesh, and a United Nations oil-for-food program in Iraq under Saddam Hussein. 'Their actions were not an anomaly,' said Joseph Persichini Jr., the head of the Washington office of the Federal Bureau of Investigation. 'They were standard operating procedures for corporate executives, who viewed bribery as a business strategy.'"

Ethics in Action

Each year Transparency International analyzes trends in global corruption. The following is an excerpt from their 2010 Global Corruption Barometer report, which captures the experiences and views of 91,500 people in 86 countries and territories:

"Corruption has increased over the last three years," say six out of ten people around the world. One in four people report paying bribes in the last year.

Views on corruption were most negative in Western Europe and North America, where 73 percent and 67 percent of people, respectively, thought corruption had increased over the last three years.

"The fallout of the financial crises continues to affect people's opinions of corruption, particular in North America and Western Europe. Institutions everywhere must be resolute in their efforts to restore good governance and trust," said Huguette Labelle, Chair of Transparency International.

In the past twelve months one in four people reported paying a bribe to one of nine institutions and services, from health to education to tax authorities. The police are cited as being the most frequent recipient of bribes, according to those surveyed. About 30 percent of those who had contact with the police reported having paid a bribe.

More than twenty countries have reported significant increases in petty bribery since 2006. The biggest increases were in Chile, Colombia, Kenya, FYR Macedonia, Nigeria, Poland, Russia, Senegal and Thailand. More than one in two people in Sub-Saharan Africa reported paying a bribe—more than anywhere else in the world.

Poorer people are twice as likely to pay bribes for basic services, such as education, than wealthier people. A third of all people under the age of thirty reported paying a bribe in the past twelve months, compared to less than one in five people aged fifty-one years and over.

Most worrying is the fact that bribes to the police have almost doubled since 2006, and more people report paying bribes to the judiciary and for registry and permit services than five years ago.

Sadly, few people trust their governments or politicians. Eight out of ten say political parties are corrupt or extremely corrupt, while half the people questioned say their government's action to stop corruption is ineffective.

"The message from the 2010 Barometer is that corruption is insidious. It makes people lose faith. The good news is that people are ready to act," said Labelle. "Public engagement in the fight against corruption will force those in authority to act—and will give people further courage to speak out and stand up for a cleaner, more transparent world."[1]

Gift giving in the global business world is used to establish or pay respects to a relationship. Bribery, on the other hand, is more commonly considered the practice in which an individual would benefit with little or no benefit to the company. It's usually paid in relation to winning a business deal, whereas gift giving is more likely to be ingrained in the culture and not associated with winning a specific piece of business. Bribery, usually in the form of a cash payment, has reached such high proportions in some countries that even locals express disgust with the corruption and its impact on daily life for businesses and consumers.

The practice of using connections to advance business interests exists in just about every country in the world. However, the extent and manner in which it is institutionalized differs from culture to culture.

In Western countries, connections are viewed informally and sometimes even with a negative connotation. In the United States and other similar countries, professionals prefer to imply that they have achieved success on their own merits and without any connections. Gift giving is not routine in the United States except during the winter holidays, and even then gift giving involves a modest expression. Businesses operating in the United States send modest gifts or cards to their customers to thank them for business loyalty in the previous year. Certain industries, such as finance, even set clear legal guidelines restricting the value of gifts, typically a maximum of $100.

In contrast, Asian, Latin American, and Middle Eastern cultures are quick to value connections and relationships and view gifts quite positively. Connections are considered essential for success. In Asia, gift giving is so ingrained in the culture, particularly in Japan and China, that it is formalized and structured.

For example, gift giving in Japan was for centuries an established practice in society and is still taken seriously. There are specific guidelines for gift giving depending on the identity of the giver or recipient, the length of the business relationship, and the number of gifts exchanged. The Japanese may give gifts out of a sense of obligation and duty as well as to convey feelings such as gratitude and regret. Therefore, much care is given to the appropriateness of the gift as well as to its aesthetic beauty.

Today there are still business gift-giving occasions in Japan, specifically *oseibo* (year's end) and *ochugen* (midsummer). These are must-give occasions for Japanese businesses. *Oseibo* gifts are presented in the first half of December as a token of gratitude for earlier favors and loyalty. This is a good opportunity to thank clients for their business. *Ochugen* usually occurs in mid-July in Tokyo and mid-August in some other regions. Originally an occasion to provide consolation to the families of those who had died in the first half of the year, *ochugen* falls two weeks before *obon*, a holiday honoring the dead.

Businesses operating in Japan at these times routinely exchange *oseibo* and *ochugen* gifts. While a professional is not obligated to participate, it clearly earns goodwill. At the most senior levels, it is not uncommon for people to exchange gifts worth $300 or $400. There is an established price level that one should pay for each corporate level.

Despite these guidelines, gift giving in Japan has occasionally crossed over into bribery. This level of corruption became more apparent in the 1980s as transparency in global business gained media attention. Asians tend to take a very different view of accountability than most Westerners. In the 1980s and 1990s, several Japanese CEOs resigned in order to apologize and take responsibility for their companies' practices, even when they did not personally engage in the offending practices. This has become an accepted managerial practice in an effort to preserve the honor of the company. While Japanese CEOs may not step down as quickly as in the past, the notion of honor remains an important business characteristic.

Long an established form of relationship development in all business conducted in Asia, the Arab world, and Africa, gift giving was clearly tipping over into outright bribery. In the past two decades, many countries have placed limits on the types and value of gifts while simultaneously banning bribery in any form. In the United States, companies must adhere to the Foreign Corrupt Practices Act, a federal law that specifically bans any form of bribery. Even foreign companies that are either listed on an American stock exchange or conduct business with the U.S. government come under the purview of this law.

There are still global firms that engage in questionable business gift giving; when caught, they face fines and sanctions. But for the most part, firms continue with business as usual. Changing the cultural practices of gift giving is an evolving process that will take time, government attention, and more transparency in the awarding of global business contracts.

Companies and their employees routinely try to balance ethical behavior with business interests. While corruption is now widely viewed as unethical, firms still lose business to companies that may be less diligent in adhering to this principle. While the media covers stories of firms that have breached this ethical conduct, the misconduct of many more companies goes undetected. Businesses, business schools, and governments are increasingly making efforts to deter firms and professionals from making and taking bribes. There are still countless less visible gestures that some would argue are also unethical.

For example, imagine that an employee works at a firm that wants to land a contract in China. A key government official in China finds out that you went to the business school that his daughter really wants to attend. He asks you to help her in the admission process. Do you? Should you? Is this just a nice thing to do, or is it a potential conflict of interest if you think the official will view your company more favorably? This is a gray area of global business ethics. Interestingly, a professional's answer to this situation may depend on his or her culture. Cultures that have clear guidelines for right and wrong behavior may see this situation differently than a culture in which doing favors is part of the normal practice. A company may declare this inappropriate behavior, but employees may still do what they think is best for their jobs. Cultures that have a higher tolerance for ambiguity, as this module discusses, may find it easier to navigate the gray areas of ethics—when it is not so clear.

Most people agree that bribery in any form only increases the cost of doing business—a cost that is either absorbed by the company or eventually passed on to the buyer or consumer in some form. While businesses agree that corruption is costly and undesirable, losing profitable business opportunities to firms that are less ethically motivated can be just as devastating to the bottom line. Until governments in every country consistently monitor and enforce anticorruption laws, bribery will remain a real and very challenging issue for global businesses.

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1. *Source: Transparency International*, "Global Corruption Barometer 2010," accessed February 22, 2011.↵

Contributors and Attributions

14.8: Reading- Currency Valuations and Exchange Rates

The Ups and Downs of Currency Valuations and Exchange Rates

If every nation used the same currency, international trade and travel would be a lot easier. Unfortunately, this is not the case. There are about 175 currencies in the world: Some you've heard of, such as the British pound; others are likely unknown to you, such as the *manat*, the official currency of Azerbaijan, a small nation in Southwest Asia. Let's pretend you suddenly find yourself in Azerbaijan and all you have with you is a credit card (which none of the restaurants or hotels will take) and U.S. dollars (which no one wants either). How can you get some Azerbaijani manats so you can buy a good meal and check into a hotel? If it's during the day, you're in luck. Head to the closest bank and ask someone there who speaks English to exchange your dollars for Azerbaijan manats. If you give the bank clerk $300 (all of your travel money), don't expect to get back 300 manats; the two currencies are not equal. To determine how much Azerbaijan money you'll get in exchange for your $300, the bank clerk will look up the day's foreign exchange rate—which tells you how much one currency is worth *relative to another currency*. If today were August 23, 2011, the clerk would find an exchange rate of 1 U.S. dollar equals .79 manats (which means that you get 79 manats for every dollar you give to the bank clerk). In other words, when you hand the clerk your $300 you'll get back only 235 manats (.79 × $300).

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

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

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

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

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

In the interest of being thorough, let's look at this phenomenon from the perspective of an American seller and a Swiss buyer. First, we need to know the exchange rate for the U.S. dollar relative to the franc, which happens to be .79 francs = US$1. This means that if you want to sell something—let's say your latest painting—for $1,000 U.S. to an art lover in Switzerland, the Swiss buyer will need only 790 francs to get the $1,000 needed to pay you. If the exchange rate went up to .89 francs = US$1, the cost of the painting would be $890. If the exchange rate went down to .69 francs = US$1, the cost of the painting would be $690. So now you also know the following:

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

Reflection Questions

- How do exchange rates affect pricing in international markets?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Contributors and Attributions

14.9: Reading- The IMF and the World Bank- How Do They Differ?

The IMF and the World Bank: How Do They Differ?

If you have difficulty distinguishing the World Bank from the International Monetary Fund, you are not alone. Most people have only the vaguest idea of what these institutions do, and very few people indeed could, if pressed, say why and how they differ. Even John Maynard Keynes, a founding father of the two institutions and considered by many the most brilliant economist of the twentieth century, admitted at the inaugural meeting of the International Monetary Fund that he was confused by the names: he thought the Fund should be called a bank, and the Bank should be called a fund. Confusion has reigned ever since.

Known collectively as the Bretton Woods Institutions after the remote village in New Hampshire, U.S.A., where they were founded by the delegates of 44 nations in July 1944, the Bank and the IMF are twin intergovernmental pillars supporting the structure of the world's economic and financial order. That there are two pillars rather than one is no accident. The international community was consciously trying to establish a division of labor in setting up the two agencies. Those who deal professionally with the IMF and Bank find them categorically distinct. To the rest of the world, the niceties of the division of labor are even more mysterious than are the activities of the two institutions.

Similarities between them do little to resolve the confusion. Superficially the Bank and IMF exhibit many common characteristics. Both are in a sense owned and directed by the governments of member nations. The People's Republic of China, by far the most populous state on earth, is a member, as is the world's largest industrial power (the United States). In fact, virtually every country on earth is a member of both institutions. Both institutions concern themselves with economic issues and concentrate their efforts on broadening and strengthening the economies of their member nations. Staff members of both the Bank and IMF often appear at international conferences, speaking the same recondite language of the economics and development professions, or are reported in the media to be negotiating involved and somewhat mystifying programs of economic adjustment with ministers of finance or other government officials. The two institutions hold joint annual meetings, which the news media cover extensively. Both have headquarters in Washington, D.C., where popular confusion over what they do and how they differ is about as pronounced as everywhere else. For many years both occupied the same building and even now, though located on opposite sides of a street very near the White House, they share a common library and other facilities, regularly exchange economic data, sometimes present joint seminars, daily hold informal meetings, and occasionally send out joint missions to member countries.

Despite these and other similarities, however, the Bank and the IMF remain distinct. The fundamental difference is this: the Bank is primarily a development institution; the IMF is a cooperative institution that seeks to maintain an orderly system of payments and receipts between nations. Each has a different purpose, a distinct structure, receives its funding from different sources, assists different categories of members, and strives to achieve distinct goals through methods peculiar to itself.

Purposes

At Bretton Woods, the international community assigned to the World Bank—its formal name was the International Bank for Reconstruction and Development (IBRD)—the primary responsibility for financing economic development. The Bank's first loans were extended during the late 1940s to finance the reconstruction of the war-ravaged economies of Western Europe. When these nations recovered some measure of economic self-sufficiency, the Bank turned its attention to assisting the world's poorer nations, known as developing countries, to which it has since the 1940s loaned more than $330 billion. The World Bank has one central purpose: to promote economic and social progress in developing countries by helping to raise productivity so that their people may live a better and fuller life.

The international community assigned to the IMF a different purpose. In establishing the IMF, the world community was reacting to the unresolved financial problems instrumental in initiating and protracting the Great Depression of the 1930s: sudden, unpredictable variations in the exchange values of national currencies and a widespread disinclination among governments to allow their national currency to be exchanged for foreign currency. Set up as a voluntary and cooperative institution, the IMF attracts to its membership nations that are prepared, in a spirit of enlightened self-interest, to relinquish some measure of national sovereignty by abjuring practices injurious to the economic well-being of their fellow member nations. The rules of the institution, contained in the IMF's Articles of Agreement signed by all members, constitute a code of conduct. The code is simple: it requires members to allow their currency to be exchanged for foreign currencies freely and without restriction, to keep the IMF informed of changes they contemplate in financial and monetary policies that will affect fellow members' economies, and, to the extent possible, to modify these policies on the advice of the IMF to accommodate the needs of the entire membership.

To help nations abide by the code of conduct, the IMF administers a pool of money from which members can borrow when they are in trouble. The IMF is not, however, primarily a lending institution as is the Bank. It is first and foremost an overseer of its members' monetary and exchange rate policies and a guardian of the code of conduct. Philosophically committed to the orderly and stable growth of the world economy, the IMF is an enemy of surprise. It receives frequent reports on members' economic policies and prospects, which it debates, comments on, and communicates to the entire membership so that other members may respond in full knowledge of the facts and a clear understanding of how their own domestic policies may affect other countries. The IMF is convinced that a fundamental condition for international prosperity is an orderly monetary system that will encourage trade, create jobs, expand economic activity, and raise living standards throughout the world. By its constitution the IMF is required to oversee and maintain this system, no more and no less.

Size and Structure

The IMF is small (about 2,300 staff members) and, unlike the World Bank, has no affiliates or subsidiaries. Most of its staff members work at headquarters in Washington, D.C., although three small offices are maintained in Paris, Geneva, and at the United Nations in New York. Its professional staff members are for the most part economists and financial experts.

The structure of the Bank is somewhat more complex. The World Bank itself comprises two major organizations: the International Bank for Reconstruction and Development and the International Development Association (IDA). Moreover, associated with, but legally and financially separate from the World Bank are the International Finance Corporation, which mobilizes funding for private enterprises in developing countries, the International Center for Settlement of Investment Disputes, and the Multilateral Guarantee Agency. With over 7,000 staff members, the World Bank Group is about three times as large as the IMF, and maintains about 40 offices throughout the world, although 95 percent of its staff work at its Washington, D.C., headquarters. The Bank employs a staff with an astonishing range of expertise: economists, engineers, urban planners, agronomists, statisticians, lawyers, portfolio managers, loan officers, project appraisers, as well as experts in telecommunications, water supply and sewerage, transportation, education, energy, rural development, population and health care, and other disciplines.

Source of Funding

The World Bank is an investment bank, intermediating between investors and recipients, borrowing from the one and lending to the other. Its owners are the governments of its 180 member nations with equity shares in the Bank, which were valued at about $176 billion in June 1995. The IBRD obtains most of the funds it lends to finance development by market borrowing through the issue of bonds (which carry an AAA rating because repayment is guaranteed by member governments) to individuals and private institutions in more than 100 countries. Its concessional loan associate, IDA, is largely financed by grants from donor nations. The Bank is a major borrower in the world's capital markets and the largest nonresident borrower in virtually all countries where its issues are sold. It also borrows money by selling bonds and notes directly to governments, their agencies, and central banks. The proceeds of these bond sales are lent in turn to developing countries at affordable rates of interest to help finance projects and policy reform programs that give promise of success.

Despite Lord Keynes's profession of confusion, the IMF is not a bank and does not intermediate between investors and recipients. Nevertheless, it has at its disposal significant resources, presently valued at over $215 billion. These resources come from quota subscriptions, or membership fees, paid in by the IMF's 182 member countries. Each member contributes to this pool of resources a certain amount of money proportionate to its economic size and strength (richer countries pay more, poorer less). While the Bank borrows and lends, the IMF is more like a credit union whose members have access to a common pool of resources (the sum total of their individual contributions) to assist them in times of need. Although under special and highly restrictive circumstances the IMF borrows from official entities (but not from private markets), it relies principally on its quota subscriptions to finance its operations. The adequacy of these resources is reviewed every five years.

Recipients of Funding

Neither wealthy countries nor private individuals borrow from the World Bank, which lends only to creditworthy governments of developing nations. The poorer the country, the more favorable the conditions under which it can borrow from the Bank. Developing countries whose per capita gross national product (GNP) exceeds $1,305 may borrow from the IBRD. (Per capita GNP, a less formidable term than it sounds, is a measure of wealth, obtained by dividing the value of goods and services produced in a country during one year by the number of people in that country.) These loans carry an interest rate slightly above the market rate at which the Bank itself borrows and must generally be repaid within 12-15 years. The IDA, on the other hand, lends only to governments of very poor developing nations whose per capita GNP is below $1,305, and in practice IDA loans go to countries with annual per capita incomes below $865. IDA loans are interest free and have a maturity of 35 or 40 years.

In contrast, all member nations, both wealthy and poor, have the right to financial assistance from the IMF. Maintaining an orderly and stable international monetary system requires all participants in that system to fulfill their financial obligations to other participants. Membership in the IMF gives to each country that experiences a shortage of foreign exchange–preventing it from fulfilling these obligations–temporary access to the IMF's pool of currencies to resolve this difficulty, usually referred to as a balance of payments problem. These problems are no respecter of economic size or level of per capita GNP, with the result that over the years almost all members of the IMF, from the smallest developing country to the largest industrial country, have at one time or other had recourse to the IMF and received from it financial assistance to tide them over difficult periods. Money received from the IMF must normally be repaid within three to five years, and in no case later than ten years. Interest rates are slightly below market rates, but are not so concessional as those assigned to the World Bank's IDA loans. Through the use of IMF resources, countries have been able to buy time to rectify economic policies and to restore growth without having to resort to actions damaging to other members' economies.

World Bank Operations

The World Bank exists to encourage poor countries to develop by providing them with technical assistance and funding for projects and policies that will realize the countries' economic potential. The Bank views development as a long-term, integrated endeavor.

During the first two decades of its existence, two thirds of the assistance provided by the Bank went to electric power and transportation projects. Although these so-called infrastructure projects remain important, the Bank has diversified its activities in recent years as it has gained experience with and acquired new insights into the development process.

The Bank gives particular attention to projects that can directly benefit the poorest people in developing countries. The direct involvement of the poorest in economic activity is being promoted through lending for agriculture and rural development, small-scale enterprises, and urban development. The Bank is helping the poor to be more productive and to gain access to such necessities as safe water and waste-disposal facilities, health care, family-planning assistance, nutrition, education, and housing. Within infrastructure projects there have also been changes. In transportation projects, greater attention is given to constructing farm-to-market roads. Rather than concentrating exclusively on cities, power projects increasingly provide lighting and power for villages and small farms. Industrial projects place greater emphasis on creating jobs in small enterprises. Labor-intensive construction is used where practical. In addition to electric power, the Bank is supporting development of oil, gas, coal, fuelwood, and biomass as alternative sources of energy.

The Bank provides most of its financial and technical assistance to developing countries by supporting specific projects. Although IBRD loans and IDA credits are made on different financial terms, the two institutions use the same standards in assessing the soundness of projects. The decision whether a project will receive IBRD or IDA financing depends on the economic condition of the country and not on the characteristics of the project.

Its borrowing member countries also look to the Bank as a source of technical assistance. By far the largest element of Bank-financed technical assistance–running over $1 billion a year recently–is that financed as a component of Bank loans or credits extended for other purposes. But the amount of Bank-financed technical assistance for free-standing loans and to prepare projects has also increased. The Bank serves as executing agency for technical assistance projects financed by the United Nations Development Program in agriculture and rural development, energy, and economic planning. In response to the economic climate in many of its member countries, the Bank is now emphasizing technical assistance for institutional development and macroeconomic policy formulation.

Every project supported by the Bank is designed in close collaboration with national governments and local agencies, and often in cooperation with other multilateral assistance organizations. Indeed, about half of all Bank-assisted projects also receive cofinancing from official sources, that is, governments, multilateral financial institutions, and export-credit agencies that directly finance the procurement of goods and services, and from private sources, such as commercial banks.

In making loans to developing countries, the Bank does not compete with other sources of finance. It assists only those projects for which the required capital is not available from other sources on reasonable terms. Through its work, the Bank seeks to strengthen the economies of borrowing nations so that they can graduate from reliance on Bank resources and meet their financial needs, on terms they can afford directly from conventional sources of capital.

The range of the Bank's activities is far broader than its lending operations. Since the Bank's lending decisions depend heavily on the economic condition of the borrowing country, the Bank carefully studies its economy and the needs of the sectors for which lending is contemplated. These analyses help in formulating an appropriate long-term development assistance strategy for the economy.

Graduation from the IBRD and IDA has occurred for many years. Of the 34 very poor countries that borrowed money from IDA during the earliest years, more than two dozen have made enough progress for them no longer to need IDA money, leaving that money available to other countries that joined the Bank more recently. Similarly, about 20 countries that formerly borrowed money from the IBRD no longer have to do so. An outstanding example is Japan. For a period of 14 years, it borrowed from the IBRD. Now, the IBRD borrows large sums in Japan.

IMF Operations

The IMF has gone through two distinct phases in its 50-year history. During the first phase, ending in 1973, the IMF oversaw the adoption of general convertibility among the major currencies, supervised a system of fixed exchange rates tied to the value of gold, and provided short-term financing to countries in need of a quick infusion of foreign exchange to keep their currencies at par value or to adjust to changing economic circumstances. Difficulties encountered in maintaining a system of fixed exchange rates gave rise to unstable monetary and financial conditions throughout the world and led the international community to reconsider how the IMF could most effectively function in a regime of flexible exchange rates. After five years of analysis and negotiation (1973-78), the IMF's second phase began with the amendment of its constitution in 1978, broadening its functions to enable it to grapple with the challenges that have arisen since the collapse of the par value system. These functions are three.

First, the IMF continues to urge its members to allow their national currencies to be exchanged without restriction for the currencies of other member countries. As of May 1996, 115 members had agreed to full convertibility of their national currencies. Second, in place of monitoring members' compliance with their obligations in a fixed exchange system, the IMF supervises economic policies that influence their balance of payments in the presently legalized flexible exchange rate environment. This supervision provides opportunities for an early warning of any exchange rate or balance of payments problem. In this, the IMF's role is principally advisory. It confers at regular intervals (usually once a year) with its members, analyzing their economic positions and apprising them of actual or potential problems arising from their policies, and keeps the entire membership informed of these developments. Third, the IMF continues to provide short- and medium-term financial assistance to member nations that run into temporary balance of payments difficulties. The financial assistance usually involves the provision by the IMF of convertible currencies to augment the afflicted member's dwindling foreign exchange reserves, but only in return for the government's promise to reform the economic policies that caused the balance of payments problem in the first place. The IMF sees its financial role in these cases not as subsidizing further deficits but as easing a country's painful transition to living within its means.

How in practice does the IMF assist its members? The key opening the door to IMF assistance is the member's balance of payments, the tally of its payments and receipts with other nations. Foreign payments should be in rough balance: a country ideally should take in just about what it pays out. When financial problems cause the price of a member's currency and the price of its goods to fall out of line, balance of payments difficulties are sure to follow. If this happens, the member country may, by virtue of the Articles of Agreement, apply to the IMF for assistance.

To illustrate, let us take the example of a small country whose economy is based on agriculture. For convenience in trade, the government of such a country generally pegs the domestic currency to a convertible currency: so many units of domestic money to a U.S. dollar or French franc. Unless the exchange rate is adjusted from time to time to take account of changes in relative prices, the domestic currency will tend to become overvalued, with an exchange rate, say, of one unit of domestic currency to one U.S. dollar, when relative prices might suggest that two units to one dollar is more realistic. Governments, however, often succumb to the temptation to tolerate overvaluation, because an overvalued currency makes imports cheaper than they would be if the currency were correctly priced.

The other side of the coin, unfortunately, is that overvaluation makes the country's exports more expensive and hence less attractive to foreign buyers. If the currency is thus overvalued, the country will eventually experience a fall-off in export earnings (exports are too expensive) and a rise in import expenditures (imports are apparently cheap and are bought on credit). In effect, the country is earning less, spending more, and going into debt, a predicament as unsustainable for a country as it is for any of us. Moreover, this situation is usually attended by a host of other economic ills for the country. Finding a diminished market for their export crops and receiving low prices from the government marketing board for produce consumed domestically, farmers either resort to illegal black market exports or lose the incentive to produce. Many of them abandon the farm to seek employment in overcrowded cities, where they become part of larger social and economic problems. Declining domestic agricultural productivity forces the government to use scarce foreign exchange reserves (scarce because export earnings are down) to buy food from abroad. The balance of payments becomes dangerously distorted.

As an IMF member, a country finding itself in this bind can turn to the IMF for consultative and financial assistance. In a collaborative effort, the country and the IMF can attempt to root out the causes of the payments imbalance by working out a comprehensive program that, depending on the particulars of the case, might include raising producer prices paid to farmers so as to encourage agricultural production and reverse migration to the cities, lowering interest rates to expand the supply of credit, and adjusting the currency to reflect the level of world prices, thereby discouraging imports and raising the competitiveness of exports.

Because reorganizing the economy to implement these reforms is disruptive and not without cost, the IMF will lend money to subsidize policy reforms during the period of transition. To ensure that this money is put to the most productive uses, the IMF closely monitors the country's economic progress during this time, providing technical assistance and further consultative services as needed.

In addition to assisting its members in this way, the IMF also helps by providing technical assistance in organizing central banks, establishing and reforming tax systems, and setting up agencies to gather and publish economic statistics. The IMF is also authorized to issue a special type of money, called the SDR, to provide its members with additional liquidity. Known technically as a fiduciary asset, the SDR can be retained by members as part of their monetary reserves or be used in place of national currencies in transactions with other members. To date the IMF has issued slightly over 21.4 billion SDRs, presently valued at about U.S. $30 billion.

Over the past few years, in response to an emerging interest by the world community to return to a more stable system of exchange rates that would reduce the present fluctuations in the values of currencies, the IMF has been strengthening its supervision of members' economic policies. Provisions exist in its Articles of Agreement that would allow the IMF to adopt a more active role, should the world community decide on stricter management of flexible exchange rates or even on a return to some system of stable exchange rates.

Measuring the success of the IMF's operations over the years is not easy, for much of the IMF's work consists in averting financial crises or in preventing their becoming worse. Most observers feel that merely to have contained the debt crisis of the 1980s, which posed the risk of collapse in the world's financial system, must be counted a success for the IMF. The Fund has also gained some recognition for assisting in setting up market-based economies in the countries of the former Soviet Union and for responding swiftly to the Mexican peso crisis in 1994, but its main contribution lies in its unobrusive, day-to-day encouragement of confidence in the international system. Nowhere will you find a bridge or a hospital built by the IMF, but the next time you buy a Japanese camera or drive a foreign car, or without difficulty exchange dollars or pounds for another currency while on holiday, you will be benefiting from the vast increase in foreign trade over the past 50 years and the widespread currency convertibility that would have been unimaginable without the world monetary system that the IMF was created to maintain.

Cooperation Between Bank and IMF

Although the Bank and IMF are distinct entities, they work together in close cooperation. This cooperation, present since their founding, has become more pronounced since the 1970s. Since then the Bank's activities have increasingly reflected the realization that the pace of economic and social development accelerates only when sound underlying financial and economic policies are in place. The IMF has also recognized that unsound financial and economic policies are often deeply rooted in long-term inefficient use of resources that resists eradication through short-term adaptations of financial policies. It does little good for the Bank to develop a long-term irrigation project to assist, say, the export of cotton, if the country's balance of payments position is so chaotic that no foreign buyers will deal with the country. On the other hand, it does little good for the IMF to help establish a sound exchange rate for a country's currency, unless the production of cotton for export will suffice to sustain that exchange rate over the medium to long term. The key to solving these problems is seen in restructuring economic sectors so that the economic potential of projects might be realized throughout the economy and the stability of the economy might enhance the effectiveness of the individual project.

Around 75 percent of the Bank's lending is applied to specific projects dealing with roads, dams, power stations, agriculture, and industry. As the global economy became mired in recession in the early 1980s, the Bank expanded the scope of its lending operations to include structural- and sector-adjustment loans. These help developing countries adjust their economic policies and structures in the face of serious balance of payments problems that threaten continued development. The main objective of structural-adjustment lending is to restructure a developing country's economy as the best basis for sustained economic growth. Loans support programs that are intended to anticipate and avert economic crises through economic reforms and changes in investment priorities. By using so-called policy-based lending, the Bank stimulates economic growth in heavily indebted countries–

particularly in Latin America and in sub-Saharan Africa–that are undertaking, often at much social pain, far-reaching programs of economic adjustment.

In addition to its traditional function as provider of short-term balance of payments assistance, the advent of the oil crisis in the mid-1970s and the debt crisis in the early 1980s induced the IMF, too, to rethink its policy of restricting its financial assistance to short-term lending. As balance of payments shortfalls grew larger and longer-term structural reforms in members' economies were called for to eliminate these shortfalls, the IMF enlarged the amount of financial assistance it provides and lengthened the period within which its financial assistance would be available. In doing so, the IMF implicitly recognizes that balance of payments problems arise not only from a temporary lack of liquidity and inadequate financial and budgetary policies but also from long-standing contradictions in the structure of members' economies, requiring reforms stretching over a number of years and suggesting closer collaboration with the World Bank, which commands both the expertise and experience to deal with protracted structural impediments to growth.

Focusing on structural reform in recent years has resulted in considerable convergence in the efforts of the Bank and IMF and has led them to greater reliance on each other's special expertise. This convergence has been hastened by the debt crisis, brought on by the inability of developing countries to repay the enormous loans they contracted during the late 1970s and early 1980s. The debt crisis has emphasized that economic growth can be sustained only when resources are being used efficiently and that resources can be used efficiently only in a stable monetary and financial environment.

The bedrock of cooperation between the Bank and IMF is the regular and frequent interaction of economists and loan officers who work on the same country. The Bank staff brings to this interchange a longer-term view of the slow process of development and a profound knowledge of the structural requirements and economic potential of a country. The IMF staff contributes its own perspective on the day-to-day capability of a country to sustain its flow of payments to creditors and to attract from them investment finance, as well as on how the country is integrated within the world economy. This interchange of information is backed up by a coordination of financial assistance to members. For instance, the Bank has been approving structural- or sector-adjustment loans for most of the countries that are taking advantage of financial assistance from the IMF. In addition, both institutions encourage other lenders, both private and official, to join with them in cofinancing projects and in mobilizing credits to countries that are in need. Cooperation between the Bretton Woods Institutions has two results: the identification of programs that will encourage growth in a stable economic environment and the coordination of financing that will ensure the success of these programs. Other lenders, particularly commercial banks, frequently make credits available only after seeing satisfactory performance by the borrowing country of its program of structural adjustment.

Cooperation between the Bank and the IMF has over the past decade been formalized with the establishment in the IMF of procedures to provide financing at below market rates to its poorest member countries. These procedures enable the IMF to make available up to $12 billion to those 70 or so poor member countries that adjust the structure of their economies to improve their balance of payment position and to foster growth. The Bank joins with the IMF in providing additional money for these countries from IDA. But what IDA can provide in financial resources is only a fraction of the world's minimum needs for concessional external finance. Happily, various governments and international agencies have responded positively to the Bank's special action program for low-income, debt-distressed countries of the region by pledging an extra $7 billion for cofinancing programs arranged by the Bank.

The Bank and the IMF have distinct mandates that allow them to contribute, each in its own way, to the stability of the international monetary and financial system and to the fostering of balanced economic growth throughout the entire membership. Since their founding 50 years ago, both institutions have been challenged by changing economic circumstances to develop new ways of assisting their membership. The Bank has expanded its assistance from an orientation toward projects to the broader aspects of economic reform. Simultaneously the IMF has gone beyond concern with simple balance of payment adjustment to interest itself in the structural reform of its members' economies. Some overlapping by both institutions has inevitably occurred, making cooperation between the Bank and the IMF crucial. Devising programs that will integrate members' economies more fully into the international monetary and financial system and at the same time encourage economic expansion continues to challenge the expertise of both Bretton Woods Institutions.

The International Monetary Fund and the World Bank at a Glance

International Monetary Fund	World Bank
• oversees the international monetary system • promotes exchange stability and orderly exchange relations among its member countries • assists all members–both industrial and developing countries–that find themselves in temporary balance of payments difficulties by providing short- to medium-term credits • supplements the currency reserves of its members through the allocation of SDRs (special drawing rights); to date SDR 21.4 billion has been issued to member countries in proportion to their quotas • draws its financial resources principally from the quota subscriptions of its member countries • has at its disposal fully paid-in quotas now totaling SDR 145 billion (about $215 billion) • has a staff of 2,300 drawn from 182 member countries	• seeks to promote the economic development of the world's poorer countries • assists developing countries through long-term financing of development projects and programs • provides to the poorest developing countries whose per capita GNP is less than $865 a year special financial assistance through the International Development Association (IDA) • encourages private enterprises in developing countries through its affiliate, the International Finance Corporation (IFC) • acquires most of its financial resources by borrowing on the international bond market • has an authorized capital of $184 billion, of which members pay in about 10 percent • has a staff of 7,000 drawn from 180 member countries

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Contributors and Attributions

14.10: Reading- International Economic Cooperation among Nations

General Agreement on Tariffs and Trade (GATT)

The General Agreement on Tariffs and Trade (GATT) is a series of rules governing trade that were first created in 1947 by twenty-three countries. By the time it was replaced with the WTO, there were 125 member nations. GATT has been credited with substantially expanding global trade, primarily through the reduction of tariffs.

The basic underlying principle of GATT was that trade should be free and equal. In other words, countries should open their markets equally to member nations, and there should be neither discrimination nor preferential treatment. One of GATT's key provisions was the most-favored-nation clause (MFN). It required that once a benefit, usually a tariff reduction, was agreed on between two or more countries, it was automatically extended to all other member countries. GATT's initial focus was on tariffs, which are taxes placed on imports or exports.

Did You Know?

As a concept, MFN can be seen in many aspects of business; it's an important provision. Companies require MFN of their trading partners for pricing, access, and other provisions. Corporate or government customers require it of the company from which they purchase goods or services. Venture capitalists (VC) require it of the companies in which they invest. For example, a VC wants to make sure that it has negotiated the best price for equity and will ask for this provision in case another financier negotiates a cheaper purchase price for the equity. The idea behind the concept of MFN is that the country, company, or entity that has MFN status shouldn't be disadvantaged in comparison with others in similar roles as a trading partner, buyer, or investor. In practice, the result is that the signing party given MFN status benefits from any better negotiation and receives the cheaper price point or better term. This terminology is also used in sales contracts or other business legal agreements.

Gradually, the GATT member countries turned their attention to other nontariff trade barriers. These included government procurement and bidding, industrial standards, subsidies, duties and customs, taxes, and licensing. GATT countries agreed to limit or remove trade barriers in these areas. The only agreed-on export subsidies were for agricultural products. Countries agreed to permit a wider range of imported products to enter their home markets by simplifying licensing guidelines and developing consistent product standards between imports and domestically produced goods. Duties had to result from uniform and consistent procedures for the same foreign and domestically produced items.

The initial successes in these categories led some countries to get more creative with developing barriers to trade as well as entering into bilateral agreements and providing more creative subsidies for select industries. The challenge for the member countries of GATT was enforcement. Other than complaining and retaliating, there was little else that a country could do to register disapproval of another country's actions and trade barriers.

Gradually, trade became more complex, leading to the Uruguay Round beginning in 1986 and ending in 1994. These trade meetings were called rounds in reference to the series of meetings among global peers held at a "roundtable." Prior to a round, each series of trade discussions began in one country. The round of discussions was then named after that country. It sometimes took several years to conclude the topic discussions for a round. The Uruguay Round took eight years and actually resulted in the end of GATT and the creation of the World Trade Organization (WTO). The current Doha Development Round began in 2001 and is actually considered part of the WTO.

World Trade Organization (WTO)

Brief History and Purpose

The World Trade Organization (WTO) developed as a result of the Uruguay Round of GATT. Formed officially on January 1, 1995, the concept of the WTO had been in development for several years. When the WTO replaced GATT, it absorbed all of GATT's standing agreements. In contrast to GATT, which was a series of agreements, the WTO was designed to be an actual institution charged with the mission of promoting free and fair trade. As explained on its website, the WTO "is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business."

The global focus on multilateral trade agreements and cooperation has expanded trade exponentially. "The past 50 years have seen an exceptional growth in world trade. Merchandise exports grew on average by 6 percent annually. Total trade in 2000 was 22-

times the level of 1950. GATT and the WTO have helped to create a strong and prosperous trading system contributing to unprecedented growth.”[1]

The WTO’s primary purpose is to serve as a negotiating forum for member nations to dispute, discuss, and debate trade-related matters. More than just a series of trade agreements, as it was under GATT, the WTO undertakes discussions on issues related to globalization and its impact on people and the environment, as well as trade-specific matters. It doesn’t necessarily establish formal agreements in all of these areas but does provide a forum to discuss how global trade impacts other aspects of the world.

Headquartered in Geneva, Switzerland, the current round is called the Doha Round and began in 2001. With 153 member nations, the WTO is the largest, global trade organization. Thirty nations have observer status, and many of these are seeking membership. With so many member nations, the concept of MFN has been eased into a new principle of normal trade relations (NTR). Advocates say that no nation really has a favored nation status; rather, all interact with each other as a normal part of global trade.

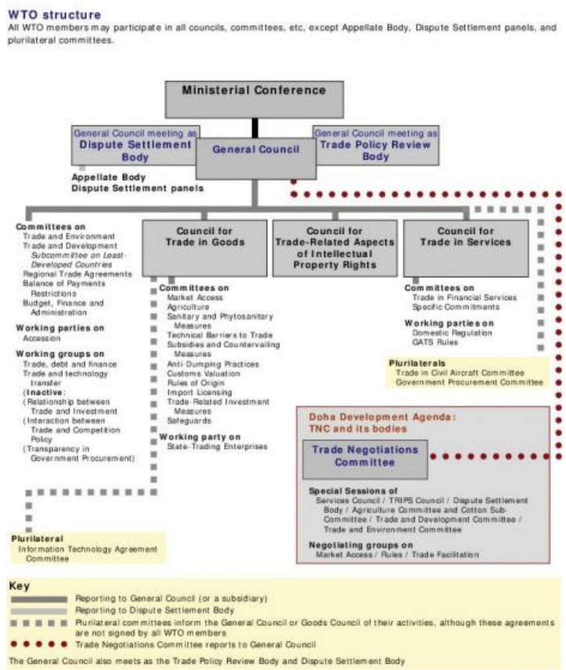

Figure 14.10.1: The Structure of the WTO. Source: World Trade Organization, 2011.

The biggest change from GATT to the WTO is the provision for the settlement of disputes. If a country finds another country’s trade practices unfair or discriminatory, it may bring the charges to the WTO, which will hear from both countries and mediate a solution.

The WTO has also undertaken the effort to focus on services rather than just goods. Resulting from the Uruguay Round, the General Agreement on Trade in Services (GATS) seeks to reduce the barriers to trade in services. Following the GATT commitment to nondiscrimination, GATS requires member nations to treat foreign service companies as they would domestic ones. For example, if a country requires banks to maintain 10 percent of deposits as reserves, then this percentage should be the same for foreign and domestic banks. Services have proven to be more complex to both define and regulate, and the member nations are continuing the discussions.

Similar to GATS is the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Intellectual property refers to just about anything that a person or entity creates with the mind. It includes inventions, music, art, and writing, as well as words, phrases, sayings, and graphics—to name a few. The basic premise of intellectual property rights (IPR) law is that the creator of the property has the right to financially benefit from his or her creation. This is particularly important for protecting the development for the creation, known as the research and development (R&D) costs. Companies can also own the intellectual property that their employees generate. This section focuses on the protection that countries agree to give to intellectual property created in another country.

Over the past few decades, companies have become increasingly diligent in protecting their intellectual property and pursuing abusers. Whether it's the knock-off designer handbag from China that lands on the sidewalks of New York or the writer protecting her thoughts in the written words of a book (commonly understood as content), or the global software company combating piracy of its technical know-how, IPR is now formally a part of the WTO agreements and ongoing dialogue.

Current Challenges and Opportunities

Agriculture and textiles are two key sectors in which the WTO faces challenges. Trade in agriculture has been impacted by export-country subsidies, import-country tariffs and restrictions, and nontariff barriers. Whether the United States provides low-cost loans and subsidies to its farmers or Japan restricts the beef imports, agriculture trade barriers are an ongoing challenge for the WTO. Global companies and trade groups that support private-sector firms seek to have their governments raise critical trade issues on their behalf through the WTO.

For example, Japan's ban of beef imports in response to mad cow disease had a heavy impact on the US beef industry during the first decade of the 21st century. Japan was the largest foreign buyer of U.S. beef before it banned all imports when the first case of the brain-wasting disease, also known bovine spongiform encephalopathy [i.e., mad cow disease], was discovered in the U.S.

Japanese restrictions on U.S. beef created distance between Japan and the U.S. Japan Agriculture Minister Hirotaka Akamatsu told reporters in 2010 after meeting [US Agriculture Secretary Tom] Vilsack in Tokyo. "For us, food safety based on Japan's scientific standards is the priority. The OIE standards are different from the Japanese scientific ones." During the beef export ban, the U.S. beef industry lost about $1 billion a year in sales because of the restrictions, according to the National Cattlemen's Beef Association, [a trade group supporting the interests of American beef producers].

The ban was eased in 2005 to allow meat from cattle aged 20 months or less, which scientists say are less likely to have contracted the fatal illness. … Japan was the third-largest destination for U.S. beef [in 2009], with trade totaling $470 million, up from $383 million in 2008, according to the U.S. Meat Export Federation. That compares with $1.39 billion in 2003. Mexico and Canada were the biggest buyers of U.S. beef [in 2009].[2]

The role of the WTO is to facilitate agreements in difficult bilateral and multilateral trade disputes, but this certainly isn't easy. Japan's reluctance for American beef may have appeared to be the result of mad cow disease, but business observers note Japan's historical cultural preference for Japanese goods, which the country often claims are superior. A similar trade conflict was triggered in the 1980s when Japan discouraged the import of rice from other countries. The prevailing Japanese thought was that its local rice was easier for the Japanese to digest. After extensive discussions in the Uruguay Round of trade talks, on "December 14, 1993 the Japanese government accepted a limited opening of the rice market under the GATT plan."[3]

Antidumping is another area on which the WTO has focused its attention. Dumping occurs when a company exports to a foreign market at a price that is either lower than the domestic prices in that country or less than the cost of production. Antidumping charges can be harder to settle, as the charge is against a company and not a country. One example is in India, which has, in the past, accused Japan and Thailand of dumping acetone, a chemical used in drugs and explosives, in the Indian market. In an effort to protect domestic manufacturers, India has raised the issue with the WTO. In fact, India was second only to Argentina among the G-20 (or Group of Twenty) nations in initiating antidumping investigations during 2009, according to a WTO report.

Future Outlook

The future for the WTO and any related organizations remains strong. With companies and countries facing a broader array of trade issues than ever before, the WTO plays a critical role in promoting and ensuring free and fair trade. Many observers expect that the WTO will have to emphasize the impact of the Internet on trade. In most cases, the WTO provides companies and countries with the best options to dispute, discuss, and settle unfair business and trade practices.

Key Takeaways

- The General Agreement on Tariffs and Trade (GATT) is a series of rules governing trade that were first created in 1947 by twenty-three countries. It remained in force until 1995, when it was replaced by the WTO.
- The World Trade Organization (WTO) is the only global, international organization dealing with the rules of trade between nations. The WTO agreements that have been negotiated and signed by the organization's 153 member nations and ratified in their parliaments are the heart of the organization. Its goal is to help the producers, exporters, and importers of goods and services conduct business. The latest round of the WTO trade negotiations is called the Doha Round.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. Source: "The Multilateral Trading System—Past, Present and Future," World Trade Organization, accessed December 29, 2010.↵
2. Source: Jae Hur and Ichiro Suzuki, "Japan, U.S. to Continue Dialogue on Beef Import Curbs (Update 1)," BusinessWeek, April 7, 2010. Restrictions were further eased in 2013.↵
3. Source: "Japan Rice Trade," case study on American University website. ↵

Contributors and Attributions

CHAPTER OVERVIEW

15: Module 6- Business Ethics and Corporate Social Responsibility

15.1: Introduction to Ethical and Legal Behavior

What you'll learn to do: differentiate between ethical and legal behavior

Ethical and legal behavior can often be confused—partially because they can often overlap. However, legal behavior and ethical behavior are different. For instance, it is not a legal issue to debate if you should buy a boat or donate to a charity, but it could be an ethical issue.

Both legal and ethical behaviors have significant consequences for business: legal misconduct can result in fines and (depending on the severity of the misconduct) incarceration of perpetrators, and ethical misconduct can result in a loss of trust from customers and partners. In this section you'll get an introduction to ethics and learn why this is an especially challenging issue for companies that are trying to "do the right thing."

Contributors and Attributions

15.2: Ethical and Legal Behavior

Learning Objectives

- Define ethical behavior
- Define legal behavior
- Differentiate between ethical and legal behavior

To Hire or Not to Hire Smokers: That Is the Question at American Express

American Express, a financial services company, found that smokers were costing the company $5,000–$6,000 more per year than nonsmokers. With medical costs rising 10 percent–15 percent per year, the board of directors wants to discuss whether the company should refuse to hire smokers.

Nationwide, about 6,000 companies refuse to hire smokers. Costs are driving the trend not to hire smokers. According to the CDC, a smoker will have 50 percent higher absenteeism and, when present, will work 39 fewer minutes per day because of smoke breaks, which leads to 1,817 lost hours of annual productivity. A smoker will have higher accident rates, cause $1,000 a year in property damage (from cigarette burns and smoke damage), and will cost up to $5,000 more a year for annual insurance premiums.

Few people would fault a company for trying to control costs and maintain a productive workforce, but the question is how far should a company go in pursuit of these goals? Law professor Don Garner believes that "If someone has the ability to do the job, he should get it. What you do in your home is your own business." Others say such policies set a dangerous precedent. "These things are extremely intrusive," said George Koodray, assistant U.S. director of the Citizens Freedom Alliance. If companies begin by discriminating against smokers, they might next discriminate against people who are overweight in order to cut costs.

As a manager, you have a hard decision regarding such a policy because your choice has implications beyond hiring decisions.

- On what basis should the company decide whether or not to hire smokers: the best interest of the firm, what the law allows, or individual rights?
- As a manager you have to consider both ethics and social responsibility. Ethical decision making is concerned with doing right and avoiding wrong. Social responsibility is a broader goal to pursue policies that benefit society. Should you protect an individual's right to smoke if it places a burden on society? Is it ethical to promote society's rights if it infringes on the rights of the individual?
- The board is charged with increasing shareholder wealth, so they particularly want a decision that's in the best interest of the company's financial health. Do you promote shareholders interests over those of the individual or society?

If you were in charge at American Express, what would you do?

This scenario enables us to explore fundamental questions about the nature of ethical and legal behavior in business. It also highlights the tension between our ideals and how they play out in the real world. Sometimes, acting in ways that are ethical and legal are one and the same thing. Other times, they are not.

Ethical Behavior

Ethics are a set of standards that govern the conduct of a person, especially a member of a profession. While ethical beliefs are held by individuals, they can also be reflected in the values, practices, and policies that shape the choices made by decision makers on behalf of their organizations. Professions and organizations regularly establish a "Code of Ethics" that serves to guide the behavior of members of the profession or organization. In the medical profession, for instance, doctors take an ethical oath to "do no harm." The American Society of Mechanical Engineers' code states, "Engineers shall hold paramount the safety, health, and welfare of the public in the performance of their professional duties."

Legal Behavior

Legal behavior follows the dictates of laws, which are written down and interpreted by the courts. In decision making, determining the legality of a course of action is facilitated by the existence of statutes, regulations, and codes. Unlike ethical considerations, there are established penalties for behaving in a way that conflicts with the law. However, as society evolves, what constitutes legal behavior also changes. For example, until recently, the possession or use of marijuana was illegal in the State of Colorado. As a result of the legislation that legalized marijuana, existing laws will need to be reinterpreted, and undoubtedly additional laws will be enacted to govern what was formerly illegal behavior. Whether or not an individual thinks it is ethical to use a potentially harmful substance, the fact is that the law now allows such behavior.

Practice Questions

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American Express

Using these as working definitions, let's return to American Express.

Ethical Considerations

If the company decides not to hire smokers, then the company would essentially be interfering with the individual's right to engage in a legal activity. If the company dictates to employees about smoking, what else can they decide for employees? The National Institute for Health reports that the aggregate national cost of overweight and obesity combined was $113.9 billion. Does the company set Body Mass Index (BMI) limits for potential employees to reduce the cost of medical coverage for obesity-related illness? As you can see, such decisions are complex—and, some would say, a slippery slope.

Legal Considerations

Would American Express's decision not to hire smokers constitute lifestyle discrimination? A company can require that employees not smoke during their shift or anywhere on company premises, but does it have the right to require them not to smoke when *not* at work or *not* on company property? According to the ACLU, it can become lifestyle discrimination if the company requires that employees not smoke when they're not at work, off duty, and/or off work premises. In fact, smokers are protected from employment-based discrimination in many states, and several states do not allow employers to base employment on smoking status. [1].

More than half of the states in the U.S. protect employees against employers who impose certain lifestyle requirements, such as only hiring non-smokers or refusing to hire individuals who are obese or have high cholesterol. Clearly American Express is dealing with a legal issue when considering the non-smoker policy, but as with the ethical issue, it's not cut and dried.

If you were in charge at American Express, what would you do?

As this example shows, people take positions and make choices within different frameworks, and those frameworks, while overlapping, are not always perfectly aligned. The legal framework establishes laws that govern behavior while the ethical framework contains sets of standards and rules governing the behavior of individuals within groups or professions.

Practice Question

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As you will see in the rest of this module, when businesses try to "do the right" thing—by the law, by their shareholders, by their employees, by their customers, and other stakeholders—there is often a complex interplay of ethical and legal considerations.

1. "Smoker Protection Laws." Findlaw. Accessed February 26, 2019. https://employment.findlaw.com/workplace-safety/smoking-tobacco-in-the-workplace.html. ↵

Contributors and Attributions

15.3: Introduction to Business Ethics

What you'll learn to do: explain the concept of business ethics, and outline the steps companies take to encourage ethical behavior

Every day, managers and business owners make business decisions based on what they believe to be right and wrong. Through their actions, they demonstrate to their employees what is and is not acceptable behavior and shape the moral standard of the organization. Personal and professional ethics are important cornerstones of an organization and shape its ultimate contributions to society in the form of corporate social responsibility.

In this section you'll learn how businesses define ethics and how they encourage their employees to behave ethically.

Contributors and Attributions

15.4: Building Business Ethics

Learning Objectives

- Explain the concept of business ethics
- Explain how ethics relates to the business and the individual
- Define "corporate code of ethics"
- Explain the role of managers in setting standards for ethical behavior

Governments use laws and regulations to point business behavior in what they perceive to be beneficial directions. **Businessethics** implicitly regulates behavior that lies beyond governmental control. Business ethics refers to contemporary standards or sets of values that govern the actions and behavior of individuals in the business organization and the actions of the business itself. It applies to all aspects of business conduct and is relevant to the conduct of individuals and entire organizations. Corporations and professional organizations, particularly licensing boards, will usually have a written "Code of Ethics" that governs standards of professional conduct expected of all in the field.

Practice Question

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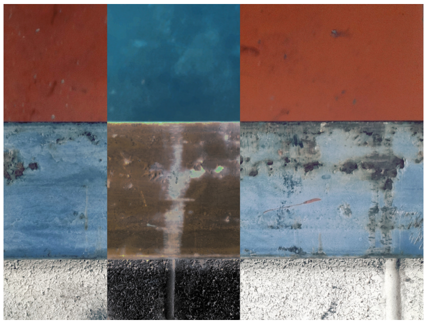
Individual and Corporate Ethics



As the definition of business ethics above suggests, business ethics is a broad term that applies to the behavior of the individuals who work at a business as well as the actions of the business itself. There is a narrower term, "corporate ethics," that is used for this second area of the actions of a business. Corporate ethics express the values of an organization to its internal and external stakeholders. Corporate ethics has become such an important concern that companies such as Covalence EthicalQuote have cropped up to monitor the ethical behavior of businesses. These private firms track the world's largest companies in areas such as corporate social responsibility, ethics, and sustainability, and then provide ratings, news, and data to investors and the general public. Web sites such as EthicalConsumer.org promote "ethical consumerism" to help consumers act in the marketplace in ways that are consistent with their ethics. Year after year, companies such as Nestle, Bayer, and Monsanto grace the top of the "worst of the worst" lists.

But it's not all grim news or tattling when it comes to business ethics. For example, the Scottsdale, Arizona-based Ethisphere Institute—an organization focused on gauging ethical business practices—publishes a list of the "World's Most Ethical Companies" on an annual basis. The overall goal of Ethisphere's rankings is to reward organizations with good practices and offer a model—and actionable advice—on how corporate entities should conduct themselves, says chief marketing and strategy officer, Tia Smallwood. "The papers are filled with scandals and companies that made judgment errors, that made policy errors or that don't have good practices in place to handle things like non-retaliation or transparency or open reporting, or have had a crisis and handled it poorly," she said. "But there a lot of companies that are really trying to do things the right way."[1]

Notable call-outs from the 2019 honorees are the eight firms that have been included every year of the list's existence:

1. Aflac
2. Ecolab Inc.
3. Fluor Corporation
4. International Paper Company

5. Kao Corporation
6. Milliken & Company
7. PepsiCo
8. Texas Instruments

? Practice Question

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Company Codes of Ethics and Codes of Practice

An increasing number of companies requires employees to attend trainings regarding business conduct. These typically include discussions of the company's policies, specific case studies, and legal requirements. Some companies even require their employees to sign agreements stating that they will abide by the company's rules of conduct.

As part of more comprehensive compliance and ethics programs, many companies have formulated internal policies pertaining to the ethical conduct of employees. They are generally documented in one of two ways:

1. **Corporate Code of Ethics.** A code of ethics begins by setting out the values that underpin the code and describes a company's obligation to its stakeholders. The code is publicly available and addressed to anyone with an interest in the company's activities and the way it does business. It includes details of how the company plans to implement its values and vision, as well as guidance to staff on ethical standards and how to achieve them. It is hoped that having such a policy will lead to greater ethical awareness, consistency in application, and the avoidance of ethical disasters.
2. **Code of Practice.** A code of practice is adopted by a profession or by a governmental or nongovernmental organization to regulate that profession. A code of practice may be styled as a code of professional responsibility, and it will discuss difficult issues, difficult decisions that will often need to be made, and provide a clear account of what behavior is considered "ethical" or "correct" or "right" in the circumstances. In a membership context, failure to comply with a code of practice can result in expulsion from the professional organization.

Richard DeGeorge, author of *Business Ethics*, has this to say about the importance of maintaining a corporate code:

Corporate codes have a certain usefulness and there are several advantages to developing them. First, the very exercise of doing so in itself is worthwhile, especially if it forces a large number of people in the firm to think through, in a fresh way, their mission and the important obligations they as a group and as individuals have to the firm, to each other, to their clients and customers, and to society as a whole. Second, once adopted, a code can be used to generate continuing discussion and possible modification to the code. Third, it could help to inculcate in new employees at all levels the perspective of responsibility, the need to think in moral terms about their actions, and the importance of developing the virtues appropriate to their position.[2]

Beyond establishing policies or codes that guide the ethical behavior of the company or employees, many companies are assessing the environmental factors that can lead employees to engage in unethical conduct. A competitive business environment may call for unethical behavior. For example, lying has become the norm in fields such as stock and security trading. Sometimes there is disconnection between the company's code of ethics and the company's actual practices. Thus, whether or not such conduct is explicitly sanctioned by management, at worst, this makes the policy duplicitous, and, at best, it is merely a marketing tool.

Not everyone supports corporate policies that govern ethical conduct. Some claim that ethical problems are better dealt with by relying upon employees to use their own judgment. Others believe that corporate ethics policies are primarily rooted in utilitarian concerns, and that they are mainly to limit the company's legal liability, or to curry public favor by giving the appearance of being a good corporate citizen. Ideally, the company will avoid a lawsuit because its employees will follow the rules. Should a lawsuit occur, the company can claim that the problem wouldn't have arisen if the employee had followed the code properly.

? Practice Question

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Encouraging Ethical Behavior

How, then, do businesses encourage and support ethical behavior? Often the ethical tone of a business is set by organizational leadership.

Consider the following observation by the Ethics and Compliance Initiative (ECI) on the results of the National Business Ethics survey:

> For discrimination in particular, employees indicated that most of the observed misconduct (56%) was committed by those in leadership. Some industries seem to be particularly perilous for employees; nearly two out of every five employees (39%) in the accommodation and food services industry have observed at least one type of interpersonal misconduct, while fewer than two in ten (17%) employees in professional services observed an incident of misconduct.[3]

If a company is looking for ways to boost or ensure ethical behavior in an organization, this is an interesting and alarming finding. In their report, the ECI suggested five strategies to promote safer and more ethical workplaces:[4]

1. Make ethics a leadership priority
2. Focus on achieving success the right way
3. Be attuned to the impact of organizational change
4. Nurture a speak up culture
5. Be transparent

These findings suggest the important role that executives play in building ethical organizations—ethics and integrity tend to start (or fail) at the top and trickle down.

Additionally, employees want to know whether leaders treat lower level employees with dignity and respect, share credit when good things happen, and uphold standards even when it reduces revenues and profits. They watch to see whether leaders are steady in crisis, hold themselves accountable or, alternatively, shift blame to others. Workers also look at day-to-day management decisions to gauge whether ethical behavior is recognized and rewarded, or whether praise and promotions go to workers who bend the rules.

The Role of Executives and Managers in Setting Ethical Standards

When executives establish specific, measurable objectives for the company, those objectives determine where people will focus their time and effort. When the objectives cannot be met and there are dire personal consequences for failure, such conditions can lead to the compromise of ethics and standards. In the National Business Ethics Survey, 70 percent of employees identified pressure to meet unrealistic business objectives as most likely to cause them to compromise their ethical standards, and 75 percent identified either their senior or middle management as the primary source of pressure they feel to compromise the standards of their organizations.

In the Volkswagen case, internal investigations have questioned how both the company culture and the behavior of former CEO Martin Winterkorn contributed to a systemic ethical breach. Like many chief executives, Martin Winterkorn was a demanding boss who didn't like failure, but critics say the pressure on managers at Volkswagen was unusual, which may go some way toward explaining the carmaker's crisis. When he became CEO in 2007, Winterkorn set an objective to make VW the world's biggest carmaker, which would require tremendous growth in the highly competitive U.S. car market. In the years since, VW has nearly doubled its global annual sales to 10 million cars and its revenue to $225 billion. In early 2015, VW finally approached its goal, selling marginally more vehicles than the world's number-one automaker, Toyota of Japan. One former sales executive said that the pressure soared under the target. "If you didn't like it, you moved of your own accord or you were performance-managed out of the business," he said.[5]

In describing a Winterkorn's leadership style, a former VW executive confidentially told Reuters News Agency, "There was always a distance, a fear and a respect . . . If he would come and visit or you had to go to him, your pulse would go up. If you presented bad news, those were the moments that it could become quite unpleasant and loud and quite demeaning."[6]

A week after U.S. regulators revealed the company's cheating, Bernd Osterloh, the employee representative on VW's supervisory board, sent a letter to VW staff suggesting the change that was needed: "We need in the future a climate in which problems aren't hidden but can be openly communicated to superiors," said Osterloh. "We need a culture in which it's possible and permissible to argue with your superior about the best way to go."[7]

In *Fortune* magazine, Dr. Paul Argenti suggested, "Rather than playing the blame game, executives should ask if pressures to grow at all costs might have created dishonest employees."[8]

It seems likely that aggressive corporate objectives (and more specifically marketing objectives related to market share) played a contributing role in the Volkswagen ethics scandal. Moreover, when executives set aggressive goals, it becomes more important to cultivate communication channels to openly address issues. This was obviously not the case at Volkswagen.

❓ Practice Question

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Executives play an important role in creating company policies on ethics—and by visibly following and upholding them. As the survey data cited above suggest, employees look to executives to decide whether standards-of-business-conduct policies should be observed and respected. When executives bend the rules or turn a blind eye to bad behavior, the policies lose value and executives lose the respect of employees. This opens the door to a range of unanticipated issues, as employees look to ethical norms outside stated policy and beyond the executives' control.

Internal promotions send very strong signals about what is important to a company. When the company hires an employee from a different company, she is likely not well known by most employees. If the company promotes an employee who is already working at the company, others may know her and understand what she has done to deserve the promotion.

If the company promotes individuals to management positions when they have displayed questionable ethics in the workplace, it creates two issues. First, it creates a level of managers who are more likely to encourage their employees to achieve business results at any cost, even when ethics are compromised. Second, it sends a message to all employees that business results are more important than ethics.

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2. DeGeorge, Richard. *Business Ethics*. Prentice Hall. pp. 207–208 ↵
3. Global Business Ethics Survey. *Interpersonal Misconduct in the Workplace*. Vienna, VA: Ethics & Compliance Initiative, 2018, p. 6. www.ethics.org/wp-content/uploads/2019/01/Global_Business_Ethics_Survey_2018_Q4_Final.pdf↵
4. Ibid, p. 16. ↵
5. Cremer, Andreas. "Fear and Respect: VW's Culture under Winterkorn." Reuters. October 10, 2015. Accessed February 27, 2019. https://www.reuters.com/article/us-volkswagen-emissions-culture-idUSKCN0S40MT20151010. ↵
6. Ibid. ↵
7. Ibid. ↵
8. "The Biggest Culprit in VW's Emissions Scandal." Fortune. Accessed February 27, 2019. http://fortune.com/2015/10/13/biggest-culprit-in-volkswagen-emissions-scandal/. ↵

Contributors and Attributions

15.5: Introduction to Ethical Challenges

What you'll learn to do: identify common ethical challenges faced by organizations

In a perfect world, it's always clear what's right or wrong. In the real world, things are often not so clear. Someone's wrong can be your right, which means your right will definitely, at some point, be someone else's wrong. Most of the time, the "right" choice is subjective. In business, many of these ethical challenges appear in the form of bribes, conflicts of interest, issues of honesty and integrity, and whistle-blowing.

In this section you'll learn some of the special terms for particular kinds of unethical behavior in business.

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15.6: Bribery and Kickbacks

Learning Objectives

- Define bribery
- Define kickback

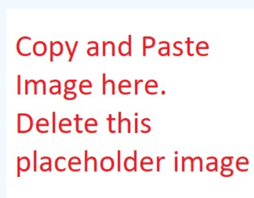
Bribery

Bribery is the act of giving money, goods, or other forms of compensation to a recipient in exchange for an alteration of their behavior (to the benefit/interest of the giver) that the recipient would otherwise not alter. Many types of payments or favors can constitute bribes: tips, gifts, favors, discount, waived fees, free foods, free advertising, free trips, free tickets, donations, campaign contribution, sponsorship/backing, higher paying job, stock options, secret commission, or promotions. The key to identifying bribery is that it is intended to alter the recipients behavior.

The simplest form of bribery: a parent who tells a child that if he behaves while at the grocery store, he will get ice cream or a toy. This is a common and mostly harmless form of bribery, but does it set the tone for expecting a future favor in exchange for good behavior? In business, bribery can be very subtle. Consider the following example.

Gifts from A Supplier

You are the purchasing manager for a manufacturing company. There are several suppliers from whom you can purchase component parts used in the production of your finished product. One of the supplier representatives comes by every Monday morning with biscuits for you and your staff. He calls you on occasion and offers you tickets to sold-out sporting events and sends a lavish gift basket every Christmas.



Is this just good business on his part, building a personal relationship with you and your staff, or is there an expectation that, in exchange for his generosity, you will select his company’s product over the competition—even though he’s not the most cost-effective choice? Are you taking a bribe when you accept the football tickets?

These small “tokens of appreciation” can be construed as bribes, and as a result, many companies prohibit their employees from accepting gifts from suppliers and vendors.

One of the challenges in determining whether or not someone has taken a bribe or simply accepted a gift is that the social and cultural norms governing bribery and gift giving can differ from place to place. Certain monetary transactions are acceptable and appropriate in some cultures but not in others. For example, political campaign contributions in the form of cash are considered criminal acts of bribery in some countries, but in the United States, as long as they adhere to election law, they're legal. Tipping is considered bribery in some societies, but in others the two concepts are very different.

Practice Question

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Kickbacks

A **kickback** is a form of negotiated bribery in which a commission is paid to the bribe-taker in exchange for services rendered. Generally speaking, money, goods, or services handed over are negotiated ahead of time. The kickback varies from other kinds of bribes in that there is implied collusion between agents of the two parties, rather than one party extorting the bribe from the other. The purpose of the kickback is usually to encourage the other party to cooperate in the illegal scheme.

Consider the following case of a former Fannie Mae employee, Armando Granillo.

Armando Granillo

Before dawn one hazy March day in L.A., Granillo pulled his SUV into a Starbucks near MacArthur Park, where he planned to pick up an envelope full of cash from an Arizona real-estate broker, federal investigators say.

Granillo, a foreclosure specialist at mortgage giant Fannie Mae, expected to drive off with $11,200—an illegal kickback for steering foreclosure listings to brokers, authorities allege in court records. Granillo would leave in handcuffs. And investigators are looking into assertions by Granillo and another former Fannie Mae foreclosure specialist that such kickbacks were "a natural part of business" at the government-sponsored housing finance company, as Granillo allegedly told the broker in a wiretapped conversation.

Regulators keep a close watch for kickback deals as the housing market heats up and new regulations take hold following the mortgage meltdown, which exposed widespread corruption in the housing and lending markets. Consumer Financial Protection Bureau Director Richard Cordray said his agency has moved to shut down kickback operations not only because they're illegal but also because they reduce competition and increase costs to the public.

Practice Question

https://assessments.lumenlearning.co...essments/14366

Contributors and Attributions

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15.7: Conflict of Interest

Learning Objectives

- Define conflict of interest

Just what entails a conflict of interest? Before you get started on this page, check in to see what you think constitutes a conflict of interest?

Practice Question

https://assessments.lumenlearning.co...essments/14367

A **conflict of interest (COI)** is an ethical challenge that occurs when an individual or organization is involved in multiple interests that are at odds with one another. COI is especially problematic in situations involving someone in a position of trust—e.g., a doctor or lawyer—who has competing professional or personal interests. These competing interests make it hard to act on behalf of one interest without compromising the integrity of the other. The following are some of the most common forms of conflict of interest:

- **Self-dealing**, in which an official who controls an organization causes it to enter into a transaction with the official, or with another organization that benefits the official, i.e., the official is on both sides of the "deal."
- **Outside employment**, in which the interests of one job contradict another.
- **Family interests**, in which a spouse, child, or other close relative is employed (or applies for employment) or where goods or services are purchased from such a relative or a firm controlled by a relative. For this reason, many employment applications ask if one is related to a current employee. In this event, the relative may be recused from any hiring decisions. Abuse of this type of conflict of interest is called **nepotism**.
- **Gifts from friends** who also do business with the person receiving the gifts (may include non-tangible things of value such as transportation and lodging).

Practice Question

https://assessments.lumenlearning.co...essments/14368

Margaret Hatch

Margaret is a member of the Pasadena County Zoning Board that is responsible for approving plans for commercial development in the county. The zoning board is currently in the preliminary stages of reviewing plans proposing a new shopping center on the north end of the county. The plans include several fast-food restaurants, a multiplex movie theater, and several national retailers that do not have a presence in the county. Everyone on the zoning board agrees that this shopping center could create a new "retail/service hub" that would attract business not just from Pasadena County but from two neighboring counties, as well.

Margaret's family owns a considerable amount of farmland adjacent to the proposed site, and after talking with the developer, it becomes clear that future expansion of the shopping center would require the use of her land plus two parcels she does not own. Margaret talks to her husband, Phil, who is a real-estate broker, about the proposed development and what she believes it will mean to the future of the area. Several days later, Phil comes home and tells Margaret that he has spoken to the owners of the other two parcels and they are willing to sell their land for below current market value if the sale can be closed quickly. Margaret and Phil agree that they will use the equity line on their home to purchase the two parcels as soon as possible.

How would the Pasadena County Zoning Board view Margaret's actions? What will be the consequences of their purchase of the additional parcels of land? What happens when the owners learn that the uncultivated farmland they sold to Margaret and Phil has been rezoned to commercial and resold to a developer? What would the State Board of Realtors say about Phil's actions? Is this just "being in the right place at the right time," or is it something much less ethical?

A code of ethics can help to minimize problems with conflicts of interest because it spells out the extent to which such conflicts are to be avoided and what the parties should do if they do arise (disclosure, etc.). Such codes also help raise awareness, making it less likely that professionals can legitimately claim that they were unaware that their behavior was unethical. In addition, the threat of disciplinary action (for example, a lawyer being disbarred) helps to minimize unacceptable conflicts or improper acts when a conflict is unavoidable.

Contributors and Attributions

15.8: Whistleblowing

Learning Objectives

- Explain how whistleblowers can contribute to a company's ethical behavior

A **whistleblower** is a person who exposes any kind of information or activity that is deemed illegal, unethical, or not correct within an organization that is either private or public. Many whistleblowers have stated that they were motivated to take action to put an end to unethical practices after witnessing injustices in their businesses or organizations. In addition to ethics, social and organizational pressure are a motivating forces. Individuals are more likely to blow the whistle when several others know about the wrongdoing, because they would otherwise fear consequences for keeping silent.

The motivation for whistleblowing isn't always virtuous, and the outcome isn't always positive either. There are cases involving employees who blew the whistle as an act of revenge against their employer or supervisor, for instance. While it's possible for the whistleblower to be viewed as a "hero" for her courage and truth telling, it's also possible to be seen as a traitor or tattletale—as just one of the many disgruntled employees who are simply trying to get even for a perceived but imaginary injustice.

One of the barriers to whistleblowing is the belief—widespread in the professional world—that individuals are bound to secrecy within their work sector. Accordingly, whistleblowing becomes a moral choice that pits the employee's loyalty to an employer against the employee's responsibility to serve the public interest. As a result, in the United States whistleblower protection laws and regulations have been enacted to guarantee freedom of speech for workers and contractors in certain situations. Whistleblowers have the right to file complaints that they believe give reasonable evidence of a violation of a law, rule, or regulation; gross mismanagement; gross waste of funds; an abuse of authority; or a substantial and specific danger to public health or safety.

Practice Question

https://assessments.lumenlearning.co...essments/14369

Whistleblowing is often the subject of heated debate and controversy. The 2013 Edward Snowden case is a good example. He disclosed information exposing the level of NSA surveillance, showing that they data-mined information on hundreds of millions of individuals.

Widely discussed in the media and academia, the verdict on Snowden's actions is still out: did he behave heroically or traitorously? Is it right to report the shady or suspect practices of the government? How does one choose between loyalty to one's employer and loyalty to those affected by the employer's (or government's) wrongdoing? These are the ethical challenges one faces.

Blowing the Whistle on Financial Fraud

As part of the 2010 Dodd-Frank legislation passed by Congress in response to the 2008 financial crisis, the Securities and Exchange Commission (SEC) established a whistleblower-rewards program to provide employees and other individuals with the opportunity to report financial securities misconduct. More than seven years after starting the Office of the Whistleblower, the SEC reports that the rewards program has recovered almost $1 billion in financial penalties from companies that have done things to damage their own reputation as well as those of employees and other stakeholders.

According to a recent SEC report, 2016 was a banner year for individuals reporting financial wrongdoings and whistleblowers being rewarded for what they discovered. In 2016 alone, more than $57 million was awarded to whistleblowers—an amount greater than the total amount of rewards issued since the program's inception in 2011.

The whistleblower program is based on three key components: monetary awards, prohibition of employer retaliation, and protection of the whistleblower's identity. The program requires the SEC to pay out monetary awards to eligible individuals who voluntarily provide original information about a violation of federal securities laws that has occurred, is ongoing, or is about to take place. The information supplied must lead to a successful enforcement action or monetary sanctions exceeding $1 million. No awards are paid out until the sanctions are collected from the offending firm.

A whistleblower must be an individual (not a company), and that individual does not need to be employed by a company to submit information about that specific organization. A typical award to a whistleblower is between 10 and 30 percent of the monetary sanctions the SEC and others (for example, the U.S. attorney general) are able to collect from the company in question.

Through September 2016, the whistleblower program received more than 18,000 tips, with more than 4,200 tips reported in 2016 alone. The program is not limited to U.S. citizens or residents; foreign persons living abroad may submit tips and are eligible to receive a monetary award. In fact, the SEC gave the largest monetary award to date of $30 million to a foreign national living abroad for original information relating to an ongoing fraud.

Despite criticisms from some financial institutions, the whistleblower-rewards program continues to be a success—reinforcing the point that financial fraud will not go unnoticed by the SEC, employees, and others individuals.

Sources: "Office of the Whistleblower," https://www.sec.gov, accessed November 1, 2017; Erika A. Kelton, "Four Important Dodd-Frank Whistleblower Program Developments to Watch for in 2017," https://wp.nyu.edu, accessed November 1, 2017; Jason Zuckerman and Matt Stock, "One Billion Reasons Why the SEC Whistleblower-Reward Program Is Effective," Forbes, http://www.forbes.com, July 18, 2017; John Maxfield, "The Dodd-Frank Act Explained," USA Today, https://www.usatoday.com, February 3, 2017; Eduardo Singerman and Paul Hugel, "The Tremendous Impact of the Dodd-Frank Whistleblower Program in 2016," Accounting Today, https://www.accountingtoday.com, December 28, 2016; Samuel Rubenfeld, "Dodd-Frank Rollback to Spare SEC Whistleblower Program, Experts Say," The Wall Street Journal, www.blogs.wsj.com, November 15, 2016.

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15.9: Examples of Unethical Business Behavior

Learning Objectives

- Give examples of unethical corporate or business behavior

In business, sometimes ethics comes down to deciding whether or not to tell the truth. Admitting an error, disclosing material facts, or sending a customer to a competitor are all decisions that business people make based on issues of honesty and integrity. Because honesty and integrity are often used in the same breath, many people believe that they are one and the same. However, they are decidedly different, and each is important in its own way. As Professor Stephen L. Carter of Yale Law School points out in his book *Integrity*, "one cannot have integrity without being honest, but one can be honest and yet lack integrity."

Integrity means adherence to principles. It's a three-step process: choosing the right course of conduct; acting consistently with the choice—even when it's inconvenient or unprofitable to do so; openly declaring where one stands. Accordingly, integrity is equated with moral reflection, steadfastness to commitments, and trustworthiness.

The major difference between honesty and integrity is that one may be entirely honest without engaging in the thought and reflection that integrity demands. The honest person may truthfully tell what he or she believes without the advance determination of whether it's right or wrong. Sometimes the difference is subtle. Take the following example:

Being himself a graduate of an elite business school, a manager gives the more challenging assignments to staff with the same background. He does this, he believes, because they will do the job best and for the benefit of others who did not attend similar institutions. He doesn't want them to fail. He claims integrity because he is acting according to his beliefs.

The manager fails the integrity test. The question is not whether his actions are consistent with what he most deeply believes but whether he has done the hard work of ascertaining whether what he believes is right and true.[1].

Companies that value honesty and integrity can expect to see those values permeate their company culture. In such a climate, coworkers trust one another, employees view management with less suspicion, and customers spread the word about the company's ethical behavior. Honest companies also don't have to worry about getting into trouble with the IRS or the media on account of ethical wrongdoing. Even though a company may have to give up short-term gains in order to maintain an atmosphere of honesty and integrity, in the long run it will come out ahead.

Practice Question

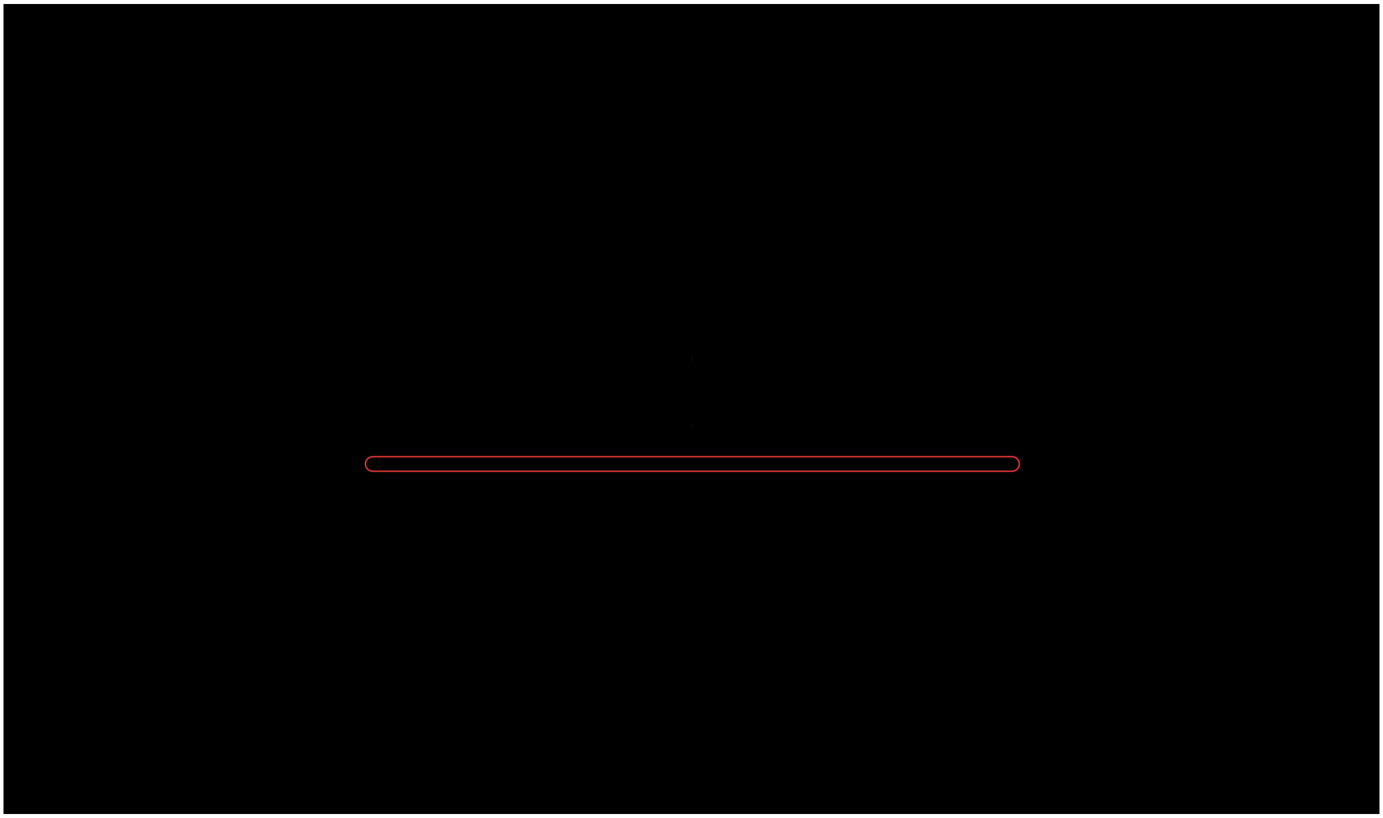
https://assessments.lumenlearning.co...essments/14370

Try It

Read how seven business leaders made decisions to act with honesty and integrity.

Try It

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



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Contributors and Attributions

15.10: Case Study- Microsoft’s Gift to Bloggers

Learning Objectives

- Define bribery
- Give examples of unethical corporate or business behavior

Gift giving in business is both commonplace and controversial at the same time. Business gifts are usually seen as an advertising, sales-promotion, and marketing-communication medium. Such gifting is usually practiced for the following reasons:

1. In appreciation for past client relationships, placing a new order, referrals to other clients, etc.
2. In the hopes of creating a positive first impression that might help to establish an initial business relationship
3. As a quid pro quo—returning a favor or expecting a favor in return for something

Making good decisions about when business gifts are appropriate is extremely complex in the United States. In a global business environment, it becomes one of the most challenging ethical issues, since the cultural norms in other countries can be at odds with standard ethical practices in the United States. For this reason, gifts and bribes warrant a deeper discussion.

Let’s examine one of Microsoft’s promotions that included a gift.

Microsoft Gives Acer Ferrari Laptops to Bloggers

When Microsoft introduced its Vista operating system, the launch included a noteworthy promotion. During the 2006 Christmas season, Microsoft sent out ninety Acer Ferrari laptops, loaded with Windows Vista Operating system, to approximately ninety influential bloggers.

Different bloggers received different machines, but the lowest model was worth around two thousand dollars. Michael Arrington, editor of TechCrunch, shared the message that accompanied his gift:

> *This would be a review machine, so I’d love to hear your opinion on the machine and OS. Full disclosure, while I hope you will blog about your experience with the PC, you don’t have to. Also, you are welcome to send the machine back to us after you are done playing with it, or you can give it away to your community, or you can hold on to it for as long as you’d like. Just let me know what you plan to do with it when the time comes. And if you run into any problems let me know. A few of the drivers aren’t quite final, but are very close.*[1]

Clearly, Microsoft was hoping to encourage reviews of Vista and wanted to make sure that the bloggers experienced Vista on a high-end machine that would optimize performance. Did they also hope to influence the bloggers’ opinions of the company along the way?

Sending the gift to bloggers was a risky marketing tactic even without the ethical question. Culturally, bloggers are a highly influential group of people with strong opinions, which they share openly to a wide audience. Many of the recipients reacted to the gift by sharing the news of the promotion and their opinions about it. A broad range of ethical issues emerged from the discussions in the blogosphere. Below are several excerpts.

The Gifts Diminish Trust in the Reviewers

> *Now that I know these guys (any gals?) have access to a tailored laptop, preloaded, etc., I know their wisdom is no longer that of The Crowd—I suspect it*

> *is going to be tainted (even if not the case), so I have already discounted them. And, since I don't know who has and has not had the gift, I will distrust them all on this subject!*[2]

The Laptops Provide a Review Experience That Will Not Match Users' Experiences

> *If you've ever tried to add a new Microsoft OS to an existing computer, you know you can't do that without totally f****** up your computer. The only way to switch to a new Microsoft OS is to start with a new computer. And, of course, to wait a year or two while they get the kinks out. Microsoft wouldn't chance having dozens of bloggers writing about how VISTA screwed up their computers, so they installed the system on brand-new computers. They gave the computers as gifts instead of lending them to the bloggers for review, which is the norm when dealing with traditional journalists.*

The Bloggers Should Disclose the Gift in Their Reviews

Microsoft's approach raises some problematic issues . . . How many bloggers have received a notebook but have not declared it on their blog? Quite a few, I suggest, which highlights the fundamental problem with blogging, which is that bloggers are not trained journalists and not necessarily in tune with the ethical problems that gifts entail . . .

Finally, sending bribes to bloggers is not a good look for Microsoft, and this is exactly how this initiative will be perceived. Even as they try to defend themselves, Microsoft's PR gurus show that they do not understand the blogosphere.[3]

Another blogger shared the disclosure concern while supporting the promotion:

That is a GREAT idea. After all, how can anyone have a decent conversation about Windows Vista without having put a bunch of time on one of the machines? Now, regarding blogger ethics. Did you disclose? If you did, you have ethics. If you didn't, you don't. It's that black-and-white with me. [4]

While there was not a clear consensus on the ethics of this promotion, the debate drowned out whatever little positive opinion Windows Vista had generated in the blogs. The Microsoft case stands as a good example of a business gift program gone wrong. The company not only wasted the money spent on the gifts (none of the bloggers reported to have returned the laptops) but suffered weeks of bad press—and soured the commercial launch of the product.

Three Dimensions of Evaluating Gifts

The Microsoft example provides a three-dimensional framework by which to evaluate whether a gift crosses the line into bribery. (Remember that a bribe is something given to induce someone to alter their behavior—in this case, to write a favorable product review.) The framework helps establish guidelines for keeping business gifting aboveboard.

Content

The chief problem with Microsoft's gift was the content. Content refers to the nature of the gift itself (a shiny, new, top-of-the-line laptop) and the price ($2,000 or more). The company claimed that such a high-end machine was necessary to showcase the full capability of the Windows Vista operating system. And, they asserted, since the bloggers were given the option of returning the laptops (or giving them away), the issue of bribery didn't come into play and the onus of acting ethically fell to the recipients.

Nonetheless, Microsoft's actions represented a departure from standard industry practice of sending preview disks of software to opinion-makers. While it might be acceptable to give out $2,000 gifts in other industries (like sending out expensive fashion clothing to movies stars), and one can dicker about whether $2,000 is or isn't too extravagant, the point is that Microsoft broke with the conventions of its own industry.

The key lesson is that *what* is being given defines the nature of gifting, and extreme care must be taken to determine whether that gift is appropriate. While the market price of a gift item can be used as a benchmark, the type of gift is as important as its price. If Microsoft had given out $2,000 worth of software, it wouldn't have been so controversial. Another point, which Microsoft surely knew, is that items sent around Christmastime are more apt to be perceived as gifts.

Context

The other objection to the Microsoft gifts was the company's motives for giving them. People argued that Microsoft sent the expensive laptops to bloggers as a quid pro quo. Though the accompanying email said "you don't have to write about Vista," that was mainly a legal disclaimer meant to protect Microsoft against formal bribery charges (U.S. corruption law prohibits corporate gifts designed to induce action by the recipient). The company may have kept itself out of legal hot water, but it remained vulnerable to the charge that it tried to exert psychological pressure on the bloggers to write about their "pleasurable" experiences with Vista.

The other argument was that laptops were given to the bloggers so that they would lack the proper testing environment of mainstream tech journalists. The bloggers were set up to write good things about Vista by seeing it function in a brand-new machine, tuned and tested for this purpose by Microsoft engineers. The experience of actual users—who might be influenced by these bloggers' opinions—would be different, since they would have to install the software on older machines with no help from Microsoft. Critics argued that the company's promotion was intended to create a false opinion of the market.

While most businesses define what is a bribe and what isn't in terms of the *content* of the gift, in most countries the matter is decided on the basis of *context*. So, regardless of the size, type, and value of the gift, if it can be established that the gift was given with the intent to induce an action, it will be regarded as a bribe. The lesson here is that it isn't enough for businesses to set clear value/type limits on corporate gifts; it's also necessary to scrutinize the motives behind the gift giving, think carefully about how the gift will be received, and stop short of anything that induces the recipient to crosses the line of ethical behavior.

Culture

Other critics held that Microsoft's blunder was not caused by the content or context of the gifts but that the company fundamentally misunderstood the culture of blogging. This view came primarily from marketing practitioners, who pointed out that giving the laptops to elite bloggers violated the egalitarian and sponsorship-free nature of social media. It's a culture whose members loathe any kind of commercial taint to their independence and are highly sensitive to charges of "selling out."

Thus, culture is clearly the third very important aspect of gift giving. It's crucial to establish clear boundaries and protocols so that gifts are truly received as gifts—not as attempts to influence. To do that means factoring in the recipient's mindset and culture, since what may be perceived as a gift in one group may seem like a bribe in another. The "cultural" dimension is easily understood in personal gift giving (a toy truck might be an excellent present for your six-year-old nephew, but it wouldn't be appropriate for your boss or grandparent). Yet, somehow the idea of discretionary gift giving hasn't gained much ground in business. However, understanding the cultural preferences of the receiver is obviously an important issue in international business.

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Contributors and Attributions

15.11: Introduction to Corporate Social Responsibility

What you'll learn to do: explain the concept of corporate social responsibility (CSR)

Acting in an ethical manner is one of the four components of the pyramid of corporate social responsibility (CSR), which is the concern of businesses for the welfare of society as a whole. It consists of obligations beyond those required by law or union contract. This definition makes two important points. First, CSR is voluntary. Beneficial action required by law, such as cleaning up factories that are polluting air and water, is not voluntary. Second, the obligations of corporate social responsibility are broad. They extend beyond investors in the company to include workers, suppliers, consumers, communities, and society at large.

Contributors and Attributions

15.12: Corporate Social Responsibility

Learning Objectives

- Define corporate social responsibility (CSR)
- Describe the impact of CSR on direct and indirect stakeholders

History of Corporate Social Responsibility

American President Calvin Coolidge said in the 1920s that "the chief business of the American people is business." It was a popular observation in a time of economic prosperity, when issues such as energy security and climate change were practically nonexistent.

Almost a century later, things are very different. Now, more than ever, private enterprise is being called upon to exercise social responsibility, especially when it comes to the environment. This trend reflects the view that companies ought to do more than simply meet the letter of the law and the bare minimum of ethical business behavior. Today we discuss the idea of "corporate social responsibility."

President Coolidge, like many American presidents before and since, kept government out of the affairs of business as much as possible. But starting in the 1960s and 1970s, the environmental impact of an ever-expanding economy was generating more and more protest from citizens. The result was a wave of legislation designed to reduce the pollution produced by business activity. Those laws had positive effects and are now vital parts of the American regulatory framework. But despite these regulations, controlling pollution continues to be a challenge. And now there are even larger problems on the horizon.

Even though businesses today are more efficient and use fewer resources to make goods—thanks to technological advances—many ecosystems continue to suffer. This is because the scale of economic activity grows every year, despite environmental improvements by individual enterprises.

Starting a few years ago, many citizens in the U.S. and around the world began calls for more action from private enterprise on these social issues—beyond compliance with regulations and traditional charity-related work. The result was a new movement known as corporate social responsibility, or CSR.

CSR Defined

Corporate social responsibility (CSR) can be simply and broadly defined as the ethical role of the corporation in society. The aim of CSR is to increase long-term profits and shareholder trust through positive public relations and high ethical standards to reduce business and legal risk by taking responsibility for corporate actions. It isn't enough for companies to generate a profit and merely meet the letter of the law in their business operations. Today, many U.S. citizens expect them to generate a profit *and* conduct themselves in an ethical and socially responsible manner.

CSR strategies encourage the company to make a positive impact on the environment and stakeholders—that is, all of the parties who have a stake in the performance and output of the corporation. Stakeholders include the company's employees, unions, investors, suppliers, consumers, local and national governments, and communities that may be affected by corporate activities such as construction, manufacturing, and pollution. For some companies, CSR means manufacturing their products in a way that doesn't harm the environment and protects the consumer from potentially hazardous materials. One such company that has staked it reputation on ethical manufacturing is LUSH Cosmetics.

You can view the transcript for “Ethical Cosmetics” (opens in new window) or the text alternative for “Ethical Cosmetics” (opens in new window).

? Practice Questions

https://assessments.lumenlearning.co...essments/14371

Demands for Corporate Social Responsibility

There are several drivers pushing businesses toward corporate social responsibility include the following:

- Increased Pressure from Consumers
- Pressure from Shareholders and Investors
- Supply-Chain Pressure

Let’s take a deeper look at each of these.

Increased Pressure from Consumers

Consumers are demanding more from the businesses that get their hard-earned money. Businesses that are perceived as valuing more than the “bottom line” are gaining favor with the buying public. Consumers—especially those in North America—are likely to vote with their wallets against companies whose social and environmental performance is poor. Fifty-five percent of North American consumers reported that they would pay more for companies who behaved more responsibly.[1]

Starbucks and Responsibility

In the early- to late-2010s, Starbucks faced the animosity of anti-globalization rioters. It has been accused of mistreating its staff, avoiding corporate tax, and even wasting water. As the following video shows, the coffee company has been forced to react to increasing consumer pressure.

You can view the transcript for “Starbucks and Consumer Pressure” (opens in new window).

Additionally, in more recent years, it seems that their efforts to refocus on responsibility have paid off. There’s no way to change perception without actions, so Starbucks is taking action to show its dedication to social improvement. In fact, if you visit their website, one of the main sections along their top menu is Starbucks Social Impact, right alongside their lists of coffee, tea, and menu items.

As a part of their social mission, Starbucks recently announced a change in the way they deliver their drinks: they will use cups made from all recyclable material and stop using plastic straws by 2020:

We're removing plastic straws in our stores globally by 2020—reducing more than 1 billion plastic straws per year from our stores.

— Starbucks Coffee (@Starbucks) July 9, 2018

If you read through the comments, you can see Starbucks replying to concerns about not having a straw option, letting customers know that there will be straws available for those who need them but that the straws will be made of alternative materials. Starbucks also recently announced their first US Signing Store on Twitter:

Coming this fall in Washington, D.C.: our first U.S. Signing Store, creating jobs and driving greater connection with the Deaf and hard of hearing community: https://t.co/aOWJKErx35pic.twitter.com/39N0HuIGVL

— Starbucks Coffee (@Starbucks) July 19, 2018

If you watch the video in the tweet, the video has captions—indicating there is no audio—as well as video description for those who are visually impaired. With this tweet, Starbucks shows that it’s willing to take the time to ensure all their customers are welcome, regardless of their physical abilities.

Pressure from Shareholders and Investors

Although not a new concept, Socially Responsible Investing (SRI) has seen increased attention over the last several decades. In fact, investors have become more active in their demands of corporations in which they have holdings. Investor activities to move these organizations to a more responsible position have had fairly good results.

In a 2017 study, Barko, Cremers, and Renneboog measure the effect of investor activism on corporate performance. A global dataset of 660 companies were profiled in the study by market share, analyst coverage, stock returns, and liquidity. Not surprisingly, over the ten-year study the Environmental, Social, and Governance (ESG) rating of the companies targeted by activist investors showed improvement in those ratings after the engagement with those investors, versus non-targeted “matched firms.”[2]

Supply-Chain Pressure

As consumers pay closer attention to the social responsibility of retailers and service providers, visibility into their supply chains has also become a priority. For example, Apple has come under scrutiny and criticism for the poor working conditions and environmental hazards taking place at assembly facilities in China. Even though these facilities are outside of the U.S. and are separate corporate entities, Apple has spent considerable corporate resources defending its reliance on such suppliers. Other companies such as the Swedish international retailer of furniture and household goods are taking a proactive approach to CSR both internally and within the supply chain. A visit to the IKEA website allows consumers and interested parties to view the company's sustainability reports and their policy on "People and Planet."

Regardless of where the pressure originates, companies are finding that ignoring their social and environmental responsibility and impact is ultimately bad for business.

? Practice Question

https://assessments.lumenlearning.co...essments/14372

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Contributors and Attributions

15.13: Examples of Corporate Social Responsibility

Learning Objectives

- Give examples of corporate social responsibility

Not all companies approach CSR in the same way. Their approach depends upon their resources, available assets, and corporate culture. In addition, some companies perceive more benefit from one type of CSR than another. The personal beliefs and priorities of senior management/ownership can also influence the company's approach to social responsibility. Below are some different approaches to CSR.

Corporate Philanthropy

Corporate philanthropy refers to a corporation's gifts to charitable organizations. There is an implication that the corporation's donations have no strings attached, which is probably quite rare. At a minimum, most corporations expect that their donations will be publicly attributed to the corporation, thus generating positive public relations. When corporations make large cash gifts to universities or museums, they are usually rewarded with a plaque or with a building or library named after the donor. Such attributions burnish the corporation's public image, and in such cases we are not dealing with true corporate philanthropy, strictly speaking, but something more in the nature of marketing or public relations.

Cause-Related Marketing

Cause-related marketing (CRM) refers to a corporation's associating the sales of its products to a program of donations or support for a charitable or civic organization. An example is provided by the famous Red campaign, in which corporations such as Nike and Gap pledged to contribute profits from the sale of certain red-colored products to a program for African development and alleviation of AIDS-related social problems. The basic idea of cause-related marketing is that the corporation markets its brand at the same time that it promotes awareness of the given social problem or civic organization that addresses the social problem. Another well-known example is the pink ribbon symbol that promotes breast-cancer awareness and is used prominently in the marketing of special lines of products by many corporations, such as Estée Lauder, Avon, New Balance, and Self Magazine. In addition to marketing products with the pink-ribbon symbol, Estée Lauder has made support for breast cancer awareness one of the defining features of its corporate philanthropy. Thus, Estée Lauder also frequently refers to such charitable contributions, currently on the order of $150 million, in its corporate communications and public relations documents.

Sustainability

Sustainability has become such an important concept that it is frequently used interchangeably with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.

Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet's environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world's environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable anytime in the near future, the development and promotion of sustainability strategies has become virtually an obsession of most large corporations today, as their websites will attest in their inevitable reference to the corporation's sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be heard to say that they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

Social Entrepreneurship and Social Enterprise

Social entrepreneurship and social enterprise refer to the use of business organizations and techniques to attain laudable social goals. As we'll discuss further in the next reading, Blake Mycoskie decided to create TOMS Shoes largely as a reaction to his travels in Argentina, which had exposed him to terrible poverty that left many school-age children without shoes. An important part of the corporate mission of TOMS Shoes lies in its pledge to give away a free pair of shoes for every pair purchased by a customer. TOMS Shoes' model has been imitated by many others, including the popular online eyewear brand, Warby Parker.

The difference between social entrepreneurship and CSR is that, with social entrepreneurship, the positive social impact is built into the mission of the company from its founding. Other examples of social entrepreneurship include The Body Shop, Ben & Jerry's ice cream, and Newman's Own. The Body Shop was founded by noted activist Anita Roddick who insisted that all products be derived from ingredients that were natural, organic, and responsibly sourced. Her employment policies famously allowed every employee to take off one day a month from work to engage in social or community projects. Similarly, Ben & Jerry's was founded to promote the use of organic, locally-produced food. The company's founders insisted on a policy that executives earn no more than seven times the salary of factory line-workers (although this policy was eventually relaxed when it became difficult to recruit a competent CEO at those wages). Ben & Jerry's engaged in a number of high-profile political activities in which they encouraged their employees to participate, such as protesting the building of the Seabrook nuclear power plant in Vermont. Newman's Own was founded by film actor Paul Newman and his friend A. E. Hotchner with the goal of selling wholesome products and giving away 100 percent of the profits to charitable ventures. To date, Newman's Own has given away more than two hundred million dollars.

Social Marketing

Social marketing refers to the use of business marketing techniques in the pursuit of social goals. Often, governments and nonprofit organizations make use of social marketing to make their points more forcefully and effectively to a wide audience. Classic examples are the extremely powerful TV commercials warning of the dangers of unsafe driving or of failing to use seat belts. Cinematic techniques are employed to portray dramatic, arresting images of crumpled cars and bodies, children and mothers crying. The source of social marketing advertisements is usually a local government or nonprofit organization.

Social marketing is usually used to try to convince citizens to drive more safely, eat better, report child and domestic abuse, and avoid various forms of criminality and drug use. As with ordinary advertising, social marketing can seem overdone or maudlin, and some social marketing ads have been mocked or considered silly. For example, former First Lady Nancy Reagan participated in a social marketing campaign that urged young people to "Just Say No" to drugs, an approach that was ridiculed as simplistic by many. Noted radical activist Abbie Hoffman said that telling drug users to "just say no" to drugs was like telling manic-depressives to "just cheer up." Despite that, drug use in America declined over the time period that the campaign was in progress, though there is no evidence that any part of this decline was due to the campaign.

? Practice Question

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15.14: Case Study- Social Entrepreneurship at Tom's Shoes

Learning Objectives

- Give examples of corporate social responsibility

While there is no universally accepted definition of *social entrepreneur*, the term is typically applied to an individual who uses market-based ideas and practices to create "social value," the enhanced well-being of individuals, communities, and the environment. Unlike ordinary business entrepreneurs who base their decisions solely on financial returns, social entrepreneurs incorporate the objective of creating social value into their founding business models.

Social entrepreneurship has become exceedingly popular in recent years and a number of prestigious business schools have created specific academic programs in the field. It is often said that social entrepreneurs are changing the world. They are lauded for their ability to effect far-reaching social change through innovative solutions that disrupt existing patterns of production, distribution, and consumption. Prominent social entrepreneurs are celebrated on magazine covers, praised at the World Economic Forum in Davos, and awarded millions of dollars in seed money from "angel" investors, and applauded as "harbingers of new ways of doing business."

Social entrepreneurs are thus often hailed as heroes—but are they actually effecting positive social change?

Undeniably, social entrepreneurship can arouse a striking level of enthusiasm among consumers. Blake Mycoskie, social entrepreneur and founder of TOMS Shoes, tells the story of a young woman who accosted him in an airport, pointing at her pair of TOMS while yelling, "This is the most amazing company in the world!" Founded in 2006, TOMS Shoes immediately attracted a devoted following with its innovative use of the so-called One for One business model, in which each purchase of a pair of shoes by a consumer triggers the gift of a free pair of shoes to an impoverished child in a developing country.

The enthusiasm associated with social entrepreneurship is perhaps emblematic of increased global social awareness, which is evidenced by increased charitable giving worldwide. A 2012 study showed that 83 percent of Americans wish brands would support causes; 41 percent have bought a product because it was associated with a cause (a figure that has doubled since 1993); 94 percent said that, given the same price and quality, they were likely to switch brands to one that represented a cause; and more than 90 percent think companies should consider giving in the communities in which they do business.

Despite the eager reception from consumers, critics of social entrepreneurship have raised concerns about the creation of social value in a for-profit context. Thus, TOMS is sometimes mistaken for a charity because it donates shoes to children in developing countries, yet it is also in business to sell shoes. The company earns an estimated $300 million a year and has made Mr. Mycoskie a wealthy man. While companies are starting to look more like charities, nonprofits are also increasingly relying on business principles to survive an uncertain economy in which donors expect to see tangible results from their charitable contributions.

Our understanding of social entrepreneurship is complicated by the absence of any consensus on ways to measure social outcomes. As a result, there is little concrete statistical data available on the impact of social entrepreneurship. Indeed, there is not much agreement on a precise definition of social entrepreneurship, so it becomes difficult to say to what extent any given company is an example of social entrepreneurship. TOMS' Chief Giving Officer, Sebastian Fries, recently told the *New York Times* that the company is "not in the business of poverty alleviation."

Does this mean that increased social value is merely a happy by-product of the business of selling shoes? If so, what makes Blake Mycoskie a social entrepreneur?

Some critics go so far as to suggest that social entrepreneurs are merely using public relations tactics to engage in social or environmental greenwashing—taking advantage of consumers' desire to do good. In some cases, it has been argued, social entrepreneurs can even do more harm than good. Lacking a full understanding of the socioeconomic and cultural dynamic of the developing countries in which they intervene, social enterprises can undermine fragile local markets and foster dependence on foreign assistance. But in the end, the individual impact of social entrepreneurial ventures may outweigh some of these concerns.

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15.15: Controversies Surrounding CSR

Learning Objectives

- Discuss controversies surrounding CSR

From the beginning, CSR has been the subject of much debate. CSR's critics argue that the main responsibility of businesses is to maximize return to their shareholders. They point to the corporate legal system as the proper place for regulating businesses' conduct with society. And besides, businesses are already fulfilling a key public service by providing jobs and services that society needs.

Other critics assert that many so-called CSR activities are really just publicity stunts and corporate "greenwashing." **Greenwashing** refers to corporations that exaggerate or misstate the impact of their environmental actions or promote products as being "eco-friendly" when in fact they're not.

Supporters of CSR contend that there are significant profit-related benefits in socially responsible behavior. Companies are using their CSR activities to recruit and keep the best management talent and to establish partnerships with communities to increase company influence on legislation. And companies that make social responsibility an integrated part of their business actually are managing risk—a key part of corporate development strategy.

Despite the ongoing debate, trends indicate that CSR is gathering force and is here to stay. More and more leading companies in America and worldwide are releasing sustainability reports. Plus, new industries like clean energy provide social and economic benefits while fighting environmental problems like climate change. The result of that combination has been called one of the greatest commercial opportunities in history.

The importance and nature of CSR is the topic of ongoing debate and controversy. Consider the following:

CSR: Sincere Ethics or Hypocritical Public Relations?

- **Facts:** CSR is a rapidly growing field of study in universities and business schools, and most large corporations have adopted CSR programs.
- **The controversial aspect:** Is CSR a good thing or is it just corporate window dressing?
- **In favor of CSR:** CSR motivates corporations to address social problems, it energizes and rewards workers, it strengthens ties to the community, and it improves the image of the corporation.
- **Against CSR:** Surveys show that citizens are more concerned about corporations treating their workers well and obeying laws than about engaging in philanthropic activities, and CSR may allow corporations to distract consumers and legislators from the need to tightly regulate corporations.

Climate Change and CSR

- **Facts:** There is a scientific consensus that global warming and climate change represent an enormous threat facing mankind.
- **The controversial aspect:** Can corporate CSR really have a significant impact on climate change, or is it just a public relations vehicle for companies and a distraction from the need for stronger government action, such as through a carbon tax?
- **In favor of global warming–related CSR:** Corporations can have a major impact in the battle against global warming by reducing their large carbon footprints, by encouraging other corporations to follow suit, and by helping discover and develop alternative sources of energy.
- **Against global warming–related CSR:** Companies spend a lot of advertising money to boast about small measures against global warming, but many of these companies are in industries—such as fossil fuels or automobiles—that produce the most greenhouse gases to begin with; self-serving claims of climate-change concern are often simply greenwashing campaigns intended to distract us from the need for society to take more effective measures through taxation and regulation.

Corporate Lobbying and Governmental Influence

- **Facts:** Most large corporations spend money on lobbying and on seeking to influence legislators and regulators. In the *Citizens United* decision, the Supreme Court ruled that, as "corporate persons," corporations enjoy the same freedom of speech protections as ordinary citizens and are entitled to relief from strict government control of their rights to political speech.
- **The controversial aspect:** Many citizens are outraged to find that the justice system accords multinational corporations the same rights as ordinary people on the grounds that corporations are "persons." However, others point out that The *New York*

Times and CNN are also corporations, and that it could have a chilling effect on freedom of speech if all corporations were legally-constrained from speaking out freely.
- **In favor of corporate lobbying:** As major employers and technological innovators, corporations benefit society. They should be free to oppose inefficient and cumbersome government regulations and taxation that can limit the benefits they provide. In this way, freedom of political speech is so important that we should be cautious about limiting it in any way.
- **Against corporate lobbying:** Corporations are not “persons” in the same sense that humans are, and therefore, they should not enjoy the same freedom of speech protection. Since corporations can become vastly wealthier than ordinary citizens, allowing them to participate in politics will enable them to bend laws and regulations to their will.

In each of the debates outlined above, there are intelligent and well-informed people on both sides of the issue. How CSR is defined and practiced differs for each enterprise. But for all those companies, the view seems to be that CSR programs are a good investment.

? Practice Question

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15.16: Putting It Together- Business Ethics and Corporate Social Responsibility

Synthesis

Throughout this module you learned about the legal and ethical challenges businesses face in today's complex environment. Decisions about doing the "right thing" are not necessarily represented by a single big decision; rather, they are often a series of many apparently small decisions that can culminate in an organization finding itself on the wrong side of its stakeholders, society, and the law. Even corporate executives who have been imprisoned for unethical conduct later admit that they *knew* that what they were doing was wrong, but somewhere along the line they lost sight of their own standards or honesty and integrity. Unfortunately, such behavior can have devastating consequences for the public, the environment, and the company—and it can cast a cloud on businesses that make good ethical, legal, and socially responsible choices every day. As the public demands a higher level of corporate social responsibility, companies are adjusting their strategies to respond to the external environment and conduct business in a way that promotes trust and loyalty from their customers. In addition, the government has stepped in and enacted legislation intended to set forth stronger guidelines, processes, and even punishments for unethical business practices. When you leave school and begin to look for your first job, a new job, or even take a closer look at your current employer, one of the questions you should now be prepared to ask is whether or not the ethics of the organization are aligned with your own sense of right and wrong.

Summary

Ethical and Legal Behavior

Standards of ethical and legal behavior are intertwined but are separate "codes" arising from different sources. Legality comes from legislation or case law that establishes standards of behaviors—illegal behavior may be punished by fines, imprisonment, or both. As a branch of philosophy, ethics investigates the questions "What is the best way for people to live?" and "What actions are right or wrong in particular circumstances?" In practice, ethics seeks to resolve questions of human morality, by defining concepts such as good and evil, right and wrong, virtue and vice, justice and crime.

Business Ethics

Businesses and organizations possess a set of ethical standards just like people. When we refer to "business ethics" we are referring to the culture, attitudes, or actions governing "right vs. wrong." Most organizations have a formal code of ethics that guide the decisions and actions of the company.

Ethical Challenges

Businesses and their employees, managers, and owners face a variety of ethical issues as they go about their working lives. Ethical issues include conflicts of interest, bribes, conflicts of loyalty, and issues of honesty and integrity.

Corporate Social Responsibility

Corporate social responsibility (CSR) refers to actions that businesses take or refrain from taking based on the impact of those actions on the external environment and community. Areas of CSR include environmental concerns (green business), poverty, human rights, and animal rights. Today, businesses are realizing the importance of CSR (Corporate Social Responsibility) in attracting and maintaining employees and customers. Stakeholders are demanding that businesses give back to the larger community in which they operate. Examples of stakeholder and social responsibility can be seen at companies such as Toms Shoes and Starbucks.

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15.17: Discussion- It’s Not Stealing if You Pay For It, Is It?

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document “Salty Pawz Background.”

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

On a Saturday, Wanda goes to the local farmers’ market to take a break from baking treats. While she is there, she sees a vendor with customers crowded around the stall. When she asks someone what all the excitement is about, a customer informs her that a woman who sells gourmet dog treats has just arrived, and if Wanda doesn’t get in line early, the woman will sell out. The customer goes on to tell Wanda that this vendor always sells out, and that since she has started buying these treats for her dogs, her dogs seem much healthier and happier. Wanda waits in line with the other customers.

When it’s Wanda’s turn, she engages the woman in conversation about the ingredients in her treats and her process for making them. The woman is very nice and actually shares a recipe with Wanda for a pumpkin peanut-butter dog biscuit that has always been one of her best-selling items. Wanda purchases one of each treat from the woman and takes the recipe when it is offered to her, never mentioning that she is in the same business. She plans to “reverse-engineer” the treats and test the new recipe out that very day.

For Discussion

- Were Wanda’s actions unethical? Why or why not?
- Write an argument that explains your views and discusses the ethical questions posed by Wanda’s actions.

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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15.18: Discussion- Are They Simply Guidelines?

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

As public pressure for corporate accountability and ethical behavior increases, businesses and industries are putting more emphasis on establishing and publicly sharing their codes of ethics with stakeholders. Businesses adopt these to help guide corporate decision-making, but they can be used against them when businesses stray from their stated codes. For instance, Enron's 64-page code of ethics was Exhibit #1 at the trial of its CEO, Ken Lay, after the company imploded. Stuart Gilman, president of the Ethics Resource Center in Washington, D.C., said that, for Enron, "ethics was simply a piece of paper with three Ps—print, post [in the company lunchroom], and then pray that something is actually going to happen."

In order to complete this discussion assignment, you will need to:

1. Select a company that you are familiar with as a customer, employee, or investor.
2. Locate a copy of the company's code of ethics. You can generally find this on their Web site in the "About Us" section of the site. Make sure to get the link/URL for the code of ethics when you are there, because you need to include that link in your initial post.
3. Do some general research about the company you selected regarding possible activities by the company or its leadership that either violates or supports this code of ethics. You will use this information to support the position you take in your initial post.

For Discussion

1. Share the company you selected, the link/URL to the company's code of ethics, and your reason for selecting the company.
2. Based on your reading of the company's code of ethics, and your research into the activities of the company, what grade would you give them for adhering to their code of ethics? Use the same grading scale you are evaluated by: A, B, C, D, F. Provide your reasoning for assigning them the grade you did.
3. Now, consider the industry in which the company operates (e.g., Disney in the entertainment industry). Are there forces at work in that *industry* that makes it easier or harder to be ethical?
4. Are there external factors (public opinion, social norms, attitudes, values) that influence public perception of the company's ethical behavior? For example, even though cigarette manufacturer Philip Morris may conduct its business according to its own code of ethics, some people believe it is unethical for them to make and sell a product that is known to cause cancer.
5. Does a company's adherence or nonadherence to a code of ethics influence your decision to do business with them?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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15.19: Why It Matters- Business Ethics and Corporate Social Responsibility

Why explain the importance of business ethics and corporate social responsibility?

The car company Volkswagen (which is part of the larger Volkswagen Group) indicates that its goal is "to offer attractive, safe, and environmentally sound vehicles that can compete in an increasingly tough market and set world standards in their respective class."[1]

In September 2015, the Environmental Protection Agency announced that Volkswagen had installed special software in its cars to manipulate emissions levels (making it appear that the cars are less polluting than they are). A week later, Volkswagen disclosed that 11 million diesel vehicles contained the devices, and CEO Martin Winterkorn resigned. The price of Volkswagen stock plunged—losing 30 percent of its value overnight—and the company scrambled to understand what had happened and control the damage to its reputation.

In the months following the discovery of the deceptive devices, investigators identified a team of Volkswagen employees who had hatched the plan and implemented it over a number of years. An internal evaluation identified a "culture of tolerance" for rule breaking at the company. It also came to light that Volkswagen's emphasis on "results at any cost" had contributed to the breach in ethical standards. Industry experts believe that the company's violation of consumers' trust will be exceedingly difficult to repair and that it may take years to rebuild the Volkswagen brand.

In this module you'll learn why business ethics and corporate social responsibility are not just means of "doing the right thing" but in many cases are good business, too.

1. Jurevicius, Ovidijus. "Volkswagen Mission Statement 2013." Strategic Management Insight. September 14, 2013. Accessed February 19, 2019. http://www.strategicmanagementinsight.com/mission-statements/volkswagen-mission-statement.html. ↵

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15.20: Assignment- What They Don't Know Won't Hurt Me

Scenario

Wanda knows that she is going to incur increased costs if she expands her business. She is concerned about the impact these costs will have on her profit margin and the long-term sustainability of the business. Currently, Wanda buys free-range chickens and bison and lamb that are fed only non-GMO feed, but this costs her almost 50 percent more than some other sources. Wanda is confident that she could still provide a high-quality product while reducing the cost of her ingredients.

The problem is that the Salty Pawz Web site and all of the product labels contain information about how her products use free-range chickens and animals not fed with GMOs. Wanda is concerned about whether she can ethically switch ingredients without informing her customers and changing her labels. The dogs will still be getting treats that are healthier than mass-produced ones, and the chances of anyone finding out about the switch are slim. Should Wanda be worried about deciding to use cheaper ingredients to make her dog treats?

Your Task

Explain the ethical considerations involved in moving from free-range, sustainable, non-GMO ingredients to cheaper ingredients that still make a good product without informing Wanda's customers. What is your advice to her concerning this decision, both for and against swapping out the higher-cost ingredients for something cheaper? Since the treats are being fed to animals, does Wanda have the same ethical responsibilities to her customers that she would have if she were making treats for human consumption?

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain the ethical considerations involved in replacing ingredients.	0 points	22 points	32 points	40 points	40%
Describe the positive ethical implications of replacing the ingredients.	0 points	8.25 points	12 points	15 points	15%
Describe the negative ethical implications of replacing the ingredients.	0 points	8.25 points	12 points	15 points	15%
Provide your recommendation to Wanda concerning the decision to replace ingredients.	0 points	11 points	16 points	20 points	20%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	5.5 points	8 points	10 points	10%

Total points possible: 100.

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15.21: Assignment- Corporate Social Responsibility

Preparation

Corporate social responsibility (CSR, also called corporate conscience, corporate citizenship, or responsible business) is a form of corporate self-regulation integrated into a business model. CSR policy functions as a self-regulatory mechanism whereby a business monitors and ensures its active compliance with the spirit of the law, ethical standards, and national or international norms. With some models, a firm's implementation of CSR goes beyond compliance and engages in "actions that appear to further some social good, beyond the interests of the firm and that which is required by law." The aim is to increase long-term profits and shareholder trust through positive public relations and high ethical standards to reduce business and legal risk by taking responsibility for corporate actions. CSR strategies encourage the company to make a positive impact on the environment and stakeholders including consumers, employees, investors, communities, and others.

Every year, Reputation Institute, a private global consulting firm based in New York, invites about 47,000 consumers, across fifteen markets, to participate in a study that ranks the world's one hundred most reputable companies—all multinational businesses with a global presence. One of their recent studies found that 42 percent of how people feel about a company is based on their perceptions of the firm's corporate social responsibility (CSR).

Your Task

1. Select a company (domestic or international) that will be the basis for your research.
2. Research the company's record in the area of CSR. Be sure to look at both their domestic and well as international reputation.
3. A good place to begin your research is the LibGuide at Rutgers University.
4. Complete a written assignment that contains the following information:
    1. A brief (one-paragraph) summary of the business you selected.
    2. According to your research, how does the company rank with regard to CSR? Be sure to provide a source for this ranking!
    3. Describe specific examples of corporate actions that resulted in this company's ranking.
    4. Does a company's approach to CSR influence your purchasing decisions? Why or why not?

DO NOT write your paper as a series of answers to these numbered questions. This assignment should follow the written assignment guidelines for the course. Be sure to include APA-formatted citations of the Web sites or other sources you used for your research.

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15.22: Assignment- Business Ethics and Corporate Social Responsibility

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 the learning outcomes of Introduction to Business 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 Objectives

- Give examples of corporate social responsibility

In the module on Business Ethics and Corporate Social Responsibility (CSR), there is a case study on TOMS shoes. For this assignment, you are going to work with a small group to hunt down useful links and resources for your fellow students about other businesses who may fit into the same CSR. This work will become a living document that future students will use.

Think of your audience as friends who have never heard of the company of your choice.

- In your own words, summarize the business' mission statement. You can take a look at TOMS website as an example of what to look for in your research.
- Does your business of choice reflect the values of a social entrepreneur? If so, why? If not, why? Cite specifics from the business' website.

A Note To Teachers: Use the case study in the course as a way to scaffold your students' discussions and research. You may want to break your students into groups and let them work on their own document that you will eventually create into one document. Over time, it may be useful to have students check to see if businesses have changed their practices for better or for worse. We chose the TOMS example because they've changed their charitable focus as they've become more successful.

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CHAPTER OVERVIEW

16: Module 6 Readings - Management

16.1: Reading- Managerial Skills

Managerial Skills

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

Technical Skills

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

Interpersonal Skills

As you move up the corporate ladder, you'll find that you can't do everything yourself: you'll have to rely on other people to help you achieve the goals for which you're responsible. That's why interpersonal skills—the ability to get along with and motivate other people—are critical for managers in midlevel positions. These managers play a pivotal role because they report to top-level managers while overseeing the activities of first-line managers. Thus, they need strong working relationships with individuals at all levels and in all areas. More than most other managers, they must use "people skills" to foster teamwork, build trust, manage conflict, and encourage improvement.[1]

Conceptual Skills

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

Communication Skills

Effective communication skills are crucial to just about everyone. At all levels of an organization, you'll often be judged on your ability to communicate, both orally and in writing. Whether you're talking informally or making a formal presentation, you must express yourself clearly and concisely. Talking too loudly, rambling, and using poor grammar reduce your ability to influence others, as does poor written communication. Confusing and error-riddled documents (including e-mails) don't do your message any good, and they will reflect poorly on you.[2]

Time-Management Skills

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

- Prioritize tasks, focusing on the most important things first.
- Set aside a certain time each day to return phone calls and answer e-mail.
- Delegate routine tasks.
- Don't procrastinate.
- Insist that meetings start and end on time, and stick to an agenda.
- Eliminate unnecessary paperwork.[3]

Decision-Making Skills

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

A Six-Step Approach to Problem Solving

Assuming your top priority is salvaging your GPA, let's tackle your problem by using a six-step approach to solving problems that don't have simple solutions. We've summarized this model in Figure 1 below.[4]

Figure 16.1.1: How to Solve a Problem

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

6. *Implement your decision and monitor your choice*. When you call your girlfriend, you're pleasantly surprised to find that she understands. The vice president is happy to take over the mountain-biking club. After the first week, you're able to attend lacrosse practice, get caught up on your team business project, and catch up in all your other classes. The real test of your solution will be the results of the semester's finals.

Key Takeaways

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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16.2: Reading- What Do Managers Do?

Functions of Management

We have discussed the skills that are important for a manager. These skills need to come together support the process of management, or the process of planning, organizing, directing, and controlling resources to achieve specific goals. A *plan* enables you to take your business concept beyond the idea stage. It does not, however, get the work *done*. You have to *organize* things if you want your plan to become a reality. You have to put people and other resources in place to make things happen. And because your note-taking venture is supposed to be better off with you in charge, you need to be a *leader* who can motivate your people to do well. Finally, to know whether things are in fact going well, you'll have to *control* your operations—that is, measure the results and compare them with the results that you laid out in your plan. Figure 1 gives you a good idea of the interrelationship between planning and the other functions that managers perform.

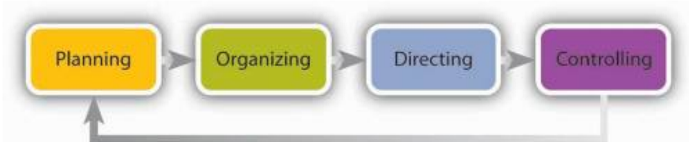

Figure 16.2.1: The Role of Planning

If you visit any small or large company, not-for-profit organization, or government agency, you will find managers doing the same things you would be doing to run your note-taking business—*planning*, *organizing*, *directing*, and *controlling*.

In the rest of this module, we will look at these four interrelated functions in detail.

KEY TAKEAWAYS

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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16.3: Reading- Planning

Developing a Strategic Plan

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

Coming up with an idea—starting a note-taking business —is a good start, but it's only a start. Planning for it is a step forward. Planning begins at the highest level and works its way down through the organization. Step one is usually called strategic planning, which is the process of establishing an overall course of action. To begin this process, you should ask yourself a couple of very basic questions: Why, for example, does the organization exist? What value does it create? After you've identified the purpose of your company, you're ready to take the remaining steps in the strategic-planning process:

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

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

Mission Statement

The *mission statement* describes the purpose of your organization—the reason for its existence. It tells the customer what the organization is committed to doing. A strong mission statement should also inspire employees and resonate with their inner motivations for working and being part of the organization.

Mission statements can be very concise, like the one from Mary Kay Inc. (the cosmetics company):

To enrich the lives of women around the world.[1]

Or it can be as detailed as the one from Harley-Davidson:

We fulfill dreams inspired by the many roads of the world by providing extraordinary motorcycles and customer experiences. We fuel the passion for freedom in our customers to express their own individuality."[2]

Core Values

Having defined your mission, your next step is to ask, what does this organization stand for? What values will define it? What principles should guide our actions as we build and operate the business? The set of guiding principles that you identify as crucial to your company are known as *core values*—fundamental beliefs about what's important and what is and isn't appropriate in conducting company activities. Core values affect the overall planning processes and operations. At Volvo, for example, three core values—safety, quality, and environmental care—define the firm's "approach to product development, design and production."[3] Core values should also guide the behavior of every individual in the organization. Coca-Cola, for instance, reports that its stated core values—leadership, collaboration, integrity, accountability, passion, diversity and quality—tell employees exactly what behaviors are acceptable.[4] How do companies communicate core values to employees and hold them accountable for putting those values into practice? They link core values to performance evaluations and compensation.

Conduct a SWOT Analysis

The next step in the strategic-planning process is to assess your company's fit with its environment. A common approach to *environmental analysis* is matching the strengths of your business with the opportunities available to it. It's called SWOT analysis because it calls for analyzing an organization's Strengths, Weaknesses, Opportunities, and Threats. It begins with an examination of *external* factors that could influence the company in either a positive or a negative way. These could include economic conditions, competition, emerging technologies, laws and regulations, and customers' expectations.

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

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

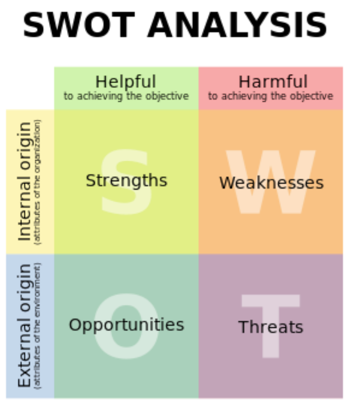

Figure 16.3.1: SWOT Analysis. Image by Xhienne from Wikimedia Commons.

Set Goals and Objectives

Your mission statement affirms what your organization is *generally* committed to doing, but it doesn't tell you *how* to do it. So the next step in the strategic-planning process is establishing goals and objectives. Goals are major accomplishments that the company wants to achieve over a long period (say, five years). Objectives are shorter-term performance targets that direct the activities of the organization toward the attainment of a goal. They should be clearly stated, attainable, and measurable: they should give target dates for the completion of tasks and stipulate who's responsible for taking necessary actions.[5]

An organization will have a number of goals and related objectives. Some will focus on financial measures, such as profit maximization and sales growth. Others will target operational efficiency or quality control. Still others will govern the company's relationships with its employees, its community, its environment, or all three.

Finally, goals and objectives change over time. As a firm reassesses its place in its business environment, it rethinks not only its mission but also its approach to fulfilling it. The reality of change was a major theme when the late McDonald's CEO Jim Cantalupo explained his goal to revitalize the company:

The world has changed. Our customers have changed. We have to change too. Growth comes from being better, not just expanding to have more restaurants. The new McDonald's is focused on building sales at existing restaurants rather than on adding new restaurants. We are introducing a new level of discipline and efficiency to all aspects of the business and are setting a new bar for performance.[6]

This change in focus was accompanied by specific performance objectives—annual sales growth of 3 to 5 percent and income growth of 6 to 7 percent at existing restaurants, plus a five-point improvement (based on customer surveys) in speed of service, friendliness, and food quality.

Develop Tactical and Operational Plans

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

Tactical Plans

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

Operational Plans

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

Plan for Contingencies and Crises

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

Contingency Planning

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

Crisis Management

Organizations also face the risk of encountering crises that require immediate attention. Rather than waiting until such a crisis occurs and then scrambling to figure out what to do, many firms practice crisis management. Some, for instance, set up teams trained to deal with emergencies. Members gather information quickly and respond to the crisis while everyone else carries out his or her normal duties. The team also keeps the public, the employees, the press, and government officials informed about the situation and the company's response to it.[7]

An example of how to handle crisis management involves Wendy's. After learning that a woman claimed she found a fingertip in a bowl of chili she bought at a Wendy's restaurant in San Jose, California, the company's public relations team responded quickly. Within a few days, the company announced that the finger didn't come from an employee or a supplier. Soon after, the police arrested the woman and charged her with attempted grand larceny for lying about how the finger got in her bowl of chili and trying to extort $2.5 million from the company. But the crisis wasn't over for Wendy's. The incident was plastered all over the news as a grossed-out public sought an answer to the question "Whose finger is (or was) it?" A $100,000 reward was offered by Wendy's to anyone with information that would help the police answer this question. The challenge Wendy's faced was how to entice customers to return to its fifty San Francisco–area restaurants (where sales had plummeted) while keeping a low profile nationally. It accomplished this by giving out free milkshakes and discount coupons to customers in the affected regions and, to avoid calling attention to the missing finger, by making no changes in its national advertising. The crisis-management strategy worked and the story died down (though it flared up temporarily when the police arrested the woman's husband, who allegedly bought the finger from a coworker who had severed it in an accident months earlier).[8]

BP Oil Spill

The response to the BP oil spill by its former CEO, Tony Hayward, is an example of poor crisis management.

Even with crisis-management plans in place, however, it is unlikely that most companies will emerge from a damaging or potentially damaging episode as unscathed as Wendy's did. For one thing, the culprits in the Wendy's case were caught, and the public is willing to forgive an organization it views as a victim. Given the current public distrust of corporate behavior, however, companies whose reputations have suffered due to questionable corporate judgment don't fare as well. These companies include the international oil company, BP, whose CEO, Tony Hayward, did a disastrous job handling the crisis created when a BP controlled oil rig exploded in the Gulf Coast killing eleven workers and creating the largest oil spill in U.S. history. Hayward's lack of sensitivity will be remembered forever; particularly his response to a reporter's question on what he would tell those whose livelihoods were ruined: "We're sorry for the massive disruption it's caused their lives. There's no one who wants this over more than I do. I would like my life back." His comment was obviously upsetting to the families of the eleven men who lost their lives on the rig and had no way to get their lives back.[9]

Given the high risk associated with a crisis, it should come as no surprise that contemporary managers spend more time anticipating crises and practicing their crisis-management responses.

Key Takeaways

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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16.4: Reading- Organizing

How Managers Are Organized

A manager engaged in organizing allocates *resources* (people, equipment, and money) to achieve a company's plans. Successful managers make sure that all the activities identified in the planning process are assigned to some person, department, or team and that everyone has the resources needed to perform assigned activities.

Figure 16.4.1: Levels of Management

A typical organization has several layers of management. Think of these layers as forming a pyramid like the one in Figure 1, with top managers occupying the narrow space at the peak, first-line managers the broad base, and middle managers the levels in between. As you move up the pyramid, management positions get more demanding, but they carry more authority and responsibility (along with more power, prestige, and pay). Top managers spend most of their time in planning and decision making, while first-line managers focus on day-to-day operations. For obvious reasons, there are far more people with positions at the base of the pyramid than there are with jobs at the other two levels (as you get to the top, there are only a few positions). Let's look at each management level in more detail.

Top Managers

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

Middle Managers

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

First-Line Managers

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

How Companies Get the Job Done

The organizing process raises some important questions: What jobs need to be done? Who does what? Who reports to whom? What are the formal relationships among people in the organization? You provide answers to these questions by developing an organizational structure: an arrangement of positions that's most appropriate for your company at a specific point in time. Remember, given the rapidly changing environment in which businesses operate, a structure that works today might be outdated tomorrow. That's why you hear so often about companies restructuring—altering existing organizational structures to become more competitive under conditions that have changed. In building an organizational structure, you engage in two activities: *job specialization* (dividing tasks into jobs) and *departmentalization* (grouping jobs into units). We'll now see how these two processes are accomplished.

Specialization

The first step in designing an organizational structure is twofold:

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

This twofold process of organizing activities into clusters of related tasks that can be handled by certain individuals or groups is called specialization. Its purpose is to improve efficiency. Obviously, specialization has advantages. In addition to increasing efficiency, for example, it results in jobs that are easier to learn. But it has disadvantages, too. Doing the same thing over and over bores people and will eventually leave employees dissatisfied with their jobs. Before long, you'll notice decreased performance and increased absenteeism and turnover.

Departmentalization

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

Functional Organization

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

If a company adopted a functional approach to departmentalization, jobs might be grouped into four clusters:

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

There are a number of advantages to the functional approach. The structure is simple to understand and enables the staff to specialize in particular areas; everyone in the marketing group would probably have similar interests and expertise. But homogeneity also has drawbacks: it can hinder communication and decision making between units and even promote interdepartmental conflict. The marketing department, for example, might butt heads with the accounting department because marketers want to spend as much as possible on advertising, while accountants want to control costs. Marketers might feel that accountants are too tight with funds, and accountants might regard marketers as spendthrifts.

Divisional Organization

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

Product Division

Product division means that a company is structured according to its product lines. General Motors, for example, has four product-based divisions: Buick, Cadillac, Chevrolet, and GMC.[1] Each division has its own research and development group, its own manufacturing operations, and its own marketing team. This allows individuals in the division to focus all their efforts on the products produced by their division. A downside is that it results in higher costs as corporate support services (such as accounting and human resources) are duplicated in each of the four divisions.

Customer Division

Some companies prefer a customer division structure because it enables them to better serve their various categories of customers. Thus, Johnson & Johnson's two hundred or so operating companies are grouped into three customer-based business segments: consumer business (personal-care and hygiene products sold to the general public), pharmaceuticals (prescription drugs sold to pharmacists), and professional business (medical devices and diagnostics products used by physicians, optometrists, hospitals, laboratories, and clinics).[2]

Process Division

If goods move through several steps during production, a company might opt for a process division structure. This form works well at Bowater Thunder Bay, a Canadian company that harvests trees and processes wood into newsprint and pulp. The first step in the production process is harvesting and stripping trees. Then, large logs are sold to lumber mills and smaller logs chopped up and sent to Bowater's mills. At the mill, wood chips are chemically converted into pulp. About 90 percent is sold to other manufacturers (as raw material for home and office products), and the remaining 10 percent is further processed into newspaper print. Bowater, then, has three divisions: tree cutting, chemical processing, and finishing (which makes newsprint).[3]

Geographical Division

Geographical division enables companies that operate in several locations to be responsive to customers at a local level. McDonald's, for example, is organized according to the regions of the world in which it operates. In the United States, the national unit is further subdivided into three geographic operating divisions: east, west and central.[4]

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

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16.5: Reading- The Organization Chart and Reporting Structure

The Organization Chart

Once an organization has set its structure, it can represent that structure in an organization chart: a diagram delineating the interrelationships of positions within the organization. Having decided on a functional structure, a company might create the organization chart shown in Figure 16.5.1.

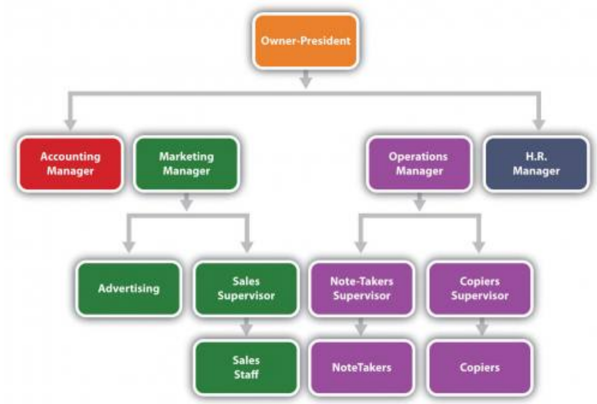

Figure 16.5.1: Organization Chart

Using the figure above for reference you can complete a hypothetical organization chart. Begin by putting yourself at the top of the chart, as the company's president. Then fill in the level directly below your name with the names and positions of the people who work directly *for you*—your accounting, marketing, operations, and human resources managers. The next level identifies the people who work for these managers. In this example, because you've started out small, neither your accounting manager nor your human resources manager currently manage anyone directly. Your marketing manager, however, oversees one person in advertising and a sales supervisor (who, in turn, oversees the sales staff). Your operations manager oversees two individuals—one to supervise notetakers and one to supervise people responsible for making copies.

Reporting Relationships

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

Theoretically, you will communicate only with your four direct reports, but this isn't the way things normally work. Behind every formal communication network there lies a network of informal communications—unofficial relationships among members of an organization. You might find that over time, you receive communications directly from members of the sales staff; in fact, you might encourage this line of communication.

Now let's look at the chart of an organization that relies on a divisional structure based on goods or services produced—say, a theme park. The top layers of this company's organization chart might look like the one in Figure 2a. We see that the president has two direct reports—a vice president in charge of rides and a vice president in charge of concessions. What about a bank that's structured according to its customer base? The bank's organization chart would begin like the one in Figure 16.5.2b. Once again, the company's top manager has two direct reports, in this case a VP of retail-customer accounts and a VP of commercial-customer accounts.

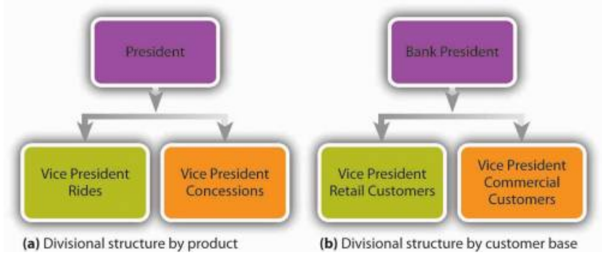

Figure 16.5.: Organization Charts for Divisional Structures

Over time, companies revise their organizational structures to accommodate growth and changes in the external environment. It's not uncommon, for example, for a firm to adopt a functional structure in its early years. Then, as it becomes bigger and more complex, it might move to a divisional structure—perhaps to accommodate new products or to become more responsive to certain customers or geographical areas. Some companies might ultimately rely on a combination of functional and divisional structures. This could be a good approach for a credit card company that issues cards in both the United States and Europe. A skeleton of this firm's organization chart might look like the one in Figure 16.5.3.

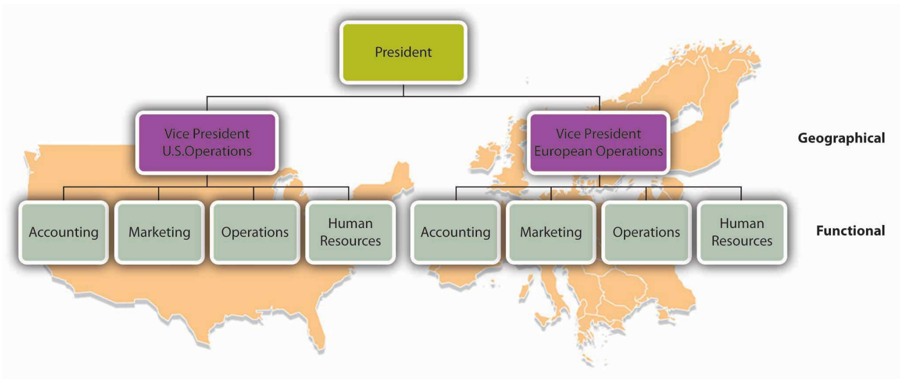

Figure 16.5.3: Organization Chart: Combination Divisional and Functional Structures

Lines of Authority

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

Chain of Command

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

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

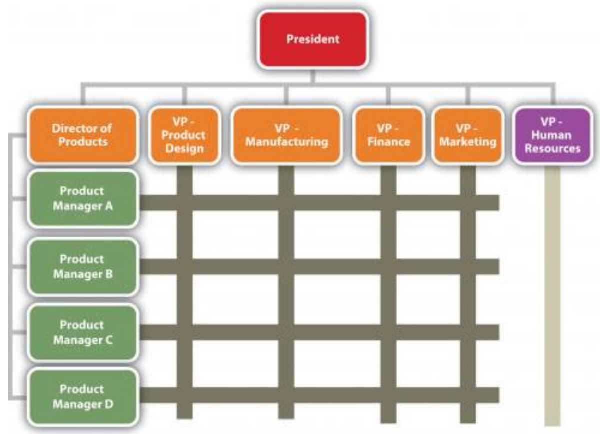

Figure 16.5.4: Organization Chart: Matrix Structure

Nike sometimes uses this type of arrangement. To design new products, the company may create product teams made up of designers, marketers, and other specialists with expertise in particular sports categories—say, running shoes or basketball shoes. Each team member would be evaluated by both the team manager and the head of his or her functional department.

Span of Control

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

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

There are trade-offs between the advantages and disadvantages of flat and tall organizations. Companies determine which trade-offs to make according to a principle called span of control, which measures the number of people reporting to a particular manager. If, for example, you remove layers of management to make your organization flatter, you end up increasing the number of positions reporting to a particular supervisor.

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

Delegating Authority

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

Responsibility and Authority

As owner of a business an individual may want to control every aspect of the business, especially during the start-up stage. But as the organization grows, they will have to assign responsibility for performing certain tasks to other people. They will also have to accept the fact that *responsibility* alone—the duty to perform a task—won't be enough to get the job done. They will need to grant subordinates the *authority* they require to complete a task—that is, the power to make the necessary decisions. (And they'll also need sufficient resources.) Ultimately, the owner will also hold his/her subordinates accountable for their performance.

Centralization and Decentralization

If and when a company expands, the owner will have to decide whether most decisions should still be made by individuals at the top or delegated to lower-level employees. The first option, in which most decision making is concentrated at the top, is called centralization. The second option, which spreads decision making throughout the organization, is called decentralization. Naturally, there are some decisions—such as strategic planning—that won't be delegated to lower-level employees, but others can be delegated, such as the management of copy-center operations. In fact, putting someone in charge of this function would probably improve customer satisfaction, because copy-center customers would be dealing directly with the manager. It would also give the manager valuable decision-making experience, and while he or she is busy making daily decisions about the copy center, upper level management and owners will have more time to work on higher-level tasks.

KEY TAKEAWAYS

- Managers coordinate the activities identified in the planning process among individuals, departments, or other units and allocate the resources needed to perform them.
- Typically, there are three levels of management: **top managers**, who are responsible for overall performance; **middle managers**, who report to top managers and oversee lower-level managers; and **first-line managers**, who supervise employees to make sure that work is performed correctly and on time.
- Management must develop an **organizational structure**, or arrangement of people within the organization, that will best achieve company goals.
- The process begins with **specialization**—dividing necessary tasks into jobs; the principle of grouping jobs into units is called **departmentalization**.
- Units are then grouped into an appropriate organizational structure. **Functional organization** groups people with comparable skills and tasks; **divisional organization** creates a structure composed of self-contained units based on **product**, **customer**, **process**, or **geographical division**. Forms of organizational division are often combined.
- An organization's structure is represented in an **organization chart**—a diagram showing the interrelationships of its positions.
- This chart highlights the **chain of command**, or authority relationships among people working at different levels.
- It also shows the number of layers between the top and lowest managerial levels. An organization with few layers has a wide **span of control**, with each manager overseeing a large number of subordinates; with a narrow span of control, only a limited number of subordinates reports to each manager.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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16.6: Reading- Leadership Styles

Leadership Styles

Leading an organization can be compared to conducting an orchestra. The leader directs the various parts of the orchestra—the string, brass, woodwind, and percussion sections—indicating when and how they should play. It's fairly easy to pick up a baton, cue each section, and strike up the band. But it doesn't follow that the music will be good.

What if your cues are ambiguous, ignored, or misinterpreted? Or what if your musicians don't like your approach to the music and decide to walk away? On top of everything else, you don't simply want to make music: you want to inspire your musicians to make *great* music. How do you accomplish this goal? How do you become an effective leader? What style or approach should you use to motivate others to achieve organizational goals? Unfortunately, there are no definitive answers to questions like these. Over time, every manager refines his or her own leadership style or way of interacting with and influencing others. Despite a vast range of personal differences, leadership styles tend to reflect one of the following approaches to directing and motivating people: the *autocratic*, the *democratic*, or the *laissez-faire*. Let's see how managerial styles reflect each of them in a work situation.

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

At first glance, you'd probably not want to work for an autocratic leader. After all, you certainly don't want to be told what to do without having any input. You probably like the idea of working for a democratic leader; it's flattering to be asked for your input. Though working in a laissez-faire environment might seem a little unsettling at first, the opportunity to make your own decisions is appealing. In general, your assessments of the three leadership styles would be accurate. Employees generally dislike working for autocratic leaders; they like working for democratic leaders, and they find working for laissez-faire leaders rewarding (as long as they feel they can handle the job). But there are situations when these generalities don't hold. To learn what these situations are, let's turn things around and pretend you're the leader.

To make it applicable to your current life, we'll say that you're leading a group of fellow students in a team project for your class. Are there times when it would be best for you to use an autocratic leadership style? What if your team was newly formed, unfamiliar with what needs to be done, under a tight deadline, and looking to you for direction? In this situation, you might find it appropriate to follow an autocratic leadership style (on a temporary basis) and assign tasks to each member of the group. Now let's look at the leadership style you probably prefer—the democratic leadership style. Can you think of a situation where this style would *not* work for your team? What if the members of your team are unmotivated, don't seem interested in providing input, and aren't getting along? It might make sense to move away from a democratic style of leadership (temporarily) and delegate specific tasks to each member of the group that they can do on their own. How about laissez-faire leadership? Will this always work with your group? Not always. It will work if your team members are willing and able to work independently and welcome the chance to make decisions. Otherwise, it could cause the team to miss deadlines or do poorly on the project. The point being made here is that no one leadership style is effective all the time for all people. While the democratic style is viewed as the most appropriate (as is the laissez-faire style, to a lesser extent), there are times when following an autocratic style is better. Good leaders learn how to adjust their styles to fit both the situation and the individuals being directed.

Transformational Leadership

Theories on what constitutes effective leadership evolve over time. One theory that has received a lot of attention in the last decade contrasts two leadership styles: *transactional* and *transformational*. So-called transactional leaders exercise authority based on their rank in the organization. They let subordinates know what's expected of them and what they will receive if they meet stated objectives. They focus their attention on identifying mistakes and disciplining employees for poor performance. By contrast, transformational leaders mentor and develop subordinates, providing them with challenging opportunities, working one-on-one to help them meet their professional and personal needs, and encouraging people to approach problems from new perspectives. They stimulate employees to look beyond personal interests to those of the group. So, which leadership style is more effective? You probably won't be surprised by the opinion of most experts. In today's organizations, in which team building and information sharing are important and projects are often collaborative in nature, transformational leadership has proven to be more effective. Modern organizations look for managers who can develop positive relationships with subordinates and motivate employees to focus on the interests of the organization.[1]

KEY TAKEAWAYS

- A manager's **leadership style** varies depending on the manager, the situation, and the people being directed. There are three common styles.
- Using an **autocratic style**, a manager tends to make decisions without soliciting input and expects subordinates to follow instructions without undue explanation.
- Managers who prefer a **democratic style** seek input on decisions.
- Exercising a **laissez-faire style**, the manager provides no more guidance than necessary and lets subordinates make decisions and solve problems.
- One current leadership theory focuses on two contrasting leadership styles: transactional and transformational.
- Managers adopting a **transactional style** exercise authority according to their rank in the organization, let subordinates know what's expected of them, and step in when mistakes are made.
- Practicing a **transformational style**, managers mentor and develop subordinates and motivate them to achieve organizational rather than merely personal goals. Transformational leadership is effective in organizations that value team building and information sharing.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. See Karen Collins, *Accountants' Management Styles and Effectiveness,* American Woman's Society of Certified Public Accountants, 1997.↵

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16.7: Reading- Controlling- A Five-Step Process

Controlling

Controlling involves ensuring that performance does not deviate from standards. Controlling consists of five steps: (1) set standards, (2) measure performance, (3) compare performance to standards, (4) determine the reasons for deviations and then (5) take corrective action as needed (see Figure 1, below). Corrective action can include changes made to the performance standards—setting them higher or lower or identifying new or additional standards. 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.

Figure 16.7.1: Five-Step Control Process

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.

Controls also come at a cost. It is useful to know that there are trade-offs between having and not having organizational controls. Let's look at some of the costs and benefits of organizational controls.

Costs

Financial costs—direct (i.e., paying for an accountant for an audit) and indirect (i.e., people employed by the organization whose primary function is related to control—internal quality control, for instance).

Culture and reputation costs—the intangible costs associated with any form of control. Examples include damaged relationships with employees or tarnished reputation with investors or government.

Responsiveness costs—downtime between a decision and the actions required to implement it due to compliance with controls.

Poorly implemented controls—implementation is botched or the implementation of a new control conflicts with other controls.

Benefits

Cost and productivity control—ensures that the firm functions effectively and efficiently.

Quality control—contributes to cost control (i.e., fewer defects, less waste), customer satisfaction (i.e., fewer returns), and greater sales (i.e., repeat customers and new customers).

*Opportunity recognitio*n—helps managers identify and isolate the source of positive surprises, such as a new growth market. Though opportunities can also be found in internal comparisons of cost control and productivity across units.

Manage uncertainty and complexity—keeps the organization focused on its strategy, and helps managers anticipate and detect negative surprises and respond opportunistically to positive surprises.

*Decentralized decision makin*g—allows the organization to be more responsive by moving decision making to those closest to customers and areas of uncertainty.

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 TAKEAWAYS

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

17: Module 7- Business Ownership

17.1: Why It Matters- Business Ownership

Why distinguish among the forms of business ownership?

The way a business is formed as a legal entity has implications far beyond the business. Did you know that if your business fails and you can't repay your business creditors, you could lose your home, car, and most of your personal belongings? Or, if you select the wrong legal form of ownership, you could find yourself in a position of owing a large sum of money to the Internal Revenue Service? Did you realize that if your business has not been formed in a way that protects you if someone slips and falls in your store that you could be personally liable for their pain and suffering?

These are a few reasons why it's important to understand the different legal forms of business. Take a look at the following video and see what happened to a family who ran their own business as a sole proprietorship and experienced the impact of the recent recession. In the rest of this module you'll learn about the factors one should consider when choosing a form of business ownership.

You can view the transcript for "An American Family Faces Poverty" (opens in a new window) or the text alternative for "An American Family Faces Poverty" (opens in new window).

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17.2: Introduction to Choosing an Organizational Type

What you'll learn to do: list and explain the important factors in choosing an organizational type

The organizational type you choose for your business, sometimes called a "legal structure," can impact your taxes and income. In this section you'll learn about the key factors that business owners should consider when choosing an organizational type.

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17.3: Selecting a Form of Business Ownership

Learning Objectives

- List the important factors in choosing an organizational type
- Explain the important factors in choosing an organizational type

One of the first and most important decisions a business owner makes is selecting the organizational form under which he or she will operate. The following are some common organizational types (also called "legal structures"):

- Sole proprietorship
- General partnership
- Franchise
- Limited partnerships and limited liability partnerships (LLP)
- Limited liability company (LLC)
- C corporation
- S corporation

Each form of ownership has advantages, disadvantages, risks, and rewards that can affect the business's chances for long-term success. The following are some of the important factors business owners should consider when selecting a form of ownership.

Cost of Start-up

Setting up a business can involve little more than printing some business cards, or it may entail hiring a corporate attorney to draft corporate charters, agreements, and articles of incorporation. As the forms of business ownership become more complex, the cost associated with establishing the business also increases. Every business owner must decide how long he/she wants to wait before getting the business up and running and also how much of his/her own money to invest.

Control vs. Responsibility

One of the primary reasons people give for wanting to start their own business is the desire to be independent and "be your own boss." Different legal structures provide the owner with more or less control and authority. There are trade-offs in each case, though, because with autonomy and control come responsibility. For instance, if you're the sole proprietor of a business with no employees, as a one-person show, you retain all the control, but you also have all the work and responsibility. Other forms of business (such as partnerships, for example,) may mean relinquishing some control, but, in return, the responsibility (and liability) may be spread among several principals. You'll learn more about these trade-offs later in the module.

Profits—to Share or Not to Share

Many first-time business owners look to people like Bill Gates, Oprah Winfrey, or Ben & Jerry and aspire to their level of wealth and success. How a business's profits are shared (or not shared) is determined by the legal structure. Some owners are willing to share the profits in exchange for assistance and support establishing and running the business. Other business owners make the conscious decision to limit the scope and nature of the business to avoid having to bring in others, thereby retaining all of the income themselves.

Taxation

When planning to start a new business, many people instinctively seek the advice of an attorney as the first step in the process. However, legal advice is not actually what's needed initially. Instead, no matter how large or small your business is going to be, it's much more important to first get the advice of a seasoned tax professional, such as a CPA. The reason for this is that each form of business ownership is treated differently by the IRS and by state and local taxing authorities. Depending on the legal structure of the business, the owner may be taxed at a lower rate than someone working for a large company, or the owner might see his or her business income taxed twice, sometimes with additional speciality taxes imposed by governmental agencies. The time for a business owner to decide how heavy a tax burden he/she is willing to bear is at the start of the business, not on April 15 when taxes are due.

Entrepreneurial Ability

At some point you've probably known someone with a particular knack for something (like fixing cars or baking bread) and said, "You should start your own business!" For example, maybe you are a talented cake decorator, but does that necessarily mean you have the requisite knowledge, skills, and abilities to open and run a successful commercial or retail bakery?

It's often easier said than done. Many businesses fail despite the owner's enthusiasm and/or talent, because the owner lacks the deep knowledge and expertise needed to transform an interest or hobby into a commercial enterprise. Performing an honest and accurate appraisal of one's skills, background, and entrepreneurial abilities *before* launching a business can prevent disappointment and failure later on.

Risk Tolerance

Everyone's tolerance for risk is different. Some people enjoy the rush of skydiving and rollercoasters, while others prefer to stick to the carousel or keep their feet on the ground. In business, one's degree of risk tolerance should be compatible with the form of ownership being considered. For example, a forty-five-year old entrepreneur with dependents might seek to protect her accumulated assets (real estate, savings, retirement, etc.) and therefore select a legal structure that carries less personal financial risk. Every prospective business owner must gauge what he or she is willing to risk losing and choose a form of business accordingly.

Financing

Few business owners start a business with lottery winnings or many years' worth of savings. Many seek funding from a bank, venture capitalist, private investor, or credit union in order to get their businesses off the ground. Lenders may be one of the greatest influences on the choice of business ownership—even more decisive than the owner's preference or ambition. Since there is risk inherent in any business venture, especially start-ups, lenders often require the business to be structured in a way that best assures the repayment of funds (whether the business makes it or not). Even businesses that have been established for a long time may be forced to change their legal structure when seeking funding to expand their operations. If an owner anticipates needing funding at any point during the life of the business, selecting a form of ownership that aligns with lender requirements from the start may be a wise decision.

Continuity and Transferability

Finally, business owners need to consider if they want their business to outlive them (or carry on after they leave). If an owner is looking to start a business that can be passed on to his or her children or other family members, then the legal structure of the business is extremely important. Certain organizational types "die" with the owner, so it's crucial for the owner to decide how and whether a business will persist and/or be sold to new ownership.

These are just some of the considerations business owners must weigh when selecting a form of business ownership. Many of these issues require owners to look far into the future of their business and imagine all of the "what if's" associated with being self-employed. Although it is possible to change legal structure once the business is established, the more complex the business operations are the more complex the change will be. In some cases, the complexity of the situation can prevent the owner from making the change that's desired. Considering as many of these factors as possible from the outset can save countless hours and great expense down the road.

? Practice Questions

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In the coming sections we will explore the possible legal structures a business owner can choose and look at the advantages and disadvantages of each. We will begin with the simplest of all organizational types: the sole proprietorship.

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17.4: Introduction to Sole Proprietorships

What you'll learn to do: discuss the advantages and disadvantages of sole proprietorships

A sole proprietorship is often a good choice for a one-person start-up operation with no employees and little risk of liability exposure. For many sole proprietors, however, this is a temporary choice, and as the business grows, the owner may be unable to operate with limited financial and managerial resources. At this point, the owner may decide to take in one or more partners to ensure that the business continues to flourish. Let's dig in a bit more into the advantages and disadvantages of sole proprietorship.

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17.5: Sole Proprietorships

Learning Objectives

- Define sole proprietorship
- Discuss the advantages and disadvantages of sole proprietorship

A sole proprietorship is the simplest and most common legal structure someone can choose. It's an unincorporated business owned and run by one individual in which there is no distinction between the business and the owner. If you own a sole proprietorship, you are entitled to all profits and are responsible for all your business's debts, losses, and liabilities.

Forming a Sole Proprietorship

You don't have to take any formal action to form a sole proprietorship. As long as you are the only owner, this status automatically arises from your business activities. In fact, you may already own one without knowing it. If you are a freelance writer, for example, you are a sole proprietor.

As is the case when you own any kind of business, you may need to obtain the necessary licenses and permits. For example, certain businesses, like ones that sell alcohol or firearms, require a federal license or permit. Some states have requirements for other specific businesses. Additionally, some professions such as Certified Public Accountants (CPAs) may have licensing or certification requirements that must be met before you can promote yourself as engaging in that business or trade. Regulations vary by industry, state, and locality.

If you choose to operate under a name different from your own, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name—short for "doing business as"). This document is usually filed in the records of the county or city in which you do business. This requirement exists because if customers want to contact (or sue) the person running the business, the law requires the owner to inform the public of the person behind the "business." You must choose an original name; it cannot already be claimed by another business. In order to check the availability of a business name, business owners may search the database maintained by the State Secretary of State. Visit this webpage to learn about naming your business.

Practice Question

https://assessments.lumenlearning.co...essments/14377

Sole Proprietor Taxes

Because you and your business are one and the same, the business itself is not taxed separately—the sole proprietorship income is *your* income. It's your responsibility to withhold and pay all income taxes, including self-employment and estimated taxes.

Advantages of a Sole Proprietorship

Sole proprietorships have several advantages that make them popular:

- **Easy and inexpensive to form.** As Jeremy Shepherd discovered, sole proprietorships have few legal requirements (local licenses and permits) and are not expensive to form, making them the business organization of choice for many small companies and start-ups.

- **Profits all go to the owner.** The owner of a sole proprietorship obtains the start-up funds and gets all the profits earned by the business. The more efficiently the firm operates, the higher the company's profitability.
- **Direct control of the business.** All business decisions are made by the sole proprietorship owner without having to consult anyone else.
- **Freedom from government regulation.** Sole proprietorships have more freedom than other forms of business with respect to government controls.
- **No special taxation.** Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.
- **Ease of dissolution.** With no co-owners or partners, the sole proprietor can sell the business or close the doors at any time, making this form of business organization an ideal way to test a new business idea.

Disadvantages of a Sole Proprietorship

Along with the freedom to operate the business as they wish, sole proprietors face several disadvantages:

- **Unlimited liability.** From a legal standpoint, the sole proprietor and the company are one and the same, making the business owner personally responsible for all debts the company incurs, even if they exceed the company's value. The owner may need to sell other personal property—their car, home, or other investments—to satisfy claims against the business.
- **Difficulty raising capital.** Business assets are unprotected against claims of personal creditors, so business lenders view sole proprietorships as high risk due to the owner's unlimited liability. Owners must often use personal funds—borrowing on credit cards, second-mortgaging their homes, or selling investments—to finance their business. Expansion plans can also be affected by an inability to raise additional funding.
- **Limited managerial expertise.** The success of a sole proprietorship rests solely with the skills and talents of the owner, who must wear many different hats and make all decisions. Owners are often not equally skilled in all areas of running a business. A graphic designer may be a wonderful artist but not know bookkeeping, how to manage production, or how to market their work.
- **Trouble finding qualified employees.** Sole proprietors often cannot offer the same pay, fringe benefits, and advancement as larger companies, making them less attractive to employees seeking the most favorable employment opportunities.
- **Personal time commitment.** Running a sole proprietorship business requires personal sacrifices and a huge time commitment, often dominating the owner's life with 12-hour workdays and 7-day workweeks.
- **Unstable business life.** The life span of a sole proprietorship can be uncertain. The owner may lose interest, experience ill health, retire, or die. The business will cease to exist unless the owner makes provisions for it to continue operating or puts it up for sale.
- **Losses are the owner's responsibility.** The sole proprietor is responsible for all losses, although tax laws allow these to be deducted from other personal income.

✔ TW's Construction

Tareq has decided that he wants to start a construction company. Given how easy it is to establish a sole proprietorship, Tareq decides that this is the form of ownership he'll choose. He doesn't need to borrow any money to start his business, and since he will be doing all the work himself, at this point he isn't worried that this type of ownership will add additional burdens or stress. He also likes the idea that he is in control of which jobs he takes and who his customers are.

He calls, Luana, his accountant, and asks her about the taxes, because that part is still a little unclear to him. She explains that when Tareq was working for his previous employer, Elliot Builders, federal and state income taxes were withheld from his paychecks. Elliot Builders then sent those funds to the IRS and state department of revenue on Tareq's behalf. Those were the taxes he got credit for when he filed his tax return at the end of the year. Elliot Builders also paid half his social security and medicare taxes for Tareq. The company also paid into the state unemployment insurance fund in case an employee ever filed for unemployment benefits.

Luana tells Tareq that now, as a sole proprietor, he'll need to plan for taxes throughout the year, not just in April—no one else will be withholding or paying taxes for him. This isn't the kind of news Tareq wanted, but he is happy to learn that he may be able to deduct many of the expenses he incurs in the course of operating his business. These include things like his work van, tools he purchases, office supplies, and possibly the small office he has set up in his home. Luana recommends that Tareq come see her at the end of each fiscal quarter (March, June, September, and December) to make sure that he is on track with his taxes for the year. He thinks this is great advice and schedules the appointments on the spot.

After leaving Luana's office, Tareq goes to the courthouse and files his DBA certificate (for the name of his business) and begins operating as a sole proprietorship: TW's Construction. Lastly, he stops by his insurance agent and makes sure that he has the proper insurance on his vehicles and equipment, verifying that he has sufficient liability insurance to cover any potential claims against him.

He heads home to start calling homeowners and setting up appointments to bid on jobs. He has joined the ranks of the self-employed!

? Practice Question

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17.6: Introduction to Partnerships

What you'll learn to do: discuss the advantages and disadvantages of partnerships

Now that we've talked about sole proprietorship, let's take a look at partnerships. Much like sole proprietorships, it's pretty easy to guess what a partnership is in business. It's simply a business that is owned by partners. In this section we'll discuss different kinds of partnerships and the pros and cons of each.

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17.7: Partnerships

Learning Objectives

- Define partnerships as a form of business
- Describe the difference between general and limited partnerships
- Discuss the advantages and disadvantages of partnerships

A partnership is a single business in which two or more people share ownership. Each partner contributes to all aspects of the business, including money, property, labor, or skill. In return, each partner shares in the profits and losses of the business.

Because partnerships entail more than one person in the decision-making process, it's important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners), and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended, and it's considered extremely risky to operate without one.

Types of Partnerships

There are two general types of partnership arrangements:

- **General Partnerships** assume that profits, liability, and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.
- **Limited Partnerships** (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.

Forming a Partnership

To form a partnership, you must register your business with your state, a process generally handled through your Secretary of State's office.

You'll also need to establish your business name. For partnerships, your legal name is the name given in your partnership agreement. If you choose to operate under a name different from the officially registered name, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name, short for "doing business as").

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

Partnership Taxes

Most businesses will need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit. An additional requirement for partnerships is that they must file an "annual information return" to report the income, deductions, gains and losses from the business's operations, but the *business itself does not pay income tax*. Instead, the business "passes through" any profits or losses to its partners. Partners include their respective share of the partnership's income or loss on their personal tax returns. Like sole proprietors, partners in the partnership are responsible for several additional taxes, including income tax, self-employment tax, and estimated tax. Since partnerships can be complex, having a professional to advise the partnership and partners on tax matters is crucial.

Practice Questions

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Advantages of a Partnership

- **Easy and Inexpensive.** Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- **Shared Financial Commitment.** In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This can be beneficial in terms of securing credit or by simply doubling the seed money available.
- **Complementary Skills.** A good partnership should capitalize on the benefits of being able to utilize the strengths, resources, and expertise of each partner.
- **Partnership Incentives for Employees.** Partnerships have an employment advantage over other entities if they offer employees the opportunity to become a partner. Partnership incentives often attract highly motivated and qualified employees.

Disadvantages of a Partnership

- **Joint and Individual Liability.** Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
- **Disagreements Among Partners.** With multiple partners, there are bound to be disagreements. Partners should consult one another on all decisions, make compromises, and resolve disputes as amicably as possible.
- **Shared Profits.** Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

TW Construction or T&T Construction?

For several months Tareq has been operating as a sole proprietorship and enjoying the control he maintains over his work and finances. Business is picking up and he has recently been contacted by a construction firm that wants to hire him to provide the trim carpentry for several large oceanfront homes they are building. He mentions this to his friend Todd, who seems very happy that Tareq's new business venture appears to be succeeding. A month later, Todd calls and asks Tareq to meet him for dinner at Sandbar's. During dinner, Todd proposes to Tareq that the two of them form a general partnership: T&T Construction. Todd points out that taking on several large jobs as a sole proprietor is very risky—a partnership would mean shared risk and responsibility. He also offers to contribute some initial capital to the newly formed partnership, which would provide financial support for their day-to-day operations. Finally, Todd makes the case that, as a frame carpenter, he has skills that would complement Tareq's and potentially yield additional business opportunities.

Surprised by the proposal, Tareq tells his friend that he needs some time to think it over before committing. During the next few days, he calls his accountant, Luana, to find out how the partnership would impact his business. He learns that he would have to share control of the business and also share the profits. That doesn't sound bad to Tareq, especially if the business really grew—which it might, with the addition of Todd's skills and labor. Tareq is leaning toward accepting the offer.

But when he Luana tells him that he would be held responsible not only for the debts of the business but also the actions of his partner, he sours on the idea. He knows Todd has made some business decisions and deals that were a little on the sketchy side. Under the proposed General Partnership structure, if Todd made similar kinds of decisions or deals—even without Tareq's knowledge—Tareq could be held responsible and liable for the consequences. He's realizes he's not willing to accept that kind of risk. He decides to turn down Todd's offer and keep running his business as a sole proprietor.

Practice Question

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17.8: Introduction to Corporations

What you'll learn to do: discuss the advantages and disadvantages of corporations

When people think of corporations, they typically think of major, well-known companies, such as Apple, Alphabet (parent company of Google), Netflix, IBM, Microsoft, Boeing, and General Electric. But corporations range in size from large multinationals with thousands of employees and billions of dollars in sales to midsize or even smaller firms with few employees and revenues under $25,000. While corporations are not the most *common* form of business ownership, they do account for the majority of the *revenue* from business in the United States.

In this section you'll learn about C and S corporations and, a newcomer to the corporate scene, the benefit corporation.

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17.9: C and S Corporations

Learning Objectives

- Summarize the differences between C and S corporations
- Discuss the advantages and disadvantages of corporations

Corporate Rights

Figure 17.9.1: As a matter of interpreting the word "person" in the Fourteenth Amendment, U.S. courts have extended certain constitutional protections to corporations. Some opponents of corporate personhood seek to amend the U.S. Constitution to limit these rights to those provided by state law and state constitutions.

Corporations have unique status and rights in the American legal system. The legal provisions for such entities extend so far as to even include something called "**corporate personhood**." Corporate personhood is the legal notion that corporations, apart from their associated human beings (like owners, managers, or employees), have some, but not all, of the legal rights and responsibilities enjoyed by natural persons (physical humans). For example, corporations have the right to enter into contracts with other parties and to sue or be sued in court in the same way as natural persons or unincorporated associations of persons.

The basis for allowing corporations to assert protection under the U.S. Constitution is that they are organizations of people, and people should not be deprived of their constitutional rights when they act collectively. In this view, treating corporations as "persons" is a convenient legal fiction that allows corporations to sue and to be sued, provides a single entity for easier taxation and regulation, simplifies complex transactions that, in the case of large corporations, would otherwise involve thousands of people, and protects the individual rights of the shareholders as well as the right of association.

Since the Supreme Court's ruling in *Citizens United v. Federal Election Commission* in 2010, upholding the rights of corporations to make political expenditures under the First Amendment, there have been several calls for a U.S. Constitutional amendment to abolish corporate personhood. While the *Citizens United* majority opinion makes no reference to corporate personhood or the Fourteenth Amendment, Justice Stevens' dissent claims that the majority opinion relies on an incorrect treatment of corporations' First Amendment rights as identical to those of individuals.

The legal status, rights, and responsibilities of corporations continue to evolve in response to cultural and economic pressures. The forms they take change over time, too. As you'll see in our discussion of benefit corporations, some types of business are very recent developments indeed.

Corporation (C Corporation)

A corporation (sometimes referred to as a **C corporation**) is an independent legal entity owned by shareholders. This means that the corporation itself, not the shareholders that own it, is held legally liable for the actions and debts the business incurs. This type of general corporation is called a "C corporation" because Subchapter C of Chapter 1 of the Internal Revenue Code is where you find general tax rules affecting corporations and their shareholders.

Corporations are more complex than other business structures because they tend to have costly administrative fees and complex tax and legal requirements. Because of these issues, corporations are generally suggested for established, larger companies with multiple employees.

For businesses in that position, corporations offer the ability to sell ownership shares in the business through stock offerings. "Going public" through an initial public offering (IPO) is a major selling point in attracting investment capital and high-quality employees.

Forming a Corporation

A corporation is formed under the laws of the state in which it is registered.

Because corporations are recognized as entities separate from their owners, the process is much more complex than establishing a sole proprietorship or partnership. The corporation must be "formed" and then recognized by the state's Secretary of State office and/or State Corporation Commission. The way that corporations are "born" is through the filing of articles of incorporation with the state's Secretary of State office. Some states require corporations to establish directors and issue stock certificates to initial shareholders in the registration process. For this reason, establishing a C Corporation can be expensive. Attorneys are often engaged to draft the initial articles of incorporation, shareholders agreements, stock option agreements, and other related documentation. Filing the articles of incorporation, establishing a registered agent, and issuing stock are also tasks that attorneys perform on behalf of those forming the corporation.

As with other forms of ownership, once the corporation is formed, you must obtain business licenses and permits. Regulations vary by industry, state, and locality. If you are hiring employees, you will need to understand and follow federal and state regulations for employers.

Corporation Taxes

When you form a corporation, you create a **separate tax-paying entity**. Unlike sole proprietors and partnerships, corporations pay income tax on their profits. In some cases, corporations are taxed twice—first, when the company makes a profit, and again when dividends are paid to shareholders. These dividends appear on the shareholder's personal tax returns and are subject to taxation. It is important to note that *only income paid as dividends* is taxed twice. Income distributed as salary or other compensation is a deduction for the corporation. This means that the amount of compensation paid is deducted from the amount of corporate income that is subject to taxation.

Just like individuals, corporations are required to pay federal, state, and in some cases, local taxes. Instead of supplying a social security number for taxpayer identification, corporations must register with the IRS and state and local revenue agencies, and obtain a tax ID number.

Advantages of a Corporation

- **Limited Liability.** When it comes to taking responsibility for business debts and actions of a corporation, shareholders' personal assets are protected. Shareholders can generally only be held accountable for their investment in stock of the company.
- **Ability to Generate Capital.** Corporations have an advantage when it comes to raising capital for their business—the ability to raise funds through the sale of stock.
- **Corporate Tax Treatment.** Corporations file taxes separately from their owners. Owners of a corporation only pay taxes on corporate profits paid to them in the form of salaries, bonuses, and dividends, while any additional profits are awarded a corporate tax rate, which is usually lower than a personal income tax rate.
- **Attractive to Potential Employees.** Corporations are generally able to attract and hire high-quality and motivated employees because they offer competitive benefits and the potential for partial ownership through stock options.

Disadvantages of a Corporation

- **Time and Money.** Corporations are costly and time-consuming ventures to start and operate. Incorporating requires start-up, operating, and tax costs that most other structures do not require.
- **Double Taxing.** In some cases, corporations are taxed twice—first, when the company makes a profit, and again when dividends are paid to shareholders.
- **Additional Paperwork.** Because corporations are highly regulated by federal, state, and in some cases local agencies, there are increased paperwork and record-keeping burdens associated with this entity.

S Corporation

An S corporation (sometimes referred to as an **S Corp**) is a special type of corporation created through an IRS tax election. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation.

An S corp is a corporation with the **Subchapter S** designation from the IRS. To be considered an S corp, you must first charter a business as a corporation in the state where it is headquartered. According to the IRS, S corporations are "considered by law to be a unique entity, separate and apart from those who own it." This limits the financial liability for which you (the owner or "shareholder") are responsible. Nevertheless, liability protection is limited—S corps do not necessarily shield you from all litigation such as an employee's tort actions as a result of a workplace incident.

What makes the S corp different from a traditional corporation (C corp) is that profits and losses can pass through to your personal tax return. *Consequently, the business is not taxed itself. Only the shareholders are taxed.* There is an important caveat, however: Any shareholder who works for the company must pay him or herself "reasonable compensation." Basically, the shareholder must be paid fair market value, or the IRS might reclassify any additional corporate earnings as "wages."

Forming an S Corporation

Before you form an S Corporation, you must determine if your business will qualify under the IRS stipulations, and you must first file as a corporation. After you are considered a corporation, all shareholders must elect your corporation to become an S corporation. As with the C corp, this process can be complex, and it's generally standard practice for an attorney with experience in corporate matters to guide the business owners/shareholders through the creation and registration of the S corp.

S Corporation Taxes

Like the C corp, S corps need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit.

However, unlike the C corp, all states *do not* tax S corps equally. Although most state taxing authorities treat them similarly to the federal government (IRS) and tax the shareholders accordingly, some states (like Massachusetts) tax S corps on profits above a specified limit. Other states don't recognize the S corp at all, and they treat the business as a C corp with all of the tax ramifications. Some states (like New York and New Jersey) tax both the S corps profits and the shareholder's proportional shares of the profits. Before deciding upon a corporate structure, business owners/shareholders need to check with an accounting professional to ensure that they make the proper election based on their state corporate tax laws.

Advantages of an S Corporation

- **Tax Savings.** One of the best features of the S corp is the tax savings for you and your business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S corp shareholder who is an employee are subject to employment tax. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.
- **Business Expense Tax Credits.** Some expenses that shareholder/employees incur can be written off as business expenses. Nevertheless, if such an employee owns 2 percent or more shares, then benefits like health and life insurance are deemed taxable income.
- **Independent Life.** An S corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders.

Disadvantages of an S Corporation

- **Stricter Operational Processes.** As a separate structure, S corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers, and records maintenance.
- **Shareholder Compensation Requirements.** A shareholder must receive reasonable compensation. The IRS takes notice of shareholder red flags like low salary/high distribution combinations, and may reclassify your distributions as wages. You could pay a higher employment tax because of an audit with these results.

? Practice Question

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17.10: Benefit Corporations

Learning Objectives

- Explain the purpose and requirements of a benefit corporation (B corp)
- Discuss the advantages and disadvantages of corporations

Over the past few decades, the boundaries between the public (government), private (business), and social (nonprofit) sectors have become blurred as many pioneering organizations merge social and environmental aims with business approaches. There are many expressions of this trend, including corporate social responsibility, microfinance, venture philanthropy, sustainable businesses, social enterprise, privatization, community development, and others. There are also new forms of corporate entities. One of the most widely established is the **benefit corporation (B corp).** In the U.S., a benefit corporation is a type of for-profit corporate entity, authorized by thirty U.S. states and the District of Columbia, that includes positive impact on society, workers, the community, and the environment—in addition to profit—as its legally defined goals. *Benefit corporations differ from traditional C corporations in purpose, accountability, and transparency, but not in taxation.*

In April 2010, Maryland became the first U.S. state to pass benefit corporation legislation.

The purpose of a benefit corporation is to create **general public benefit**, which is defined as a material positive impact on society and the environment. A benefit corporation's directors and officers operate the business with the same authority as in a traditional corporation, but they are required to consider the impact of their decisions not only on shareholders but on society and the environment, too. In a traditional corporation, shareholders judge the company's financial performance; with a benefit corporation, shareholders judge performance based on the company's social, environmental, and financial performance. Transparency provisions require benefit corporations to publish annual benefit reports of their social and environmental performance using a comprehensive, credible, independent, and transparent third-party standard.

Some well-known examples of benefit corporations are Kickstarter, Patagonia, and King Arthur Flour.

Forming a Benefit Corporation

New companies can incorporate as a benefit corporation in any state where benefit corporation legislation has been passed. (Instead of recognizing benefit corporations, Washington created social purpose corporations in 2012 with a similar focus and intent.) The process varies by state, but many states require benefit corporations to do the following:

- declare a commitment to creating general public benefit
- adopt a third-party standard
- prepare an annual benefit report
- distribute the annual benefit report to the owners and post it on the company's Web site

B Corp Certification

Businesses that want to take their social and environmental commitment even further can become a Certified B Corporation. This involves a rigorous assessment process by B Lab, which uses a survey to rate a company's environmental practices, employee treatment, activism within its community, and other factors. Businesses that surpass a certain score are certified by B Lab, which then audits them from time to time to ensure that they are living up to the movement's standards.

[B Lab certification] is like a Good Housekeeping seal of approval," said David Murphy, former CEO of Better World Books, in a 2011 Business News Daily interview. "If your company is a Certified B Corporation, that really says something. You're there to serve all those stakeholders, and you're willing to prove it.[1]

Benefit Corporation Taxes

Benefit corporations are treated like all other corporations for tax purposes. B corps elect to be taxed either as a C or S corp.

? Practice Question

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Advantages of a Benefit Corporation

- **Protection of Mission**. Becoming a benefit corporation gives companies more options and protections if they decide to sell the business to someone else or take it public, because other factors besides price (e.g., the public benefit mission) must also be taken into account.
- **Reputation**. Incorporating as a benefit corporation allows companies to stand out as businesses that have a social conscience and aspire to a standard they consider higher than maximizing profit for shareholders. For investors and consumers who are committed to social and environmental responsibility, benefit corporations provide additional choices.
- **Creation of Value**. Because it's committed to considering other stakeholders' interests, a benefit corporation may create value via employee engagement and customer loyalty, thereby improving results for all stakeholders—including the owners/shareholders. As well, certain profit-making opportunities may not be available without an assured commitment to other stakeholders.[2]

Disadvantages of a Benefit Corporation

- **Transparency and Reporting Requirements**. Benefit corporations must provide an annual benefit report according to a third-party standard (such as B Lab) and make the report available on their company Web sites. The purpose of this is to assess the company's performance with regard to its public purpose(s).
- **Annual Fees to Retain Certified B Corp Status.** If a B corp elects to receive certification from a third party, such as B Lab, fees for "certified" B-corp status are based on annual sales, with a minimum of $500. To keep certification, the company must pay a renewal fee each year and recertify every two years.
- **Compliance and Governance Obligations**. Most states require publicly traded companies with a B corp designation to have a "benefit director" who is responsible for ensuring that the corporation meets its stated public purpose.

? Practice Question

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17.11: Introduction to Hybrid Forms of Ownership

What you'll learn to do: discuss the advantages and disadvantages of hybrid forms of business ownership

The concept of "limited liability" has given rise to hybrid forms of business ownership such as LLCs and LLPs. In this section you'll learn what these forms are and the pros and cons of each.

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17.12: Limited Liability Company (LLC)

Learning Objectives

- Define limited liability company (LLC) as a form of business
- Discuss the advantages and disadvantages of LLCs

A limited liability company (LLC) is a hybrid business structure allowed by state statute. LLCs are attractive to small business owners because they provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. *Each state may use different regulations*, and you should check with your state if you are interested in starting a limited liability company.

Owners of an LLC are called members. Most states do not restrict ownership, and so members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit “single-member” LLCs, those having only one owner.

Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are “passed through” the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

Forming an LLC

While each state has slight variations on forming an LLC, they all adhere to some general principles:

Choose a Business Name. There are three rules that your LLC name needs to follow: (1) it must be different from an existing LLC in your state, (2) it must indicate that it’s an LLC (such as “LLC” or Limited Company”) and (3) it must not include words restricted by your state (such as “bank” and “insurance”). Your business name is automatically registered with your state when you register your business, so you do not have to go through a separate process.

File the Articles of Organization. The “articles of organization” is a simple document that legitimizes your LLC and includes information like your business name, address, and the names of its members. For most states, you file with the Secretary of State. However, other states may require that you file with a different office such as the State Corporation Commission, Department of Commerce and Consumer Affairs, Department of Consumer and Regulatory Affairs, or the Division of Corporations & Commercial Code.

Create an Operating Agreement. Most states do not require operating agreements. However, an operating agreement is highly recommended for multimember LLCs because it structures your LLC’s finances and organization, and provides rules and regulations for smooth operation. The operating agreement usually includes percentage of interests, allocation of profits and losses, member’s rights and responsibilities, and other provisions.

Obtain Licenses and Permits. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

Announce Your Business. Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLC formation.

LLC Taxes

In the eyes of the federal government, an **LLC is not a separate tax entity**, so the business itself is not taxed. Instead, all federal income taxes are passed on to the LLC’s members and are paid through their personal income tax. While the federal government does not tax income on an LLC, some states do, so check with your state’s income tax agency.

Since the federal government does not recognize LLC as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. Certain LLCs are automatically classified and taxed as a corporation by federal tax law.

Practice Question

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Advantages of an LLC

- **Limited Liability.** Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is similar to the liability protections afforded to shareholders of a corporation. Keep in mind that limited liability means "limited" liability—members are not necessarily shielded from wrongful acts, including those of their employees.
- **Less Record Keeping.** An LLC's operational ease is one of its greatest advantages. Compared to an S Corporation, there is less registration paperwork and there are smaller start-up costs. However, it is very important to keep proper and separate business financial records. If it appears that the LLC is co-mingling personal and business funds, it can be legally reclassified and end up assuming additional liability.
- **Sharing of Profits.** There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC

- **Possible Limited Life.** When an LLC is formed, the members must decide on the duration of the LLC. If an LLC is formed in a state where perpetual life is not permitted, then the death or disassociation of a member will dissolve the LLC, and the members must fulfill all remaining legal and business obligations to close the business. For this reason, it is important for individuals seeking to use this form of ownership verify the requirements for an LLC in the state in which they intend to operate.
- **Self-Employment Taxes.** Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

PRactice Question

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17.13: Limited Liability Partnership (LLP)

Learning Objectives

- Define limited liability partnerships (LLP) as a form of business
- Discuss the advantages and disadvantages of LLPs

A **limited liability partnership** (**LLP**) is a partnership in which some or all partners (depending on the jurisdiction) have limited liabilities. It therefore exhibits elements of partnerships and corporations. In an LLP, one partner is not responsible or liable for another partner's misconduct or negligence.

In an LLP, some partners have a form of limited liability similar to that of the shareholders of a corporation. Some states require one partner to be a "general partner" with unlimited liability, meaning he/she is ultimately responsible for the debts of the business and for any lawsuits such as personal injury or breach of contract. Unlike corporate shareholders, the partners have the right to manage the business directly. In contrast, corporate shareholders have to elect a board of directors under the laws of various state charters. The board organizes itself (also under the laws of the various state charters) and hires corporate officers who, as "corporate" individuals, then have the legal responsibility to manage the corporation in the corporation's best interest. An LLP also has a different level of tax liability compared with that of a corporation.

As in a partnership or limited liability company (LLC), the profits of an LLP are allocated among the partners for tax purposes, avoiding the problem of "double taxation" often found in corporations.

Forming an LLP

Verify Eligibility Status. In the United States, each individual state has its own law governing the formation of LLPs. Although found in many business fields, the LLP is an especially popular form of organization among professionals such as lawyers, accountants, and architects. In California, New York, Oregon, and Nevada, LLPs can only be formed for such professional uses.

Choose a Business Name. When selecting a name for the LLP, generally the name (1) must be different from an existing LLP in your state, and (2) most states require the inclusion of "Limited Liability Partnership," "LLP," or another related abbreviation at the end of your business name.

Draft a Limited Liability Partnership Agreement. Although not required in every state, this agreement is strongly recommended. A limited liability partnership agreement should define each partner's role and responsibilities. It should clearly define the partners' assets and liability limitations. The agreement should also outline capital contributions, distribution of profits and losses, buyout agreements, expulsion or addition of partners, etc.

File a Certificate of Limited Liability Partnership. The drafting of an LLP agreement is optional; however all LLPs must file a certificate of limited liability partnership (sometimes called a certificate of registration as a limited liability partnership). The certificate of limited liability partnership is more general than the limited liability partnership agreement, as it does not detail responsibilities, capital contributions, buyouts, etc. The certificate requires the listing of your business's name and address, the names and contact information of the partners, and information on the registered agent of the LLP.

Obtain Licenses and Permits. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality.

Announce Your Business. Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLP formation.

LLP Taxes

The tax treatment for LLPs is similar to general partnerships, as discussed earlier. Profits and losses are passed through to the partners so the partners reflect them on their individual tax return.

Practice Question

https://assessments.lumenlearning.co...essments/14387

Advantages of an LLP

- **Single Taxation**. The credits and deductions of the company are passed through to partners to file on their individual tax returns. Credits and deductions are divided by the percentage of individual interest each partner has in the company.
- **Limited Liability**. The LLP structure protects individual limited partners from personal liability for negligent acts of other partners or employees not under their direct control. In addition, individual partners are not personally responsible for company debts or other obligations.
- **Flexibility**. LLPs provide the partners flexibility in business ownership. Partners have the ability to decide how they will individually contribute to business operations, both financially and physically. Management duties can be divided equally or unequally based on the experience of each partner. Partners who have a financial interest in the company can elect not to have any authority over business decisions but still maintain ownership rights based on their percentage interest in the company.

Disadvantages of an LLP

- **Duration** . The business life of a LLP is unstable because the partnership can be dissolved by agreement of the partners or upon the death or withdrawal of a partner. A limited liability partnership agreement can prevent dissolution if a partner dies or withdraws.
- **Limitation of Formation**: Unlike general partnerships, limited liability partnerships are not recognized as legal business structures in every state. Some states limit the creation of a limited liability partnership to professionals such as doctors or lawyers.
- **Partner Control.** If an LLP is formed without a limited liability partnership agreement, individual partners are not obligated to consult with other participants in certain business agreements. The fact that a partner can make business decisions without consulting the other partners can be problematic, to say the least.

? Practice Question

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17.14: Introduction to Franchises

What you'll learn to do: discuss the advantages and disadvantages of franchises

For aspiring business owners who lack the time, vision, or resources to start from scratch, franchising is a viable alternative. Many industries such as fast food are almost wholly comprised of franchises. As appealing as it may seem to open a franchise, there are still risks for both the franchisor and franchisee.

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17.15: Franchises

Learning Objectives

- Define franchises as a form of business
- Discuss the advantages and disadvantages of franchising for the franchisee
- Discuss the advantages and disadvantages of franchising for the franchisor

A **franchise** is a business model that involves one business owner (the **franchisor**) licensing trademarks and methods to an independent entrepreneur (the **franchisee**) for a prescribed period of time. For the franchisor, the franchise is an alternative to expanding through the establishment of a new location, which avoids the financial investment and liability of a chain of stores. Ultimately, the franchisor's success depends on the success of the franchisees. If the franchisees are successful then the franchisor can grow its brand and market presence while the franchisee, in effect, does all of the work.

The United States is a leader in franchising, a position it has held since the 1930s when it used the approach for fast-food restaurants, food inns, and, slightly later, motels during the time of the Great Depression. Today, the world's largest franchise chains are U.S. companies:

- **Subway**: start-up costs $84,300–$258,300; 45,512 locations worldwide in 2017
- **McDonald's**: start-up costs in 2010: $995,900–$1,842,700; 37,855 locations in 2017
- **7-Eleven Inc.**: start-up costs in 2010: $40,500–$775,300; 68,236 locations in 2017
- **Great Clips**: start-up costs in 2010: $109,000 – $203,000; 3,694 locations in 2015
- **Hampton Inns & Suites**: start-up costs in 2010: $3,716,000–$15,148,800

Buying a Franchise

The decision to purchase a franchise involves many factors, including how much you can afford to invest, what abilities you have, and what your goals are. Before you decide to purchase a franchise, it's important to do thorough research. You could lose a significant amount of money if you don't investigate a business carefully before you buy. By law, franchisors must disclose certain information about their business to potential buyers. Make sure you get all the information you need first before entering into this form of business.

The following strategies can help you gain a solid understanding of what to expect as well as the risks that could be involved:

- **Be a Detective.** In addition to the routine investigation that should be conducted prior to any business purchase, you should be able to contact other franchisees before deciding to invest. You can obtain a Uniform Franchise Offering Circular (UFOC), which contains vital details about the franchise's legal, financial, and personnel history, before you sign a contract.
- **Know What You Are Getting Into.** Before entering into any contract as a franchisee, you should make sure that you would have the right to use the franchise name and trademark, receive training and management assistance from the franchisor, use the franchisor's expertise in marketing, advertising, facility design, layouts, displays and fixtures, and do business in an area protected from other competing franchisees.
- **Watch Out for Possible Pitfalls.** The contract between the two parties usually benefits the franchisor far more than the franchisee. The franchisee is generally subject to meeting sales quotas and is required to purchase equipment, supplies, and inventory exclusively from the franchisor.
- **Seek Professional Help.** The tax rules surrounding franchises are often complex, and an attorney, preferably a specialist in franchise law, should assist you to evaluate the franchise package and tax considerations. An accountant may be needed to determine the full costs of purchasing and operating the business as well as to assess the potential profit to the franchisee.

Franchise Taxes

The taxation of a franchise depends on the underlying form of ownership. Generally franchises are required by the franchisor to be established as a corporation or LLC. Ultimately, the franchise agreement governs this, and individuals looking to purchase a franchise should scrutinize any agreements with regard to prescribed legal ownership structure.

? Practice Question

https://assessments.lumenlearning.co...essments/14389

Advantages for the Franchisee

- **Less Risk**. In certain industries, when compared with starting one's own business from scratch, buying a franchise enables the franchisee to own a business with a proven track record and an established market presence, thereby reducing the risk of failure. However, purchasing a franchise still doesn't guarantee success, and many franchisees go out of business, losing their initial investment and start-up capital.
- **Name/Brand Recognition**. The franchise has an established image and identity already, which can reduce or simplify marketing efforts. Many franchises are nationally advertised brands, shortening the time it takes for the franchisee to establish a market presence.
- **Access to Expertise, Ongoing Support**. Franchisee often receives help with site selection, training materials, product supply, and marketing plans. The franchisee gets to take advantage of a business model whose strategies and processes have already been tested and streamlined.
- **Relative Autonomy**. Franchisee must comply with the terms and standards of the franchisor, but otherwise has a fair amount control over the day-to-day operations of the franchise.

Disadvantages for the Franchisee

- **Cost**. Buying and running a franchise can be very expensive. Jimmy John's Subs was listed as one of the top franchises in 2016, but the initial investment to open a location was $325,000–$555,000. Franchise fees generally run in the $20,000-to-$30,000 range, though they can top $100,000 for higher-end, more established brands. Once open, there are ongoing royalties to pay, which typically range from 4 percent to 8 percent of gross revenues and include an ongoing assessment for marketing and advertising.
- **Unequal Partnership**. The franchisor sets the rules, and the franchisee must follow them. The franchisee doesn't have much leverage if the franchisor falls short on promises or makes unreasonable demands.
- **Rules and Enforcement.** Franchisor rules imposed by the franchising authority are becoming increasingly strict. Some franchisors are using minor rule violations to terminate contracts and seize the franchise without any reimbursement. Often this happens when a franchise location becomes very profitable or the franchisor sees an opportunity to profit by seizing and liquidating the location.

? Try It

https://assessments.lumenlearning.co...essments/14390

Advantages for the Franchisor

- **Access to Capital for Growth and Expansion**. After the brand and formula are carefully designed and properly executed, franchisors are able to sell franchises and expand rapidly across countries and continents using the capital and resources of their franchisees.
- **Cash Flow for Operations.** In addition to initial franchise fees that can range from $50,000 to $5 million, franchisors receive payments in the form of royalties from each franchisee. These royalties typically range from 4 percent to 8 percent of gross revenues. In addition, franchisees are also assessed for marketing and advertising.
- **Economies of Scale**. Once a franchise is established with multiple locations, the company may be able to leverage its buying power to realize economies of scale with suppliers, advertisers, and vendors. If purchasing and distribution for the franchise locations can be centralized, then the cost savings will increase the franchisor's bottom line, particularly if the franchise agreement provides for a percent-of-sales payment to the franchisor.

Disadvantages for the Franchisor

- **Lack of Control.** Despite the language of the franchise agreement, once the franchisee has established their location, the franchisor may have difficulty ensuring that quality standards are met and the franchise is operating in a manner that benefits the brand. A Dunkin' Donuts franchise in Russia had to be closed after it was discovered that instead of serving donuts and coffee, the franchisee was serving vodka and meat pies.
- **Trade Secrets.** If the success of a business is based on a trade secret, special process, or innovative technology, establishing a franchise may make the business vulnerable to knock-offs or imitation. Although the franchise agreement specifically prohibits the disclosure of trade secrets, the fact that the franchisee may see opportunities to improve upon the process and become a competitor is not expressly prohibited.
- **Overexposure, Brand Dilution**. One or two locations of a business is unique and may generate enough demand that the business can charge top dollar for goods or services. When franchises appear on almost every street corner, the allure of the business may fade and the brand or business may suffer.

Practice question

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17.16: Introduction to Mergers and Acquisitions

What you'll learn to do: describe the two types of mergers and acquisitions

One of the quickest ways for a business to expand into other markets or products lines is either to merge or acquire/purchase another company. Although this is common in today's business environment, there are still many complex factors to consider before deciding whether a merger or acquisition is the optimal solution.

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17.17: Mergers and Acquisitions

Learning Objectives

- Define merger as a business strategy
- Define acquisition as a business strategy
- Explain why companies undertake horizontal mergers and acquisitions
- Explain why companies undertake vertical mergers and acquisitions

Integration Strategies: Mergers and Acquisitions

When businesses acquire other businesses or operations that were previously competitors, suppliers, buyers, or sellers, they are engaging in a strategy known as **integration**. This strategy is based on the possibility of *synergy*, the idea that the sum of two entities will be greater than their individual parts—often expressed as 1 + 1 = 3. Integration can be accomplished in two primary ways: through mergers or acquisitions. A **merger** is the consolidation of two companies that, prior to the merger, were operating as independent entities. A merger usually creates one larger company, and one of the original companies ceases to exist. Mergers can be either horizontal or vertical.

A **horizontal merger** occurs between companies in the same industry. This type of merger is essentially a consolidation of two or more businesses that operate in the same market space, often as competitors offering the same good or service. Horizontal mergers are common in industries with fewer firms, since competition tends to be higher, and the synergies and potential market-share gains are much greater in those industries.

Facebook + Instagram = Horizontal Merger

When Facebook acquired Instagram in 2012 for a reported $1 billion, Facebook was looking to strengthen its position in the social-media and social-sharing space. Both Facebook and Instagram operated in the same industry and were in similar positions with regard to their photo-sharing services. Facebook clearly saw Instagram as an opportunity to grow its market share, increase its product line, reduce competition, and access new markets.

A **vertical merger** is characterized by the merger of two organizations that have a buyer-seller relationship or, more generally, two or more firms that are operating at different levels within an industry's supply chain. Most often the logic behind the merger is to increase synergies by merging firms that would be more efficient operating as one.

Apple: The King of Vertical Integration

Apple Inc. is famous for perfecting the art of vertical integration. The company manufactures its custom A-series chips for its iPhones and iPads. It also manufactures its custom touch ID fingerprint sensor. Apple opened up a laboratory in Taiwan for the development of LCD and OLED screen technologies in 2015. It also paid $18.2 million for a 70,000-square-foot manufacturing facility in North San Jose in 2015. These investments (i.e., mergers) enable Apple to move along the supply chain in a backward integration, giving it flexibility and freedom in its manufacturing capabilities.[1]

An **acquisition**, on the other hand, occurs when a company purchases the assets of another business (such as stock, property, plants, equipment) and usually permits the acquired company to continue operating as it did prior to the acquisition. *Acquisition* usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger and/or longer-established company and retain the name of the latter for the post-acquisition combined entity.

? Practice Questions

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Reasons for Mergers and Acquisitions

There are many good reasons for growing your business through an acquisition or merger. These include:

1. Obtaining quality staff or additional skills, knowledge of your industry or sector, and other business intelligence. For instance, a business with good management and process systems will be useful to a buyer who wants to improve their own. Ideally, the business you choose should have systems that complement your own and that will adapt to running a larger business.
2. Accessing funds or valuable assets for new development. Better production or distribution facilities are often less expensive to buy than to build. Look for target businesses that are only marginally profitable and have large unused capacity that can be bought at a small premium-to-net-asset value.
3. Your business is underperforming. For example, if you are struggling with regional or national growth, it may well be less expensive to buy an existing business than to expand internally.
4. Accessing a wider customer base and increasing your market share. Your target business may have distribution channels and systems you can use for your own offers.
5. Diversification of the products, services, and long-term prospects of your business. A target business may be able to offer you products or services that you can sell through your own distribution channels.
6. Reducing your costs and overheads through shared marketing budgets, increased purchasing power, and lower costs.
7. Reducing competition. Buying up new intellectual property, products, or services may be cheaper than developing these yourself.
8. Organic growth (i.e., the existing business plan for growth needs to be accelerated). Businesses in the same sector or location can combine resources to reduce costs, eliminate duplicated facilities or departments, and increase revenue.

? Practice Questions

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https://assessments.lumenlearning.co...essments/14395

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1. Kenton, Will. "Vertical Integration." Investopedia. August 21, 2019. http://www.investopedia.com/terms/v/verticalintegration.asp#ixzz4PRMbV5zm↵

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17.18: Putting It Together- Business Ownership

Synthesis

Now that you have come to the end of this module, you should understand that there is a range of possibilities for structuring, starting, and growing a business. Each choice has its advantages and disadvantages, and there is no single set of choices that will accommodate all businesses. Just knowing that there are choices to be made and a variety of possible paths is critical to the success of any business venture—large or small.

Summary

In this module you learned about the various legal forms for a business and the advantages and disadvantages of each. The following are key takeaways from this module:

Choosing an Organizational Type

Sole proprietorship, partnerships, corporations, and hybrids (LLC, LLP) are all possible options for the legal formation of a business. Each structure carries risks and rewards, costs and benefits. Which form of business ownership is best for an individual depends not only upon the nature of the business opportunity but also the level of personal exposure to risk the owner is willing to accept.

Sole Proprietorships

Sole proprietorships are the simplest and most common legal structure for a business. These businesses are owned and run by one person.

Partnerships

A partnership is a single business in which two or more people share ownership. There are two general types of partnership arrangements: general partnerships and limited partnerships.

Corporations

Although not the most *common* form of business ownership, corporations account for the majority of the *revenue* from business in the U.S. They are also the most complex type of organization to start and maintain. Types of corporations include C corporations, S corporations, and B corporations.

Hybrid Forms of Ownership

Fortunately there are options that enable the business owner to take advantage of limited personal liability and the benefits of partnership or corporate organization. These include the limited liability corporation (LLC) and limited liability partnership (LLP). Which type of ownership an owner selects will largely be determined by the size, objectives, and vision for the business.

Let's take a look at how these different forms of ownership compare to one another.

Comparing Characteristics of Business Ownership Types

Characteristic	Sole Proprietorship	Partnership	LLC	LLP	Corporation	S Corporation
Owner(s)	1 sole proprietor	2 or more partners	1 or more members	2 or more partners	1 or more shareholders	1 or more shareholders
Sole authority for decisions	Yes	No	No[1]	No	No[2]	No[3]

Characteristic	Sole Proprietorship	Partnership	LLC	LLP	Corporation	S Corporation
Easy setup	Yes	Yes	Yes	Yes	No	No
Minimal regulations	Yes	Yes	Yes	Yes	No	No
Single taxation	Yes	Yes	Yes	Yes	No	Yes
Easy access to expertise	No	Somewhat	Somewhat	Somewhat	Yes	Yes
Easy access to capital	No	Somewhat	Somewhat	Somewhat	Yes	Yes
Limited legal liability	No	No	Yes	Yes	Yes	Yes
Unlimited life	No	No	Possible	Possible	Yes	Yes
Easy transfer of ownership	No	No	No	No	Yes	Yes

Franchising

For aspiring business owners who do not have the time, vision, or resources to "start from scratch," franchising is a viable alternative for business ownership. Everyone is familiar with franchises—many industries such as fast food are almost wholly comprised of franchises. As appealing as this may seem, there are still risks to franchising for both the franchisor and franchisee.

Mergers and Acquisitions

One of the quickest ways for a business to expand into other markets or products lines is either to merge or acquire/purchase another company. Although this is common in today's business environment, there are still many complex factors to consider before deciding whether a merger or acquisition is the optimal solution.

Additional Resources

U.S. Small Business Association (SBA) website

1. Yes, if only one member ↵
2. Yes, if only one shareholder ↵
3. Yes, if only one shareholder ↵

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17.19: Discussion- Business Structure Does Matter

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda is concerned that if she grows the business, she may face more financial and personal responsibility and liability than she is comfortable with. After reading this module, you know that one way to limit the liability and financial exposure of a business owner is by selecting the appropriate ownership structure. However, each form of ownership has its advantages and disadvantages.

For Discussion

1. Consider the options available to Wanda as she selects a forms of business ownership for Salty Pawz and expands the business. For each form of ownership, carefully study the advantages and disadvantages of each ownership option as they relate to Wanda's business. Which form of ownership would you recommend for Wanda and Salty Pawz and why?
2. What if YOU were a business owner and you needed to select a form of business ownership? Would you select the same form of ownership you just recommended for Wanda? What would YOU take into consideration if YOU were the owner and needed to select from the ownership options available to Wanda? Are they the same things Wanda needs to consider, or are they different?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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17.20: Discussion- Entrepreneurs and Business Ownership

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Although sole proprietorships are the most common form of ownership, the majority of Americans work for corporations. Between sole proprietorship and corporation, there is a range of options: partnership, LLC, LLP, benefit corporation (B corp), S corporation, C corporation, and then a range of not-for-profit and nonprofit structures. Each form of ownership has its advantages and disadvantages, but ultimately the business owner must choose.

For Discussion

1. What if YOU were a business owner and you needed to select a legal form of ownership. What form of ownership would you choose?
2. What would YOU take into consideration if YOU were the owner and needed to select from the ownership options available?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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17.21: Assignment- Wanda’s Business-Ownership Options

Scenario

Wanda is concerned that if she grows the business, she may take on more financial and personal responsibility than she is comfortable with.

Your Task

1. Prepare a chart showing the forms of business ownership Wanda could adopt for Salty Pawz as she expands. For each type of ownership, you need to provide the advantages and disadvantages of each option as they relate to Wanda’s businesses.
2. After having explored the advantages and disadvantages of each form of ownership, which form would you recommend for Wanda and Salty Pawz, and why?
3. Lastly, if Wanda decides she wants the two friends she works with to become more formally involved in ownership of the business, does that change the advice you gave her in part (b) above. If so, how? If it does not affect your advice to her, then why not?

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Prepare a chart showing Wanda the forms of ownership she could adopt for Salty Pawz as she expands the business.	0 points	9.9 points	14.4 points	18 points	18%
Discuss the advantages and disadvantages of each ownership option.	0 points	9.9 points	14.4 points	18 points	18%
Explain your recommendation for the Salty Pawz form of ownership with supporting evidence.	0 points	9.9 points	14.4 points	18 points	18%
Explain the implications of formally adding additional people as owners of Salty Pawz.	0 points	9.9 points	14.4 points	18 points	18%
Discuss the impact of adding additional owners to Salty Pawz on your advice for ownership options.	0 points	9.9 points	14.4 points	18 points	18%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	5.5 points	8 points	10 points	10%

Total points possible: 100.

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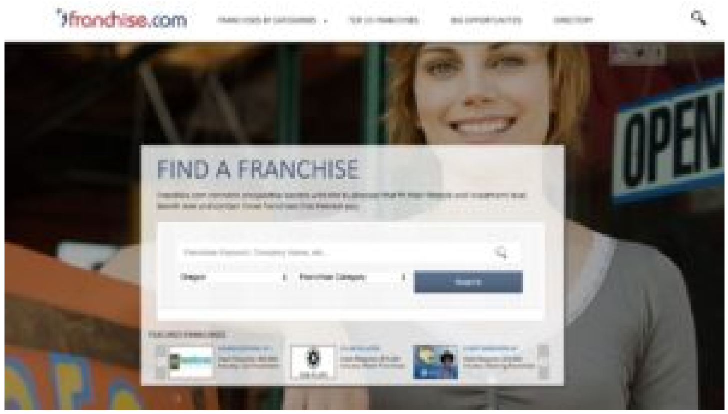
17.22: Assignment- Franchising—an Alternative to Start-up

Preparation

This is a written assignment that should conform to the Guidelines for Written Assignments.

In order to complete this assignment, you will need to go to one of the following websites:

- https://www.franchise.com/



- http://www.franchising.com/

You'll see that it's possible to research franchise opportunities at both Web sites. Choose one or the other site as the basis for your research.

Your Task

- Using the search tools on the Web site, perform a search, and select a franchise that interests you.
- Once you have looked at the information provided, please prepare and submit a written report that covers the following:
  - Name of franchise you selected and a brief summary of the business opportunity.
  - Why you selected the franchise you did. What was it about this particular franchise that attracted you to it?
  - Start-up costs. Specify what the owner ("franchisee") will have to invest, as well as any contributions toward start-up that the franchisor will make.
  - Potential profit or income from the business. It is possible that this information will not be provided at the sites above, so be prepared to do some research beyond what's available there.
  - Support that the franchisor will provide the owner ("franchisee"), such as training, supplies, materials/equipment, location, building.
  - Any other general comments or observations that you feel are relevant to evaluating this opportunity. This could include information you find online about what people who have invested in the franchise have to say about their experience. Again, you may need to search the Internet beyond the two franchising Web sites listed in order to obtain this additional information.

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CHAPTER OVERVIEW

18: Module 7 Readings - Legal Ownership

18.1: Reading- Selecting a Form of Business Ownership

Selecting a Form of Business Ownership: 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—sole proprietorship, partnership, and corporation—let's address some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business.

1. What are you willing to do to set up and operate your business? Do you want to minimize the costs of getting started? Do you hope to avoid complex government regulations and reporting requirements?
2. How much control would you like? Do you want to own the company yourself, or do you want to share ownership with other people? Are you willing to share responsibility for running the business?
3. Do you want to be the sole benefactor of your efforts or are you willing to share profits with other people? Do you want to be in charge of deciding how much of the company's profits will be retained in the business?
4. Do you want to avoid special taxes? Do you want to avoid paying "business" income taxes on your business and then paying "personal" income taxes on profits earned by the business?
5. Do you have all the skills needed to run the business? Do you possess the talent and skills to run the business yourself, or would the business benefit from a diverse group of owners? Are you likely to get along with co-owners over an extended period of time?
6. Should it be possible for the business to continue without you? Is it important to you that the business survive you? Do you want to know that other owners can take over if you die or become disabled? Do you want to make it easy for ownership to change hands?
7. What are your financing needs? How do you plan to finance your company? Will you need a lot of money to start, operate, and grow your business? Can you furnish the money yourself, or will you need some investment from other people? Will you need bank loans? If so, will you have difficulty getting them yourself?
8. How much liability exposure are you willing to accept? Are you willing to risk your personal assets—your bank account, your car, maybe even your home—for your business? Are you prepared to pay business debts out of your personal funds? Do you feel uneasy about accepting personal liability for the actions of fellow owners?

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

KEY TAKEAWAYS

- Some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business include the following:
  - *What are you willing to do to set up and operate your business*?
  - *How much control do you want*?
  - *Do you want to share profits with others*?
  - *Do you want to avoid special taxes on your business*?
  - *Do you have all the skills needed to run the business*?
  - *Should it be possible for the business to continue without you*?
  - *What are your financing needs*?
  - *How much liability exposure are you willing to accept*?
- No single form of ownership—sole proprietorship, partnership, or corporation—will give you everything you want. Each has advantages and disadvantages.

In this next section we will examine two very common forms of ownership: **Sole Proprietorship** and **Partnerships**.

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18.2: Reading- Sole Proprietorship and Partnerships

Sole Proprietorship

A **sole proprietorship** is a business owned by only one person. The most common form of ownership, it accounts for about 72 percent of all U.S. businesses[1]. It's the easiest and cheapest type of business to form: if you're using your own name as the name of your business, you just need a license to get started, and once you're in business, you're subject to few government regulations.

Advantages and Disadvantages of Sole Proprietorships

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

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control, for example, is having to supply all the different talents that may be necessary to make the business a success. And if you die, the business dissolves. You also have to rely on your own resources for financing: in effect, you *are* the business, and any money borrowed by the business is loaned to *you personally*. Even more important, the sole proprietor bears **unlimited liability** for any losses incurred by the business. As you can see from Figure 1, the principle of unlimited personal liability means that if the *company* incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the *owner* is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.

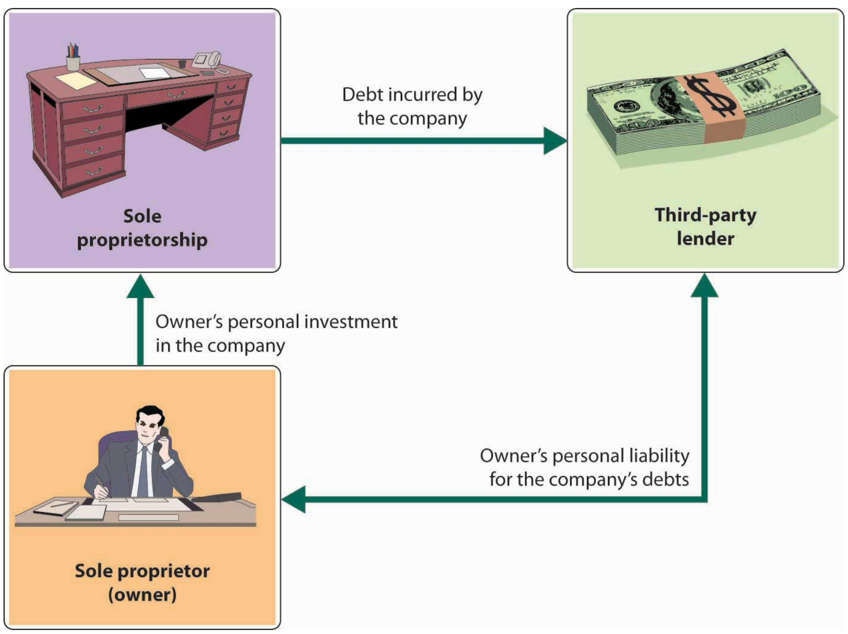

Figure 18.2.1: Sole Proprietorship and Unlimited Liability

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 accounting firm Deloitte, Haskins and Sells is a partnership. In 2014 it had revenues of $34.2B and 210,000 employees.[3]

Setting up a partnership is more complex than setting up a sole proprietorship, but it's still relatively easy and inexpensive. The cost varies according to size and complexity. It's possible to form a simple partnership without the help of a lawyer or an accountant, though it's usually a good idea to get professional advice. Professionals can help you identify and resolve issues that may later create disputes among partners.

The Partnership Agreement

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

- Amount of cash and other contributions to be made by each partner
- Division of partnership income (or loss)
- Partner responsibilities—who does what
- Conditions under which a partner can sell an interest in the company
- Conditions for dissolving the partnership
- Conditions for settling disputes

Unlimited Liability and the Partnership

Figure 2 shows that a major problem with partnerships, as with sole proprietorships, is unlimited liability: each partner is personally liable not only for his or her own actions but also for *the actions of all the partners*. In a partnership, it may work according to the following scenario. Say that you're a partner in a dry cleaning business. One day, you return from lunch to find your establishment on fire. You're intercepted by your partner, who tells you that the fire started because he fell asleep while smoking. As you watch your livelihood go up in flames, your partner tells you something else: because he forgot to pay the bill, your fire insurance was canceled. When it's all over, you estimate the loss to the building and everything inside at $1.2 million. And here's the really bad news: if the business doesn't have the cash or other assets to cover losses, *you can be personally sued for the amount owed*. In other words, any party who suffered a loss because of the fire can go after your personal assets.

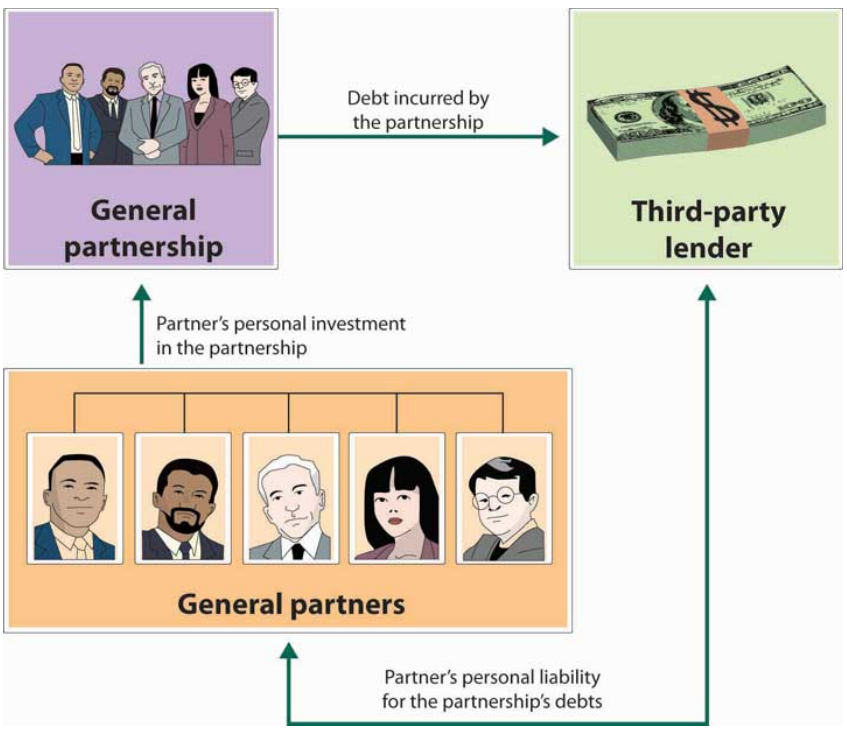

Figure 18.2.2:General Partnership and Unlimited Liability

Limited Partnerships

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

Advantages and Disadvantages of Partnerships

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

Still, there are some negatives. First, as discussed earlier, partners are subject to unlimited liability. Second, being a partner means that you have to share decision making, and many people aren't comfortable with that situation. Not surprisingly, partners often have differences of opinion on how to run a business, and disagreements can escalate to the point of actual conflict; in fact, they can even jeopardize the continuance of the business. Third, in addition to sharing ideas, partners also share profits. This arrangement can work as long as all partners feel that they're being rewarded according to their efforts and accomplishments, but that isn't always the case.

While the partnership form of ownership is viewed negatively by some, it was particularly appealing to Ben Cohen and Jerry Greenfield. Starting their ice cream business as a partnership was inexpensive and let them combine their limited financial resources and use their diverse skills and talents. As friends they trusted each other and welcomed shared decision making and profit sharing. They were also not reluctant to be held personally liable for each other's actions.

KEY TAKEAWAYS

- A sole proprietorship is a business owned by only one person.
- It's the most common form of ownership and accounts for about 72 percent of all U.S. businesses.
- Advantages of a sole proprietorship include the following:
  - Easy and inexpensive to form; few government regulations
  - Complete control over your business
  - Get all the profits earned by the business
  - Don't have to pay any special income taxes
- Disadvantages of a sole proprietorship include the following:
  - Have to supply all the different talents needed to make the business a success
  - If you die, the business dissolves
  - Have to rely on your own resources for financing
  - If the company incurs a debt or suffers a catastrophe, you are personally liable (you have unlimited liability)
- A general partnership is a business owned jointly by two or more people.
- About 10 percent of U.S. businesses are partnerships.
- The impact of disputes can be reduced if the partners have a partnership agreement that specifies everyone's rights and responsibilities.
- A partnership has several advantages over a sole proprietorship:
  - It's relatively inexpensive to set up and subject to few government regulations.
  - Partners pay personal income taxes on their share of profits; the partnership doesn't pay any special taxes.
  - It brings a diverse group of people together to share managerial responsibilities.
  - Partners can agree legally to allow the partnership to survive if one or more partners die.
  - It makes financing easier because the partnership can draw on resources from a number of partners.
- A partnership has several disadvantages over a sole proprietorship:
  - Shared decision making can result in disagreements.
  - Profits must be shared.
  - Each partner is personally liable not only for his or her own actions but also for those of all partners—a principle called **unlimited liability**.
- A limited partnership has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

Reflection Questions

- Would you prefer to carry the full weight of a business, or to trust a partner?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/186

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1. Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, accessed January 27, 2012 ↵
2. Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, accessed January 27, 2012 ↵
3. www.deloitte.com/view/en_GB/uk/about/our-history/index.htm ↵

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18.3: Reading- Corporations

Corporations

A **corporation** (sometimes called a *regular* or C-corporation) differs from a sole proprietorship and a partnership because it's a legal entity that is entirely separate from the parties who own it. It can enter into binding contracts, buy and sell property, sue and be sued, be held responsible for its actions, and be taxed. As Figure 1 shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues[1]. Most large well-known businesses are corporations, but so are many of the smaller firms with which you do business.

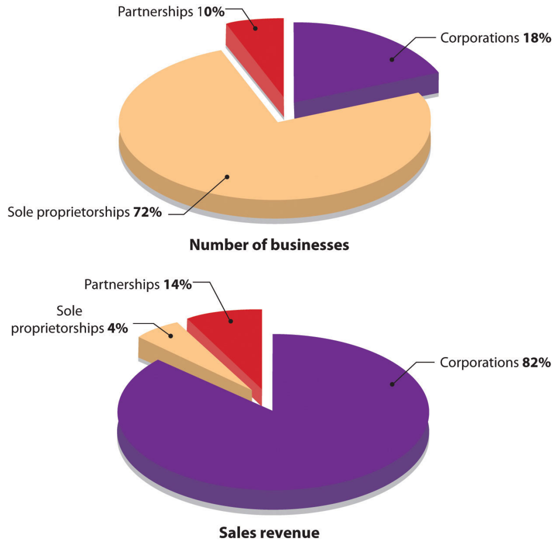

Figure 18.3.1: Types of U.S. Businesses[2]

Ownership and Stock

Corporations are owned by **shareholders,** who invest money in the business by buying shares of **stock**. The portion of the corporation they own depends on the percentage of stock they hold. For example, if a corporation has issued 100 shares of stock, and you own 30 shares, you own 30 percent of the company. The shareholders elect a **board of directors**, a group of people (primarily from outside the corporation) who are legally responsible for governing the corporation. The board oversees the major policies and decisions made by the corporation, sets goals, and holds management accountable for achieving them, and hires and evaluates the top executive, generally called the CEO (chief executive officer). The board also approves the distribution of income to shareholders in the form of cash payments called **dividends**.

Benefits of Incorporation

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

Limited Liability

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

Financial Resources

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

Specialized Management

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

Continuity and Transferability

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

Drawbacks to Incorporation

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

Another drawback to incorporation—one that often discourages small businesses from incorporating—is the fact that corporations are costly to set up. When you combine filing and licensing fees with accounting and attorney fees, incorporating a business could set you back by $1,000 to $6,000 or more depending on the size and scope of your business ("How Much Does It Cost to Incorporate?" *San Francisco Chronicle*, accessed August 27, 2011). 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" (Fred Chico Lager, *Ben & Jerry's: The Inside Scoop*, New York: Crown Publishers, 1994, p 91). 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 (Fred Chico Lager, *Ben & Jerry's: The Inside Scoop*, New York: Crown Publishers, 1994, p 103). Eventually, as the company continued to expand, the stock was sold on a national level.

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

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

Hybrids: S-Corporations and Limited-Liability Companies

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

Attractive and Unattractive Features of Corporations

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

What feature of corporations do business owners find **least attractive**? Most would agree that the least attractive feature of a corporation is "double taxation." Double taxation occurs when the same earnings are taxed twice by the government. Let's use a simple example to show how this happens. You're the only shareholder in a very small corporation. This past year it earned $10,000. It had to pay the government $3,000 corporate tax on the $10,000 earned. The remaining $7,000 was paid to you by the corporation in the form of a dividend. When you filed your personal income tax form, you had to pay personal taxes on the $7,000 dividend. So the $7,000 was taxed twice: the corporation paid the taxes the first time and you (the shareholder) paid the taxes the second time.

Attractive and Unattractive Features of Sole Proprietorships and Partnerships

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

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

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1. Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, accessed January 27, 2012 ↵
2. "Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2011 Statistical Abstract: The National Data Book, (accessed August 27, 2011); "Number of Tax Returns and Business Receipts by Size of Receipts," The 2011 Statistical Abstract: The National Data Book, (accessed August 27, 2011). ↵

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18.4: Reading- Hybrid Forms of Organization

Hybrid Forms of Organization

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

S-Corporation

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

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

Deciding to operate as an S-corporation presented the Tocci’s with some disadvantages: They had no flexibility in the way profits were divided among the owners. In an S-corporation, profits must be allocated based on percentage ownership. So if an owner/shareholder holds 25 percent of the stock in the S-corporation, 25 percent of the company profits are allocated to this shareholder regardless of the amount of effort he or she exerts in running the business. Additionally, the owners had to follow a number of formal procedures, such as electing a board of directors and holding annual meetings. Finally, they were subjected to heavy recordkeeping requirements. Despite these disadvantages, the Tocci’s concluded that on balance the S-corporation was the best form of organization for their business.

Limited-Liability Company

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

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

1. Has fewer ownership restrictions. It can have as many members as it wants—it is not restricted to a maximum of 100 shareholders.
2. Its members don’t have to be U.S. residents or citizens.
3. Profits do not have to be allocated to owners based on percentage ownership. Members can distribute profits in any way they want.
4. Is easier to operate because it doesn’t have as many rules and restrictions as does an S-corporation. It doesn’t have to elect a board of directors, hold annual meetings, or contend with a heavy record-keeping burden.

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

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

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

- Personally guarantees a business debt or bank loan which the company fails to pay
- Fails to pay employment taxes to the government that were withheld from workers' wages
- 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

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

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

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

Cooperatives

A **cooperative** (also known as a co-op) is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members. If run correctly, cooperatives increase profits for its producer-members and lower costs for its consumer-members. Cooperatives are common in the agricultural community. For example, some 750 cranberry and grapefruit member growers market their cranberry sauce, fruit juices, and dried cranberries through the Ocean Spray Cooperative (Ocean Spray History, company website, "about us," history, accessed June 19, 2008). More than three hundred thousand farmers obtain products they need for production—feed, seed, fertilizer, farm supplies, fuel—through the Southern States Cooperative. (Corporate information, Southern States Cooperative, accessed June 19, 2008). Co-ops also exist outside agriculture. For example, REI (Recreational Equipment Incorporated), which sells quality outdoor gear, is the largest consumer cooperative in the United States with more than three million active members. The company shares its financial success each year with its members, who get a refund each year based on their eligible purchases (2006 REI Stewardship Report, accessed June 19, 2008).

Not-for-Profit Corporations

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

There are more than 1.5 million not-for-profit organizations in the United States ("Number of Nonprofit Organizations in the United States, 1999–2009," Urban Institute, National Center for Charitable Statistics, accessed August 27, 2011). Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately $38 billion and has given away $25.36 billion since its inception ("Foundation Fact Sheet," The Bill and Melinda Gates Foundation, June 30, 2011, accessed August 27, 2011). Others are nationally recognized, such as United Way, Goodwill Industries, Habitat for Humanity, and the Red Cross. The vast majority is neither rich nor famous but nevertheless makes significant contributions to society.

Benefit Corporations

More companies are registering as benefit corporations which can more freely divert profits to their community and the environment, instead of focusing on maximizing shareholder profits.

KEY TAKEAWAYS

- A **corporation** (sometimes called a *regular* or C-corporation) is a legal entity that's separate from the parties who own it.
- Corporations are owned by shareholders who invest money in them by buying shares of stock.
- They elect a board of directors that's legally responsible for governing the corporation.
- A corporation has several advantages over a sole proprietorship and partnership:
  - An important advantage of incorporation is limited liability: Owners are not responsible for the obligations of the corporation and can lose no more than the amount that they have personally invested in the company.
  - Incorporation also makes it easier to access financing.
  - Because the corporation is a separate legal entity, it exists beyond the lives of its owners.
  - Corporations are generally able to attract skilled and talented employees.
- A corporation has several disadvantages over a sole proprietorship and partnership:
  - The goals of corporate managers, who don't necessarily own stock, and shareholders, who don't necessarily work for the company, can differ.
  - It's costly to set up and subject to burdensome regulations and government oversight.
  - It's subject to "double taxation." Corporations are taxed on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends.
- The **S-corporation** gives small business owners limited liability protection, but taxes company profits only once, when they are paid out as dividends. It can't have more than one hundred stockholders.
- A **limited-liability company** (LLC) is similar to an S-corporation: its members are not personally liable for company debts and its earnings are taxed only once, when they're paid out as dividends. But it has fewer rules and restrictions than does an S-

corporation. For example, an LLC can have any number of members.

- A **cooperative** is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members.
- A **not-for-profit corporation** is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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18.5: Reading- Franchising

Franchising

If you want to be a small business owner but are averse to the risks of starting your own business, you might opt to buy a franchise.

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

As you can see from the figure "The Growth of Franchising, 1980–2007" below, franchising has become an extremely popular way to do business. A new franchise outlet opens once every eight minutes in the United States, where one in ten businesses is now a franchise. Franchises employ eight million people (13 percent of the workforce) and account for 17 percent of all sales in this country ($1.3 trillion) ("Census Bureau's First Release of Comprehensive Franchise Data Shows Franchises Make Up More Than 10 Percent of Employer Businesses," U.S. Census Bureau, September 14, 2010," U.S. Census Bureau, www.census.gov/newsroom/releases/archives/economic_census/cb10-141.html, accessed August 31, 2011).

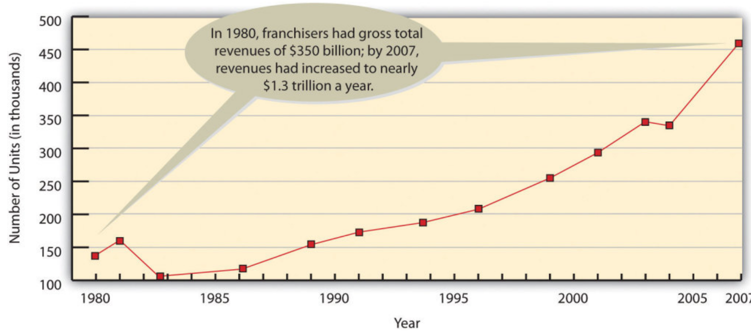

Figure 18.5.1: The Growth of Franchising, 1980–2007

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

Not surprisingly, these advantages don't come cheaply. Franchises can be very expensive, usually depending on the amount of business that a franchisee is expected to do. KFC franchises, for example, require a total investment of $1.3 million to $2.5 million each. This fee includes the cost of the property, equipment, training, start-up costs, and the franchise fee—a one-time charge for the right to operate as a KFC outlet. McDonald's is in the same price range ($1.1 million to $1.9 million). SUBWAY sandwich shops are more affordable, with expected total investment ranging from $84,000 to $258,000. If you'd prefer teaching dance and exercise classes, you could get a Jazzercise franchise for anywhere from $3,000 to $76,000. If you don't want to deal in food or dance, you might want to buy a dating service. The Right One® franchises go for an initial investment of $98,000 to $254,000, depending on location.

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

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

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

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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18.6: Reading- Mergers and Acquisitions

Mergers and Acquisitions

The headlines read, "Wanted: More than 2,000 in Google Hiring Spree" and "Help Wanted: Google Hiring in 2011." 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 with no new company being formed. An example of a *merger* is the merging in 2010 of United Airlines and Continental Airlines. The combined company, the largest carrier in the world, flies under the name United Airlines, but its planes display the Continental Airlines logo. The merger will combine the scale of United Airlines with the management culture of Continental. Another example of a fairly recent *acquisition* is the purchase of Reebok by Adidas for $3.8 billion (Theresa Howard, "Adidas, Reebok lace up for run at Nike," *US Today*, August 3, 2005, accessed June 20, 2008). The deal was expected to give Adidas a stronger presence in North America and help the company compete with rival Nike. Though Adidas still sells shoes under the Reebok brand, Reebok as a company no longer exists.

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

Do you think by acquiring Reebok, Adidas has had an impact on Nike's command of the running shoe market?

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" (Theresa Howard, "Adidas, Reebok lace up for run at Nike," *US Today*, August 3, 2005, accessed June 20, 2008).

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 is a major player on the East Coast, the Caribbean and Europe, while America West is 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 ("America West, US Air in Merger Deal," CNNMoney.com, May 20, 2005, accessed June 20, 2008).

Realize More Efficient Economies of Scale

The purchase of Pharmacia Corporation (a Swedish pharmaceutical company) by Pfizer (a research-based pharmaceutical company based in the United States) in 2003 created the world's largest drug maker and the leading pharmaceutical company, by revenue, in every major market around the globe. The acquisition created an industry giant with more than $48 billion in revenue and a research-and-development budget of more than $7 billion (Robert Frank and Scott Hensley, "Pfizer to Buy Pharmacia For $60 Billion in Stock," Wall Street Journal Online, WJS.com, July 15, 2002, accessed June 20, 2008). Each day, almost forty million people around the glove are treated with Pfizer medicines (About Pfizer, company Web site, accessed August 28, 2011). Its subsequent $68 billion purchase of rival drug maker Wyeth further increased its presence in the pharmaceutical market ("Pfizer Agrees to Pay $68 Billion for Rival Drug Maker Wyeth," *New York Times*, January 25, 2009, accessed August 28, 2011).

Hostile Takeover

What happens, though, if one company wants to acquire another company, but that company doesn't want to be acquired? You can end up with a very unfriendly situation. 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 unfriendly situations: Unilever—a very large Dutch/British company that owns three ice cream brands—wanted to buy Ben & Jerry's, against the founders' wishes. To make matters worse, 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 and run. In the end, Unilever won; Ben & Jerry's was acquired by Unilever in a hostile takeover. Despite fears that the company's social mission would end, this 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.

KEY TAKEAWAYS

- A **merger** occurs when two companies combine to form a new company.
- An **acquisition** is the purchase of one company by another with no new company being formed.
- Companies merge or acquire other companies to gain complementary products, attain new markets or distribution channels, and realize more-efficient economies of scale.
- A hostile takeover is an act of assuming control that is resisted by the targeted company's management and its board of directors.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

19: Module 8- Entrepreneurship

19.1: Why It Matters- Entrepreneurship

Why discuss the role of entrepreneurship in small business?

Figure 19.1.1: What do all of these items have in common? They all represent the efforts of entrepreneurs.

The American psyche often equates size with success, applying a “get big or get out” standard to industries ranging from agriculture and energy to social enterprise. Indeed, that phrase (decades before a variation became associated with living large) was the mantra of Secretary of Agriculture Earl Butz, whose policy changes supported the growth of major agribusiness corporations at the expense of the small family farm.

However, if American history has taught us anything, it’s that we are in charge of our destiny and our definition of success. Success can be achieved at any size and from any number of incubators (kitchen, garage, dorm room) and ad hoc office spaces.

Large financial institutions and corporations are often considered to be the engines of our economy, but big business is only half of the story—literally. While the majority of small businesses don’t operate at scale (roughly 70 percent have less than 100 employees) their cumulative economic impact is significant. Through inventions and innovations, entrepreneurs also shape how and how well we communicate, learn, live and experience life. Entrepreneurship matters not only because of the employment and productivity impact, but because small businesses contribute to the resilience of their communities and the nation and, by extension, to stability globally.

In this module, we’ll define small businesses and entrepreneurship, provide perspective on the opportunities and the risks, discuss common motivations and traits and finally the steps involved in developing a business plan.

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19.2: Introduction to Small Business

What you'll learn to do: Discuss the contributions of small business to the U.S. economy

Individual business ownership is a fundamental aspect of the American dream. Through the lens of award-winning documentary filmmaker Ken Burns: "Entrepreneurship is at the heart of who we are in terms of the American promise and the American dream."[1]

In this section, we'll discuss the definition and significance of the term "small business" and explore the impact small business has had on the US economy.

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1. Bova, Dan. "Ken Burns Talks About Leadership, Productivity and Achieving Immortality Through Storytelling," *Entrepreneur.com*. 15 Aug 2017. Web. 11 Nov 2018. ↵

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19.3: Understanding Small Businesses

Learning Objectives

- Define small business

The US Small Business Association, referred to as the "SBA," is the go-to source for all things small business—including the statutory definition of a small business. Classification as a small business is determined by size standards—either number of employees or revenue—based on industry. Specifically, size standards are based on the 6-digit "NAICS" or North American Industry Classification System code that describes a business's economic activity. Note that the form or legal structure of a business (e.g., sole proprietor, limited liability corporation (LLC), partnership, or corporation) is not a factor in determining whether an enterprise is a small business.

For manufacturing businesses, the standard is generally the number of employees, with maximums ranging from 500 to 1,500. For example, the employee maximum for a commercial bakery is 1,000 and for a business brewery, it's 1,250. For non-manufacturing industries—think retailers and wholesalers—the standard is based on a three-year average of annual revenue, with the maximum ranging from $750,000 for agriculture enterprises to $38,500,000 for Electronic Shopping and Mail-Order Houses, Hospitals and Building Material and Garden Home Centers.

The small business size standard for professional services (NAICS prefix 541) ranges from $7,500,000 for Architectural Services to $38,500,000 for Military and Aerospace Engineering. Research activities are subject to an employee standard. Financial institutions are an exception to the employee or revenue rule; commercial banks, savings institutions and credit unions are subject to a $550 million asset limitation. Clearly, small is relative! Note that size standards change periodically (above data is current as of October 2018). For the most recent criteria information, refer to the source: Code of Federal Regulations (eCFR) Part 121-Small Business Size Regulations, Section 121.201; direct link: Small Business Size Standards by NAICS Industry

Another determination option is to use the SBA's interactive Size Standards Tool. This tool is designed to answer the question "Are you a small business eligible for government contracting?" The tool provides a determination of either Yes ("you may be") or No, with the relevant small business size standard. To use this tool, you need to know your NAICS code or codes (multiple selections allowed). You can use the search tool on the census.gov site to determine the NAICS code(s) associated with your primary business activity (activities).

As alluded to above, classification as a small business matters because the SBA size standard is used to determine whether a business, including any affiliates or subsidiaries, is eligible to participate in SBA and federal contracting programs. This eligibility can have significant financial implications, from obtaining access to small business financing, including access to loans, investment capital and grants to preferential access to government contracts, totaling $392.4B (billion!) in eligible dollars in 2018.

In addition to meeting the relevant numerical size standard, a business must also meet the following criteria in order to be eligible for SBA and government contracting programs:

- For-profit enterprise
- Independently owned & operated
- Physically located & operating in the United States or its territories
  - If located outside the United States, it must maintain a US operation and make a significant contribution to the US economy through the payment of taxes or use of American labor, materials, or products
- Not in a dominant market position nationally

? PRactice Question

https://assessments.lumenlearning.co...essments/11026

? Try It

For perspective, the value of small business contracts rose from $100.1 billion in fiscal 2016 to $105.9 billion in fiscal 2017. To see data by year and category (e.g., Women Owned, Small Disadvantaged Business, Service Disabled Veteran) view the source at Small Business Dashboard. For additional information on federal contracting, visit the SBA’s Federal Contracting page.

Contributors and Attributions

19.4: Contributions of Small Businesses on the U.S. Economy

Learning Objectives

- Discuss the contributions of small businesses to the U.S. economy

When the Small Business & Entrepreneurship Council states that "American business is overwhelmingly small business," it's not just hype. According to the U.S. Small Business Administration, there are over 30 million small business in the United States, with small businesses accounting for 99.9% of all businesses. Small businesses play a crucial role in the US economy, responsible for roughly half of new job creation and economic activity, measured by GDP or Gross Domestic Product. Small businesses employ approximately 60 million Americans, or 47.5% of all U.S. employees. Embedded in the community, small businesses also drive local economic growth and vitality. There's a multiplier effect—an additional economic benefit that accrues to the community—when people spend locally. For example, If you spend $100 at a locally-owned business, $68 stays in the community. If you spend $100 at a national chain, only $43 stays in the community.

Small businesses are not only economic engines, they represent a source of innovation. In an article for Inc., Babson College entrepreneurship professor Patricia Green refers to small businesses as "the innovators of the world." In research done with Goldman Sachs 10,000 Small Business Program participants, Green found that the small-business owners were actively engaged in pursuing opportunities that met one or more of the innovation criteria established by economist and author Joseph Schumpeter:

1. new products
2. new methods
3. new markets
4. new sources of supply
5. new market structures

Entrepreneurs have conceived many of our most beloved products, including beer, chocolate chip cookies, Monopoly and personal computers. More recent innovations include a 3D printer for fabricating living cells, charitable crowdfunding, disinfectant light fixtures, artery stents, microfinance, non-toxic paints, and Structural Insulated Panels (SIPs).

Small businesses are as unique as the individuals that start them. Starting your own business allows you to develop a business concept and future vision that achieves your specific definition of "success." And different entrepreneurs will pursue different paths in achieving that vision.

Practice Question

https://assessments.lumenlearning.co...essments/11027

BioSIP

Award-winning architect and Colorado University architecture professor Julee Herdt is developing and testing her green building innovations primarily in the academic environment, using collegiate home design competitions as proof of concept. Herdt's BioSIP invention was cited by the international Solar Decathlon judges as being critical to the CU team's back-to-back (2002, 2005) wins in the Solar Decathlon competition.

Since those awards, Herdt has advanced BioSIPs structural insulated wall, floor and roof panels to exhibit strengths surpassing other SIPs in specific areas (compressive and transverse loading) as well as to exhibit super thermal values.

Herdt has been awarded 2 patents and her BioSIPs inventions have garnered a State of Colorado, US Green Building Council (USGBC) "New Products" and "Excellence in Renewable Energy in Buildings" awards and numerous grant awards.

Herdt is CEO of BioSIPs, Inc., a woman-owned tech-based corporation and CU's technology spin-off for commercialization of BioSIPs and other products from 100 percent diverted waste fibers.

LISNR

LISNR CEO Rodney Williams co-founded Lisnr, a technology start-up, while he was still working at Procter & Gamble. Technology wasn't new to him; he had 3 patents by the age of 27.

Williams, who had a vision for the Lisnr technology, met co-founder Chris Ostoich at P&G. The two co-found took their idea on The Startup Bus, a 72-hour technology business concept competition. The team met their third co-founder and first investor at South by Southwest, where the aspiring entrepreneurs made their pitches to business scouts and investors.

Their journey includes a number of lessons and cash flow challenges—common challenges for entrepreneurs. Read Williams' CNBC profile or watch the video for perspective on lessons learned on his journey from a six-figure corporate salary to $100,000 in debt to now, with 40 employees and founding of over $14 million. LISNR leadership was named a 2017 E&Y Entrepreneur of the Year.

Try It

- IndependentWeStand.org's article "What Happens When You Shop Locally."
- Time's article "25 Best Inventions of 2017."
- Inc.com's article "The 14 Coolest Products From Millennial Entrepreneurs."

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19.5: Introduction to Entrepreneurs

What you'll learn to do: identify the common traits of successful entrepreneurs

Free enterprise or entrepreneurship is ingrained in both the American legal system and psyche. There is a cultural ideal that people will be rewarded equitably for the work they put forth (though it's certainly up for debate how accurately this ideal reflects reality). This ideal is often what prompts entrepreneurship: the idea that one person can work hard enough to make a good idea a successful company, product, or service.

Although one's "entrepreneurial DNA" and definition of success may vary, entrepreneurship is universally an act of self-actualization. In this section, we'll explore what it means to be an entrepreneur, from definition to categories, traits and motivation.

Contributors and Attributions

19.6: What Is an Entrepreneur?

Learning Objectives

- Define entrepreneur
- Identify the common traits of successful entrepreneurs

An entrepreneur is someone who has a bias towards action. Someone who views the world through a different lens. Someone who takes 'no' for a challenge, not an answer.

—Matt Mickiewicz, Owner of 99Designs.com, Flippa.com & Sitepoint.com

Merriam-Webster defines an entrepreneur as "one who organizes, manages, and assumes the risks of a business or enterprise." What's missing—or perhaps understated—in this definition is the importance of initiative. That is to say, grammar aside, entrepreneur is a verb. Given this, it might be more accurate to define an entrepreneur as someone who sees an opportunity—some hole in the market, or some way to better provide a current service—and works effectively to create a solution, carefully designing how the solution will be made and distributed.

In expressing an insider's perspective, Atari and Chuck E. Cheese Founder Nolan Bushnell captures both the initiative and sense of urgency that is part of the entrepreneur's DNA: "A lot of people have ideas, but there are few who decide to do something about them now. Not tomorrow. Not next week. But today. The true entrepreneur is a doer, not a dreamer."

Try It

https://assessments.lumenlearning.co...essments/11028

Example: Young Entrepreneur Living the Dream

Jack Bonneau is the quintessential entrepreneur. In the three years he has been in business, he has expanded his product line, opened multiple locations, established strategic partnerships, and secured sponsorship from several national brands. His business has garnered publicity from *The New York Times*, *The Denver Post*, *The Today Show*, *Good Morning America*, and numerous other media. He has shared his business success on several stages, speaking at TechStars and the Aspen Ideas Festival, and recently delivered the closing keynote speech at a national STEM conference. He even landed a gig on *Shark Tank*.

Jack Bonneau is smart, charismatic, an excellent spokesperson, and persistent in his mission. And he is only 11 years old—which also makes him very adorable.

Jack's business was born from a need that most kids have: a desire for toys. He asked his dad, Steve Bonneau, for a LEGO Star Wars Death Star. The problem was that it cost $400. Jack's dad said he could have it but only if he paid for it himself. This led Jack to do what a lot of kids do to earn some extra cash. He opened a lemonade stand. But he quickly learned that this would never help him realize his dream, so, with the advice and help of his father, he decided to open a lemonade stand at a local farmers market. "There were lots of people who wanted to buy great lemonade from an eight-year-old," says Jack. In no time, Jack had earned enough to buy his LEGO Death Star. "I had sales of around $2,000, and my total profit was $900," Jack said.

Jack realized that he was on to something. Adults love to buy things from cute kids. What if he could make even more money by opening more locations? Jack developed an expansion plan to open three new "Jack Stands" the following spring. Realizing that he would need more working capital, he secured a $5,000 loan from Young Americas Bank, a bank in Denver that specializes in loans to children. Jack made $25,000 in 2015.

The following year, Jack wanted to expand operations, so he secured a second loan for $12,000. He opened stands in several more locations, including shopping malls during the holiday season, selling apple cider and hot chocolate instead of lemonade. He also added additional shop space and recruited other young entrepreneurial kids to sell their products in his space, changing the name to Jack's Stands and Marketplace. One of his first partnerships was Sweet Bee Sisters, a lip balm and lotion company founded by Lily, Chloe, and Sophie Warren. He also worked with 18 other young entrepreneurs who sell a range of products from organic dog treats to scarves and headbands.

Jack's strategy worked, and the business brought in more than $100,000 last year. This year, he became the spokesperson for Santa Cruz Organic Lemonade, and he's now looking at expanding into other cities such as Detroit and New Orleans.

Even though Jack is only 11 years old, he has already mastered financial literacy, customer service, marketing and sales, social skills, and other sound business practices—all the qualities of a successful entrepreneur.

Sources

"About Jack's Stands & Marketplaces," www.jackstands.com, accessed February 1, 2018; Peter Gasca

"This 11-Year-Old Founder's Advice Is As Profound as Any You Could Receive," Inc., https://www.inc.com, July 27, 2017; Claire Martin

"Some Kids Sell Lemonade. He Starts a Chain," The New York Times, https://www.nytimes.com, February 26, 2016.

Common Traits of Entrepreneurs

"The only skills you need to be an entrepreneur: an ability to fail, an ability to have ideas, to sell those ideas, to execute on those ideas, and to be persistent so even as you fail you learn and move onto the next adventure."

—James Altucher

As Joe Abraham found in his research, there's no blueprint for entrepreneurial success. There are, however, common characteristics of successful entrepreneurs. In Harvard Business Review's Entrepreneurs Handbook, the editors draw on research from multiple authors, organizing these common denominators in 5 categories:

1. Ideas & Drive
2. People Skills
3. Work Style
4. Financial Savvy
5. Entrepreneurial Background

Ideas and drive—creativity, vision and an ability to identify opportunities, in particular—are the elements without which there is no entrepreneurial venture. People skills include not only leadership but the ability to build networks, communicate an inspiring vision and influence people. Critical work style traits include a goal and planning orientation, a tolerance for uncertainty, a boot-strapping mindset, a commitment to continuous improvement, resilience and core business and relationship characteristics such as the ability to close a deal and accept advice. While in-depth accounting expertise isn't required, entrepreneurs should have a basic understanding of financial statements and associated concepts. Finally, entrepreneurship tends to run in the family, with 48% of entrepreneurs raised in a family business, Prior experience—from formal education, previous work experience, and past failures—are all factors that contribute to entrepreneurial success. In addition to the task-specific traits mentioned above, an ability to maintain balance; "grit and gratitude," as Avi Savar phrases it in an Inc. article, is essential for long-term business and psychological health.

? Try It

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To the health point, it's worth noting that at the extreme, our strengths become our weaknesses or vulnerabilities. We see this most clearly in the Builder, but the downside risk is not limited to that personality type. In "The Psychological Price of Entrepreneurship," Jessica Bruder provides perspective on the emotional toll a startup business can take on an entrepreneur. This is not just a rite of passage; veteran entrepreneur Elon Musk publicly exhibited and discussed the "excruciating" personal toll Tesla has had on him in 2018 and his claims regarding privatization cost him his role as Tesla Chairman (he remains CEO).

Entrepreneurship can also have a steep financial toll: it's difficult (if not sometimes impossible) to maintain a separate job to pay the bills while working to create a new business. Any new venture will take up-front financial investment, and sometimes that investment comes from the entrepreneur's own pocket rather than a third-party investor. However, if your idea pays off, the financial reward can make it worth it in the end.

Try It

Do you have what it takes to be an entrepreneur? Here are a few self-assessment options:

- Harvard Business Review's Should You Be an Entrepreneur? Test developed by Babson College Management Practice Professor Daniel Isenberg
- SBA's Small Business Readiness Assessment

If the assessments leave you undecided, consider one additional trait, drawn from Entrepreneur's "The 7 Traits of Successful Entrepreneurs" article: confidence. This is also a point made by LISNR Co-Founder & CEO Rodney Williams in his "So, You Want to Be An Entrepreneur?" article. His position: if you have to ask whether you're an entrepreneur, you're probably not. He refers to this as the "Miles Davis Test." Late in life, Davis was asked if he planned to continue making music. His response: I have to. I can't help it. That, according to Williams, captures "the soul of the entrepreneur."

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19.7: Types of Entrepreneurs

Learning Objectives

- Discuss the different types of people who become entrepreneurs

How do we begin to understand entrepreneurship and entrepreneurs? Entrepreneurs can be categorized by a number of dimensions including the size and scalability of the business, the form of business, whether a business is home-based, brick & mortar or online and other dimensions.

It's tempting (and, quite frankly, comforting) to believe that a successful entrepreneurial game plan can be used by another entrepreneur with similar success. The problem with this logic is that it assumes that all entrepreneurs are essentially the same. Clearly, that's not the case. In working with a number of startups, "Entrepreneurial DNA" author Joe Abraham realized that although entrepreneurs share common traits, they have distinctly different personalities and to be successful, the strategy has to match the person. Abraham found that entrepreneurs exhibit one of four distinct types of "entrepreneurial DNA," each with its own strengths, weaknesses and characteristics. In presenting his concept in a TED Talk, Abraham proposed thinking of the DNA types as "presets on your radio." Each button is associated with a set of predisposed behaviors and decision-making matrix. And for each preset, there's a different path to market.

Abraham translated this insight into the BOSI Framework, with four entrepreneurial DNAs: Builder, Opportunist, Specialist, and Innovator.

Builders

A **builder** is, as one would expect, focused on scaling the business quickly. They tend to be serial entrepreneurs, perpetually building and selling businesses, often in completely unrelated industries. To a builder, success is measured in infrastructure terms—for example, office square footage and size of payroll. Builders tend to excel at attracting talent, investors and customers, but can exhibit a Dr. Jekyll and Mr. Hyde behavior that results in high turnover. As Abraham notes, "if you look back on their history, you see a wake of dead bodies: key employees, spouses, children."

Brothers Jeff and Rich Sloan are a good example of builders, having turned numerous improbable ideas into successful companies. Over the past 20-plus years, they have renovated houses, owned a horse breeding and marketing business, invented a device to prevent car batteries from dying, and so on. Their latest venture, a multimedia company called StartupNation, helps individuals realize their entrepreneurial dreams. And the brothers know what company they want to start next: yours.[1]

Opportunists

An **opportunist** measures success in financial terms and is always scanning for the next money-making opportunity. Opportunists tend to be impulsive decision makers—for better or worse.

Jeff Bezos recognized that with Internet technology he could compete with large chains of traditional book retailers. Bezos's goal was to build his company into a high-growth enterprise—and he chose a name that reflected his strategy: Amazon.com. Once his company succeeded in the book sector, Bezos applied his online retailing model to other product lines, from toys and house and garden items to tools, apparel, music, and services. In partnership with other retailers, Bezos is well on his way to making Amazon's vision "to be Earth's most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online."—a reality.[2]

Specialists

Specialists are experts (e.g., accountants, doctors, lawyers) who generally spend their careers in one industry. They measure success based on their personal income. With an aversion to selling, their primary weakness is demand generation.

Sarah Levy loved her job as a restaurant pastry chef but not the low pay, high stress, and long hours of a commercial kitchen. So she found a new one—in her parents' home—and launched Sarah's Pastries and Candies.[3] In 2011, she rebranded her company as S. Levy Foods, expanding beyond her pastry focus. She now has five operating restaurants in airports across the United States where she seeks to bring "real food" to those traveling.[4]

Innovators

Innovators are the mad scientists of the world. They measure success based on impact; it's about the mission, not the money. Innovators are often accidental entrepreneurs; their weakness is business operations. They often start businesses just for personal satisfaction and the lifestyle. Miho Inagi is a good example of an innovator who built a company just for her personal satisfaction.

On a visit to New York with college friends in 1998, Inagi fell in love with the city's bagels. "I just didn't think anything like a bagel could taste so good," she said. Her passion for bagels led the young office assistant to quit her job and pursue her dream of one day opening her own bagel shop in Tokyo. Although her parents tried to talk her out of it, and bagels were virtually unknown in Japan, nothing deterred her. Other trips to New York followed, including an unpaid six-month apprenticeship at Ess-a-Bagel, where Inagi took orders, cleared trays, and swept floors. On weekends, owner Florence Wilpon let her make dough.

In August 2004, using $20,000 of her own savings and a $30,000 loan from her parents, Inagi finally opened tiny Maruichi Bagel. The timing was fortuitous, as Japan was about to experience a bagel boom. After a slow start, a favorable review on a local bagel website brought customers flocking for what are considered the best bagels in Tokyo. Inagi earns only about $2,300 a month after expenses, the same amount she was making as a company employee. "Before I opened this store I had no goals," she says, "but now I feel so satisfied."[5]

Practice Question

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To put faces on the labels, Donald Trump and Elon Musk are typical Builders, Virgin Group Founder Sir Richard Branson is a classic Opportunist, Bill Gates was a Specialist, and Mark Zuckerberg is an Innovator.

So why does the "type" of entrepreneur you are matter? Knowing yourself—your strengths and weaknesses—is key to selecting a business, assembling a team and developing a strategy that leverages your individual and collective (team's) entrepreneurial DNA. Specifically, it allows you to work with your strengths and hire to cover your weaknesses.

In an article for Entrepreneur, veteran startup mentor and angel investor Martin Zwilling recommends that every aspiring entrepreneur understand their DNA before they commit to a business venture. Indeed, he notes that investors and incubators have adopted the use of formal assessments such as StrengthsFinder as part of their screening process.

Try It

To identify your entrepreneurial DNA type, take the free assessment at the BOSI DNA website.

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1. "About StartupNation," https://startupnation.com, accessed February 1, 2018; Jim Morrison, "Entrepreneurs," American Way Magazine, October 15, 2005, p. 94. ↵
2. Barbara Farfan, "Amazon.com's Mission Statement", The Balance. April 15, 2018, https://www.thebalance.com/amazon-mission-statement-4068548. ↵
3. Martha Irvine, "More 20-Somethings Are Blazing Own Paths in Business," San Diego Union-Tribune, November 22, 2004, p. C6. ↵
4. S. Levy Foods, "About Us," http://slevyfoods.com. ↵
5. Andrew Morse, "An Entrepreneur Finds Tokyo Shares Her Passion for Bagels," The Wall Street Journal, October 18, 2005, p. B1. ↵

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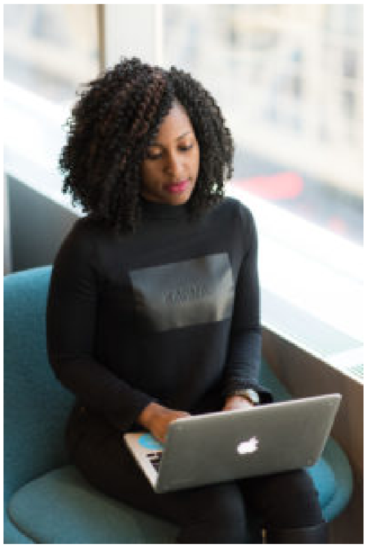
19.8: Reasons to Be an Entrepreneur

Learning Objectives

- List common reasons for choosing to be an entrepreneurs



As entrepreneurs often caution, being an entrepreneur is not a job, it's a lifestyle. Of course, that's precisely the attraction for many potential entrepreneurs. Life is more than a paycheck. Entrepreneurship is an alternative way of looking at the world and your place in it. For many, it's an opportunity to achieve their potential—a potential that may be limited or managed in a traditional job.

In an article for Entrepreneur, Uber Brands founder Jonathan Long cites 60 reasons to be an entrepreneur. Number 1 on his list: You have full control over your destiny. That's a particularly powerful motivator. Especially when you factor in the "at will" employment law (that is, you can be fired without cause), increased use of contingent labor (no benefits), gender and racial wage gaps and other predatory behaviors.

To the salary point, a woman earns on average 80.5 cents for every dollar a man earns. Breaking it down, the percentage of a white man's annual earnings by race is 87% for Asian women, 79% for white women, 63% for Black women and 54% for Hispanic women. A November 2017 World Economic Forum study projected that will take 100 years to close the gender pay gap. Further, instead of decreasing, the gap appears to be widening; the 2016 prediction was 86 years. What's particularly disturbing is what's been termed the "mommy penalty." A Senate Joint Economic Committee report found that women with children often earn less after returning to the workforce, while the opposite is true for working fathers. Key takeaway: if you're a woman and/or minority, the game is stacked against you. Perhaps it's time to take your marbles and start your own game with your own rules.

Try It

- The number of Hispanic-owned businesses almost tripled between 1997 (1.2 million) and 2012 (3.3 million).
- The percentage of U.S. businesses with 1 to 50 employees owned by African Americans increased by 50% between 1996 and 2015.
- Almost a million firms with employees are minority owned: 53% are Asian American owned, 11% are African American owned, and almost a third are Hispanic owned.
- 19% of all companies with employees are owned by women.

Entrepreneurial motivation short-list:

1. Opportunity to make an impact.
2. Ability to live by your own rules, from values and culture to dress code, work environment and location.
3. Membership in an elite group of leaders and doers.
4. No bench time or waiting to be chosen

5. Opportunity based on performance rather than degrees
6. Relative freedom from discrimination
7. The thrill of creation and the ongoing challenges of growth
8. Unlimited upside (financial) potential; no growth ceilings
9. Extreme learning & personal growth
10. Working with stimulating people and emerging ideas/technologies
11. Recognition—after all, entrepreneurs are the rock stars of the business world.
12. Build something for future generations.
13. Defining "success" in your own terms.

Employment dynamics and dysfunctions aside, the key is to understand your values and priorities and decide whether the entrepreneurial lifestyle is a fit of you. For more on this point, read The Balance Careers article How to Use Self Assessment Tools to Help You Choose A Career.

Watch It

The following short video is an example of the entrepreneurial spirit in action!

You can view the transcript for "Sriracha" (opens in new window) or the text alternative for "Sriracha" (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/11031

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1. Robert Bernstein, "Hispanic-Owned Businesses on the Upswing," International Trade Management Division, U.S. Census, https://www.census.gov, December 1, 2016; The Kauffman Index of Main Street Entrepreneurship, https://www.kauffman.org, November 2016. ↵

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19.9: Introduction to Advantages, Disadvantages, and Considerations

What you'll learn to do: discuss the advantages, disadvantages, and important considerations of starting a small business

As author and retired entrepreneur Carol Denbow writes in Are Your Ready to Be Your Own Boss?, "If you want your new business to succeed, you must know why most businesses fail." New business survival statistics are grim. From 2005–2017, approximately 21% of new businesses failed in the first year. Roughly half of new business fail within 4 years. And only 33% of new businesses survive for 10 or more years. Why do you think that is? Denbow's next sentence provides a clue: "Most people spend more time planning their vacations than they do their new businesses." In this section, we'll discuss the pros and cons of starting a small business and, in particular, how to improve the odds of success.

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19.10: Advantages and Disadvantages of Small-Business Ownership

Learning Objectives

- Describe the advantages and disadvantages of starting a small business

There are very few things in life that can compare to the experience of creating your own business. As investor and former entrepreneur James Caan expresses it: "Nothing will ever replace the thrill of creating a profitable company from scratch."

Starting a small business is a matter of self-selection and self-determination. While the founders of small businesses still are a part of the society they live in, their business ventures can allow them to step into an alternate reality, part of a social order in which each person—regardless of gender, race, ethnicity, religion, birth or circumstances—can achieve their fullest potential and receive recognition for their achievements.

A small business owner has an extreme amount of latitude in both business and lifestyle choices, from developing the business concept and operating environment to defining success. The benefits—measured in impact, revenue, or infrastructure terms—are essentially unlimited. Perhaps the most nebulous, but important, benefit of being a small business owner is the freedom to choose your business's purpose and goals.

The flip side is that you own the decisions and the results of those decisions. Evasion is not an option: you can't say, "it's not my job," point fingers, shrug or check out. Additionally, as a small business owner, you will probably be risking your own (and, perhaps, friends & family) capital. Essentially, you're flying without a net. There's no guarantee of a regular paycheck and no paid or subsidized benefits (including a retirement plan, holidays, or perks). You're responsible for business development, business planning, HR, IT, and every other function as well.

Freedom from an employer's expectations comes at a cost: you're responsible for setting and managing expectations—for yourself and others—and for making the magic happen.

Practice Question

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19.11: Why Some Ventures Fail

Learning Objectives

- Explain why some business ventures fail

Denbow's point about the importance of planning is cited in virtually every list of causes of failure. Why is this so critical? Failure to do the research, analysis and financial projections that business planning entails makes a small business more vulnerable to the following common causes of failure:

- Inability to execute on the business concept
- Lack of or insufficient market demand
- Lack of product or service (competitive) differentiation & other marketing issues (the four Ps of marketing)
- Lack of awareness of and/or ability to respond to emerging trends, relevant developments (technology, regulatory, geo-political, environmental) and competitive actions
- Overdependence on a single customer
- Inability to manage growth
- Inadequate cash reserves or failure to effectively manage cash flows. Related point: inadequate cash controls or personal/business separation, including using business revenue as a personal slush fund
- Insufficient management experience or product/services expertise
- Lack of self-awareness and related personal/professional development
- An inability to acknowledge weakness and/or compensate for skill and expertise gaps

One of the most critical risk factors is the founder's attitude and self-awareness, including the ability to objectively assess his or her management skills (or accept external feedback on this point), recruit to address skill and expertise gaps and effectively delegate responsibilities.

Statistics aside, it's important to understand that failure isn't final. The upside of failure is experience, a factor that contributes to success. Thus, the phrase "fail forward." As Mike Maddock notes in his take-off on this concept: "the most inventive people are usually the best at failing forward, i.e., learning from what went wrong."

Practice Question

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19.12: Considerations When Starting a Business

Learning Objectives

- List important considerations in deciding to start a business

The three fundamental questions to consider when deciding to start a business are:

1. Do you have what it takes?
2. Do you have a viable concept?
3. Is the reason you want to start a business consistent with your character and concept?

Yourself

Do you have what it takes?

The entrepreneurial assessments discussed earlier this module are a good starting point for self-assessment. Additionally, you might want to take the Grit Test developed by psychology professor and researcher Angela Duckworth.

Another way to approach the question is to review the type of questions a founder might ask in an interview and consider whether you would hire yourself. For perspective, scan the questions —and thought process behind the questions—shared by startup leaders and others in Firstround.com's The Best Interview Questions We've Ever Published. According to Anne Dwane, one of the serial entrepreneurs interviewed, "the most important quality any start-up leader (current or aspiring) can have is adaptability." To get at that, she asks (and you might want to ask yourself – and reflect on your responses) the following questions:

- What have you started?
- How would you describe yourself in your own words?
- How would a colleague describe you in three adjectives?
- What current trends are you seeing in your profession? (Substitute your target industry/market for your profession)
- What new things have you tried recently?

Additional questions to consider include Koru co-founder and CEO Kristen Hamilton's questions regarding grit, rigor, impact and ownership.

Your Concept

Do you have a viable concept?

Viability is something that will come out of the business planning process, which we will discuss in the next few sections. Before you dive into a business, it's essential to do careful planning to ensure that the venture has potential to succeed. Jumping in with no information and no plan is a recipe for disaster.

Your Business

Is the reason you want to start a business consistent with your character and concept?

The third consideration is doing a reality check on why you want to start a business. Consider Dwane's opening question: "what motivates you and what do you want to do next?" Can you connect the dots? Starting a new small business will require a lot of time and energy—if you're not truly passionate about your venture, especially when it's new, it (and you!) won't be able to stand up to the stress of day-to-day business.

Practice Question

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Starting a Business

Starting a business doesn't have to be an all or nothing proposition. A number of successful entrepreneurs developed their business concepts while in school or working a traditional job. In his "The Surprising Habits of Original Thinkers" TED Talk, Organizational psychologist, professor and author Adam Grant discusses the mistake he made in passing on an opportunity to one of his student's start-ups. He assumed that because the founders were working internships while developing the concept and had lined up jobs as a Plan B, they didn't have the commitment to make the business a success.

The business the students launched: Warby Parker, a glasses e-tailer that Fast Company named as the world's most innovative company in 2016. Warby Parker is currently valued at $1.75 million. For additional perspective, read Jason DeMers The Pros and Cons of Starting a Business While Working A Full-Time Job for Entrepreneur.

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19.13: Introduction to Steps to Starting a Business

What you'll learn to do: describe the steps to starting a business

In this section, we move from introspection and the nature of entrepreneurship to the specific steps involved in starting a business. Reducing the process to a list of steps is deceptive; it can take from a month to a year to get started and the work involved will test both your grit and your rigor. As Walt Disney said: "The way to get started is to quit talking and begin doing."

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19.14: Ten Steps to Starting a Business

Learning Objectives

- List the steps to starting a business
- Briefly describe the steps to starting a business

The Small Business Association's (SBA) 10 Step Guide to Starting a Small Business includes the following action items, with links to the associated detail page.

1. Conduct market research
2. Write your business plan
3. Fund your business
4. Pick your business location
5. Choose a business structure
6. Choose your business name
7. Register your business
8. Obtain federal and state tax IDs
9. Apply for state licenses and permits
10. Open a business bank account

The IRS site is the source of federal action items, including requesting employer IDs and accessing tax forms and publications. Direct link to the IRS Small Business and Self-Employed portal. For state-specific guidelines, you can use the IRS' State Government Websites page as a jumping off point or use a search phrase such as "starting a business in [state]." Your city or county may have additional requirements; refer to the relevant site for any permit or licensing requirements.

The nonprofit small business education and mentoring organization SCORE is another source of start-up information including a Simple Steps for Starting Your Business workbook, online course and additional resources and webinars. Visit SCORE's website if you want to learn more. Finally, your city or county may have an economic development program that provides business planning expertise, relevant economic data and access to funding.

Practice Question

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In this section, we'll discuss each of the 10 start-up steps briefly, so you understand the flow and see the connections between the individual action items.

Step 1: Conduct Market Research

As Peri Pakroo notes in The Women's Small Business Start-Up Kit (an excellent resource regardless of your gender), "Before you launch any business—even before you write a business plan—you'll need to gather information and do research to demonstrate that your idea will be successful." The key insight is that doing research first allows you to test drive and fine tune—or reject, if necessary—your business concept, reducing the risk of your new venture.

SBA's Conduct Market Research page recommends two areas of research: market and competitive. You'll use market research to understand consumer behavior and market and economic factors. Competitive research will inform your business offering and positioning relative to the existing product or service providers in your market.

Step 2: Write Your Business Plan

We'll drill down into business plans in the next section. Interim perspective: Your business plan distills your research and analysis into an actionable plan, including your unique value proposition, competitive strategy and what it will take—in specific operating and financial statement terms—to succeed.

Step 3: Fund Your Business

There's a range of options for funding your business: self-financing, microloans, crowdfunding (see Fundly's top 40 ranking), regional development or government grants and loans, business competition awards and venture capital. What's important to note is that a business' start-up costs (developed in the business plan) and choice of funding have implications for the business structure and business ownership/management.

Step 4: Pick Your Business Location

Selecting a business location depends on a range of factors including your type of business, proximity to your target market, business partners, economic development support, suppliers and your personal preferences. In addition, you will need to factor in taxes, zoning laws and other fees and regulations relevant to your business operation.

Step 5: Choose A Business Structure

As the SBA site notes: "The business structure you choose influences everything from day-to-day operations, to taxes, to how much of your personal assets are at risk. You should choose a business structure that gives you the right balance of legal protections and benefits." The table below summarizes the options and liability and tax implications.

Liability and Tax Implications for Different Types of Business Ownership

Business structure	Ownership	Liability	Taxes
Sole proprietorship	One person	Unlimited personal liability	Personal tax only
Partnerships	Two or more people	Unlimited personal liability unless structured as a limited partnership	Self-employment tax (except for limited partners) Personal tax
Limited liability company (LLC)	One or more people	Owners are not personally liable	Self-employment tax Personal tax or corporate tax
Corporation – C corp	One or more people	Owners are not personally liable	Corporate tax
Corporation – S corp	One or more people, but no more than 100, and all must be U.S. citizens	Owners are not personally liable	Personal tax
Corporation – B corp	One or more people	Owners are not personally liable	Corporate tax
Corporation – Nonprofit	One or more people	Owners are not personally liable	Tax-exempt, but corporate profits can't be distributed

Note as well that the business structures entail different levels of administrative paperwork and cost of incorporation. For example, the cost of a sole proprietorship is generally just the cost of registering a "DBA" or Doing Business As (also referred to as a trade name, fictitious name if you're not conducting business in your own name; incorporating requires extensive record-keeping, operational processes and reporting as well as higher registration or filing fees. If you're particularly focused on social impact and/or sustainability, you may want to explore structuring as a Benefit Corporation, Certified B Corp or "L3C," low-profit limited liability company structures.

Step 6: Choose Your Business Name

Choosing a business name is an opportunity to communicate not only what you do but who you are: the personality and your unique value proposition. You may want to create multiple options and test drive your short list with people who represent your target audience. Also consider how your name will look in print and using the type of signage and advertising you plan to use. Prior to committing to a name, check domain name and DNA registrations to make sure the name is available and use a trademark search tool such as the U.S. Patent and Trademark Office's trademark search tool to avoid infringement.

Depending on your business, your social media presence may be your website, so be sure to claim and manager your business identity on relevant rating sites such as Yelp, TripAdvisor. One way to monitor your business reviews is to set up a Google Alert on your business name.

Step 7: Register Your Business

Business registration requirements are based on business structure and location. As the SBA site notes:

- Entity name protects you at state level
- Trademark protects you at a federal level
- Doing Business As (DBA) doesn't give legal protection, but might be legally required
- Domain name protects your business website address

To the DBA point: A duplicate name will generally not be approved. Prior to filing, conduct a DBA search to verify that the name you want to use is not already in use. At a local If you're conducting business using your legal name (versus a DBA), there is generally no registration required.

Step 8: Obtain Federal and State Tax IDs

The downstream effect of income is taxes. Enter federal and state tax IDs. At a minimum, you will need an Employer Identification Number (EIN) or federal tax ID number, with the potential exception of sole proprietors. For elaboration on that point, refer to the When does a sole proprietor need a EIN? Discussion on the NOLO site. In addition to paying federal taxes, you will need an EIN to hire employees, open a business bank account and apply for business licenses and permits. To determine whether you need a state tax ID, use the state lookup function on the SBA site and research from there.

Step 9: Apply For State Licenses and Permits

Depending on where you plan to open your business, the licenses and permits will vary. The SBA advises that in order to make an informed strategic decision about your business' location and activities, you will need to apply for state licenses and permits and keep track of when they expire.

Step 10: Open A Business Bank Account

The SBA advises new business owners to open a business bank account as soon as they start accepting or spending money as a business. Doing so avoids one of the risk factor the commingling of personal and business assets cited as a failure risk factor in the prior section. Business author and coach Peri Pakroo also cautions against running your business out of your personal account, citing two specific reasons:

1. If you created an LLC or a corporation to protect your personal assets, commingling business and transactions undermines that protection.
2. If combining business and personal transactions will make it much more difficult to do essential financial management tasks.

You may want to read a few Best Banks for Small Business articles to evaluate the options. SmartAsset's Best Banks for Small Business (2020) analysis is one of a number of analyses.

Practice Question

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19.15: Introduction to Business Plans

What you'll learn to do: list and describe the key components of a business plan

Alan Lakein, an author who writes about personal time, sets the stage for this section. He says, "Planning is bringing the future into the present so that you can do something about it now."

Business planning forces an entrepreneur to develop a detailed understanding of the market—including their unique value proposition, competitive strategy, and what it will take to succeed. This understanding includes specific operating and financial statement terms, which often take a significant amount of research and time to discover.

In this section, we will focus in on the business plan, which pulls together the research, analysis and self-assessment of prior sections.

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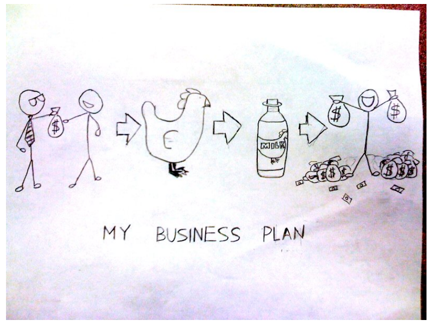
19.16: Create Your Business Plan

19.16: Create Your Business Plan

Learning Objectives

- List the components of a business plan
- Briefly describe the components of a business plan



The SBA recommends prospective entrepreneurs address the following nine elements in their business plan:

1. Executive Summary
2. Company Description
3. Market Analysis
4. Organization & Management
5. Service or Product Line
6. Marketing & Sales
7. Funding Request
8. Financial Projections
9. Appendix

The SBA provides two example business plans for reference: consulting firm example business plan and toy manufacturer example business plan.

Note that the length and depth of business plans vary depending on the audience and objective. For example, a business owner(s) seeking a traditional bank loan will likely need a more detailed plan. An alternative is the lean business plan, which PaloAlto Software and BPlan founder and CEO Tim Berry claims can be completed in an hour. The process and timeframe is probably more applicable to a seasoned entrepreneur, but it may be worth reading Berry's Fundamentals of Lean Business Planning blog post to see if it's a fit. There are a number of one page business plan templates freely available online; to view a range of options, conduct an image search on "one page business plan template." A final approach for consideration is venture capitalist Guy Kawasaki's 10/20/30 formula: 10 slides, 20 minutes, 30 point font. In those 10 slides, Kawasaki recommends eliminating pitch-speak and focusing on the topics that matter to a VC:

1. Problem
2. Your solution
3. Business model
4. Underlying magic/technology
5. Marketing and sales
6. Competition
7. Team
8. Projections and milestones
9. Status and timeline
10. Summary and call to action

? Practice Question

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Understanding the Components of Business Plans

Although terminology and formats differ, most business plans include the same key ingredients. Let's drill down into the elements SBA recommends:

Executive Summary

Briefly summarize what you do (Product or Service) for whom (Target Market) and what will make you successful. Elements to include: mission statement, management and organizational structure highlights, intended location and scale of operation. If you're seeking financing, include summary-level financial information and growth projections.

Company Description

In this section, provide a more detailed description of your company, including the opportunity (aka market problem addressed) and your solution. Be specific in identifying your target market, including a description of the consumer profile or list of target businesses or organizations. This is where detail your competitive advantage, including management expertise and/or product, process, or other differentiators.

Market Analysis

This is where the rigor of your research pays off. Use this section to summarize your understanding of the economy, industry, your target market and related trends and developments. This is also where you would incorporate competitive research, including success factors and what your positioning and value proposition will be relative to competitors. For perspective on competitive mapping, see the links to sample analyses below:

- Business News Daily.com: Porter's Five Forces: Analyzing the Competition
- Simplicable's 3 Examples of a Competitive Map
- Harvard Business Review's Mapping Your Competitive Position

Organization & Management

In this section, describe your legal structure (e.g., sole proprietor, partnership, corporation) and introduce yourself and management team or advisors, if applicable. You may also want to elaborate on any related points or motivations such as a social impact or sustainability orientation. If applicable, include an organizational chart so readers can visualize who's in charge of what functions.

You may also want to include key accomplishments to illustrate what specific expertise each person brings to the team. Key management resumes can be included in the Appendix.

Service or Product Line

Use the product or service section to detail your offerings and any market differentiators such as copyrights or patents. Explain what benefit your product or service delivers to your customers, in particular relative to competitive offerings. If applicable, highlight quality and/or process or material supply certifications and any other points that influence purchase decisions or reduce business risk.

✔ Cliff Bar

Cliff Bar is a case study in using sustainability as a business strategy and competitive differentiator. For perspective, read UC Davis' Clif Bar: Raises the Bar on Sustainability write-up of Clif Bar President and Chief Operating Officer Kevin Cleary's Dean's Distinguished Speaker presentation. Research and development activities and any related funding should also be detailed in this section.

Marketing & Sales

In a world where consumers are overwhelmed by choices, you can't expect a better product or service to win on merit alone. Your task in this section is to describe your plan to bring your product or service to market. You should also detail how the sales will happen so related costs and technology can be factored into your financials. The complexity of your marketing activities and sales process (and corresponding sales lead time) will depend on your product or service.

? Try It

For a general perspective, see Fitsmallbusiness.com's Sales Funnel Templates, Definition & Stages article. The approach that works for you will depend on your business and your nature. The good news is technology has made a range of low cost options available.

For a dose of marketing perspective and creative inspiration, read Creative Guerilla Marketing's What is Guerilla Marketing article.

Funding Request (if applicable)

If you're using your business plan to request funding, this section is where you'll detail your funding requirements and the intended use of those funds over the next five years. The SBA recommends specifying whether you're asking for debt or equity financing and your desired terms, including interest rate and time period. Provide an explanation of the funding need—for example, to cover operating expenses while building a revenue pipeline. Finally, state your future strategic plan, whether it's paying off debt or selling the business.

Financial Projections

A business plan is nothing without numbers and financial statements should be prepared regardless of whether you're requesting funding or using your business plan as proof of concept. Projections should cover a five year period and include a financial outlook summary as well as forecasted income statements, balance sheets, cash flow statements and capital expenditure budgets.

The SBA advises using more detailed (quarterly or monthly) projections for the first year. This level of detail also serves as a reality check and early warning for you as a business manager as you implement your plan. If your business is an ongoing concern, include actual income statements, balance sheets, and cash flow statements for the last three to five years. If you have other assets you're prepared to offer as collateral, list them in this section. Review your projections and funding request details to make sure the narrative and numbers are in synch. This section runs the risk of becoming a blur of numbers without significance. Be thoughtful and creative (with your design, not the numbers) in order to present your financials in a clear and compelling manner.

Appendix

The Appendix is used to provide supporting detail and provide any other relevant or requested documentation. The SBA lists the following common items to include: credit histories, resumes, product pictures, letters of reference, licenses, permits, or patents, legal documents, permits, and other contracts.

Resources

SBA's Business Plan Tool (registration required)

? Practice Question

https://assessments.lumenlearning.co...essments/11038

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19.17: Putting It Together- Entrepreneurship

We began this module by considering the contributions of entrepreneurs not only to the economy but to our daily lives. Reflecting on what you have learned in this module, think for a moment about how far entrepreneurs have taken us, our economy, and the world. From the Wright Brothers who owned a bicycle shop in Dayton, Ohio…

. . . to this video of a modern day airplane.

You can view the transcript for "Plans for Space Tourism" (opens in new window) or text alternative for "Plans for Space Tourism" (opens in new window).

Summary

Entrepreneurs are the rockstars of the business world. However, as entrepreneur and venture capitalist Mark Suster notes, being an entrepreneur is only sexy for those who aren't entrepreneurs. The reality is "it's gritty, tough work where you will be filled with self-doubt. Entrepreneurs are survivors." In a Forbes interview, serial entrepreneur and Dopple Cofounder Chao Wang echoed that sentiment, noting that behind the social media scenes – what interviewer and fellow entrepreneur Carrie Kerpen terms "hustlebrags" – "is the unglamorous nuts and bolts of building a company." The flip side is that working for someone else can also be gritty, tough work – without the ownership upside (or glory).

Many people consider working for someone else – the "guarantee" of a weekly or biweekly paycheck – as the less risky option. Risk is relative. During the last ("Great") recession, officially from December 2007 to June 2009—financial institutions and automotive manufacturers were bailed out but 8.7 million people lost their jobs, approximately eight million homes were foreclosed on, 2.5 million businesses closed, food insecurity spiked and income inequality grew to a level not seen since the Great Depression. Perhaps the most significant statistic: 95% percent of the gains from economic recovery since 2009 have gone to the top 1% of earners. On the risk point, legendary investor and Berkshire Hathaway chairman and CEO Warren Buffet comments: If you think being an entrepreneur is risky, try working for someone else for 40 years and living off social security."

There's an essential difference between someone who is looking for a job and someone who wants to start a business. Entrepreneurship isn't so much a choice as a compulsion. LISNR CEO and Cofounder Rodney Williams cites "sheer ambition" as his driver, a desire to test his grit and a belief that he could "do something great….So I did."

For those who are flirting with the idea of entrepreneurship, there are a multitude of assessments and articles on the best time or place or age to become an entrepreneur. All good perspective, but trying to time an entrepreneurial bid is a bit like trying to time the market. The only things that have proven to improve the odds of a successful start-up are planning—specifically, developing a business plan that reflects economic, personal and marketing realities—and experience.

To the latter point, Wang mentions in her interview that she had originally considered attending business school but found "actually building companies was so much more educational and gratifying." Her closing advice: "Just get started—it's never the perfect time. It's always going to feel scary. And detach your sense of accomplishment, happiness, and self-worth from how productive you are, or how fast your company is growing, or whatever OKRs or KPIs that seem hugely important. I've always placed high importance on loving the process—I'm excited by the day-to-day challenges versus just finding happiness in reaching the milestones."

? Try It

The Small Business Administration Website has a wealth of resources for starting entrepreneurial ventures in the U.S.

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19.18: Discussion- Wanda’s Entrepreneurial Spirit

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document “Salty Pawz Background.”

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda comes to you because she is discouraged and needs to talk. Her parents have heard she is thinking of expanding her business and even possibly taking out a second mortgage on her home to fund the expansion. They have never been overly supportive of her business, but as long as it seemed like a hobby, they didn’t have much to say. Recently Wanda’s mother expressed strong reservations about Wanda taking such a large step. This made a big impression on Wanda. She tells you she doesn’t want her business to cause a rift in the family. Perhaps she should take her parents’ advice and just forget expanding the business. Moreover, she doesn’t understand why her parents aren’t as excited about the prospects for the business as she is.

For Discussion

1. Using what you know about entrepreneurs, why would Wanda’s parents not see things the way that she does? What positive characteristics of entrepreneurs is Wanda exhibiting?
2. Do you know an entrepreneur personally? If so, what characteristics do you see in entrepreneurs that you have to presume Wanda shares? If you don’t know an entrepreneur, then look to the world of business and use one about whom you can do a little research. Some examples of famous entrepreneurs are Sir Richard Branson (Virgin Wireless, Virgin Galactic), Elon Musk (Tesla), Oprah Winfrey (the “O” Brands). What characteristics do you think these famous entrepreneurs probably share with Wanda?

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

Contributors and Attributions

19.19: Discussion- Am I an Entrepreneur?

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Download and complete the "Entrepreneurial Self-Assessment Survey" that your instructor has provided (You can download the .docx file for the Entrepreneurial Self-Assessment Survey here). When completing this survey, remember that there is no right or wrong answer, and you should be as honest in your responses as possible. Once you have completed the survey, score your results using the scale found on the last page of the survey. You will need your score in order to complete the discussion assignment.

Once you have completed and scored your Entrepreneurial Self-Assessment Survey, when making your initial post, begin your post with something like this: "I scored 44 and self-employment may not be an appropriate career for me."

For Discussion

1. Were you surprised by the results of your self-assessment? In other words, did you regard yourself as more or less of an entrepreneur than the survey indicated?
2. Of the entrepreneur characteristics measured in this assessment, which do you believe is the most important and why?
3. What do you believe the outcome would be if someone took this assessment and scored very low, but ignored the results and opened a business anyway?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

Contributors and Attributions

19.20: Assignment- Dear Wanda's Mom

Scenario

Wanda comes to you because she is discouraged and needs to talk. Her parents learned that she is thinking of expanding her business and possibly even taking out a second mortgage on her home to fund the expansion. They have never been overly supportive of her business, but as long as it seemed like a hobby, they didn't have much to say. Recently Wanda's mother called and expressed strong reservations about Wanda taking such a large step. This made a big impression on Wanda. She tells you that she doesn't want her business to cause a rift in the family. Perhaps she should take her parents' advice and just forget about expanding the business. Moreover, she doesn't understand why her parents aren't as excited about the prospects for the business as she is.

Your Task

You decide that you are going to take matters into your own hands and go directly to the source of the problem: Wanda's mother! In this assignment you will write a letter to Wanda's mother and explain to her the positive characteristics of entrepreneurs that Wanda exhibits and how you know she will be successful. You can compare Wanda's Salty Pawz start-up to other more well-known entrepreneurs who took a risk and succeeded, or you can recount your actual experiences with an entrepreneur you know personally. The key is for Wanda's mother to understand that (1) it is not unusual for "non-entrepreneurs" to see things differently from the entrepreneurs, and (2) Wanda possesses many of the characteristics shared by successful entrepreneurs.

Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain why entrepreneurs encounter people who may not see things the way they do	0 points	22 points	32 points	40 points	40%
Discuss the positive characteristics of entrepreneurs exhibited by Wanda	0 points	22 points	32 points	40 points	40%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas.)	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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19.21: Assignment- Today’s Hottest Entrepreneurs

Preparation

Your life today would probably be very different if it weren’t for entrepreneurs—past and present. What if Steve Jobs had decided to become a dentist, or Jeff Bezos had taken a job as an accountant instead of founding Amazon? In the same way that entrepreneurs have shaped our past, there are those out there shaping our future.

In this written assignment, you will research an entrepreneur who is influencing not just the world you live in today but also the world you will live in tomorrow.

Your Task

1. Select an individual from the list below as the subject of your paper:
   - Reid Hoffman
   - Elon Musk
   - Drew Houston
   - Sara Blakely
   - David Karp
   - Jack Dorsey
   - Sergey Brin
2. Your paper must include, at a minimum, the following information:
   - General background information about the entrepreneur.
   - Specific information about the product, service, or industry that the entrepreneur is involved with, has founded, or plans to develop in the future.
   - How the entrepreneur’s innovations, products, service, goods have *already* affected our lives.
   - How the entrepreneur’s innovations, products, service, goods might affect our lives in the coming years.

Be sure to provide properly formatted APA citations for the sources you use in your paper.

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CHAPTER OVERVIEW

20: Module 8 Readings - Managing Processes

20.1: Reading- Operations Management in Manufacturing and Production

The Challenge: Producing Quality Jetboards

The product development process can be complex and lengthy. It took sixteen years for Bob Montgomery and others at his company to develop the PowerSki Jetboard, and this involved thousands of design changes. It seemed worth it: the Jetboard, an exciting, engine-propelled personal watercraft that's a cross between a high-performance surfboard and a competition water-ski/wakeboard, received extensive media attention and earned rave reviews. It was showered with honors, including *Time* magazine's "Best Invention of the Year" award. Stories about the Jetboard appeared in more than fifty magazines around the world, and it appeared in several movies, in over twenty-five TV shows, and on YouTube.[1] One reviewer of the Jetboard exclaimed, "Up, up and away. PowerSki's the closest you'll get to being Superman on the water. With 40 hp under your toes, the 100-pound board literally flies. You supply the cape."[2]

Montgomery and his team at PowerSki enjoyed taking their well-deserved bows for the job they did designing the product. But having a product was only the beginning for the company. The next step was developing a system that would produce high-quality Jetboards at reasonable prices. Before putting this system in place, PowerSki managers had to address several questions: What kind of production process should they use to make the Jetboards? How large should their production facilities be, and where should they be located? How should the plant be laid out? Should every component be made in-house, or should some be furnished by subcontractors? Where should they buy the materials they needed to build Jetboards? What systems would they need to ensure that production was as efficient as possible and that quality standards were maintained? Answering these questions helped PowerSki set up a manufacturing system through which it could accomplish the most important task that it had set for itself: efficiently producing quality Jetboards.

Like PowerSki, every organization—whether it produces goods or provides services—sees job number one 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 20.1.1 below illustrates this traditional function of operations management.

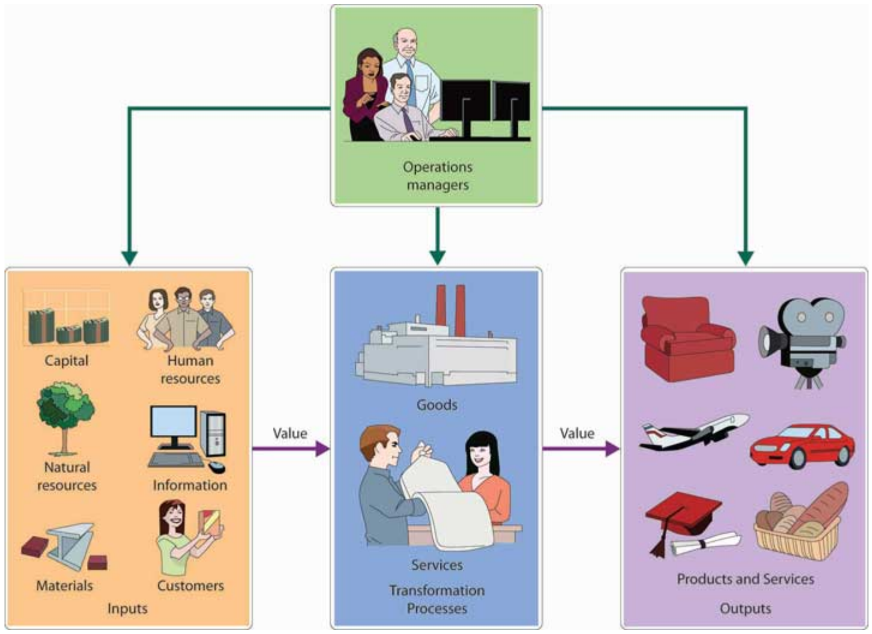

Figure 20.1.1: The Transformation Process

In the rest of this module, 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 by explaining the role of operations management in such processes as quality control and outsourcing.

Operations Management in Manufacturing

Like PowerSki, all manufacturers set out to perform the same basic function: *to transform resources into finished goods*. To perform this function in today's business environment, manufacturers must continually strive to improve operational efficiency. They must fine-tune their production processes to focus on quality, to hold down the costs of materials and labor, and to eliminate all costs that add no value to the finished product. Making the decisions involved in the effort to attain these goals is the job of the operations manager. That person's responsibilities can be grouped in the following way:

- *Production planning*. During production planning, managers determine how goods will be produced, where production will take place, and how manufacturing facilities will be laid out.
- *Production control*. Once the production process is under way, managers must continually schedule and monitor the activities that make up that process. They must solicit and respond to feedback and make adjustments where needed. At this stage, they also oversee the purchasing of raw materials and the handling of inventories.
- *Quality control*. Finally, the operations manager is directly involved in efforts to ensure that goods are produced according to specifications and that quality standards are maintained.

Let's take a closer look at each of these responsibilities.

Planning the Production Process

The decisions made in the planning stage have long-range implications and are crucial to a firm's success. Before making decisions about the operations process, managers must consider the goals set by marketing managers. Does the company intend to be a low-cost producer and to compete on the basis of price? Or does it plan to focus on quality and go after the high end of the market? Perhaps it wants to build a reputation for reliability. What if it intends to offer a wide range of products? To make things even more complicated, all these decisions involve tradeoffs. Upholding a reputation for reliability isn't necessarily compatible with offering a wide range of products. Low cost doesn't normally go hand in hand with high quality.

With these factors in mind, let's look at the specific types of decisions that have to be made in the production planning process. We've divided these decisions into those dealing with production methods, site selection, facility layout, and components and materials management.

Production-Method Decisions

The first step in production planning is deciding which type of production process is best for making the goods that your company intends to manufacture. In reaching this decision, you should answer questions such as the following:

- How much input do I receive from a particular customer before producing my goods?
- Am I making a one-of-a-kind good based solely on customer specifications, or am I producing high-volume standardized goods to be sold later?
- Do I offer customers the option of "customizing" an otherwise standardized good to meet their specific needs?

One way to appreciate the nature of this decision is by comparing three basic types of processes or methods: *make-to-order, mass production*, and *mass customization*. The task of the operations manager is to work with other managers, particularly marketers, to select the process that best serves the needs of the company's customers.

Make-to-Order

At one time, most consumer goods, such as furniture and clothing, were made by individuals practicing various crafts. By their very nature, products were *customized* to meet the needs of the buyers who ordered them. This process, which is called a make-to-order strategy, is still commonly used by such businesses as print or sign shops that produce low-volume, high-variety goods according to customer specifications.

Mass Production

By the early twentieth century, however, a new concept of producing goods had been introduced: mass production (or make-to-stock strategy)is the practice of producing high volumes of identical goods at a cost low enough to price them for large numbers of customers. Goods are made in anticipation of future demand (based on forecasts) and kept in inventory for later sale. This approach is particularly appropriate for standardized goods ranging from processed foods to electronic appliances.

Mass Customization

But there's a disadvantage to mass production: customers, as one contemporary advertising slogan puts it, can't "have it their way." They have to accept standardized products as they come off assembly lines. Increasingly, however, customers are looking for products that are designed to accommodate individual tastes or needs but can still be bought at reasonable prices. To meet the demands of these consumers, many companies have turned to an approach called mass customization, which (as the term suggests) combines the advantages of customized products with those of mass production.

This approach requires that a company interact with the customer to find out exactly what the customer wants and then manufacture the good, using efficient production methods to hold down costs. One efficient method is to mass-produce a product up to a certain cutoff point and then to customize it to satisfy different customers.

The list of companies devoting at least a portion of their operations to mass customization is growing steadily. One of the best-known mass customizer is Nike, which has achieved success by allowing customers to configure their own athletic shoes, apparel, and equipment through Nike's iD program. The Web has a lot to do with the growth of mass customization. Levi's, for instance, lets a woman find a pair of perfect fitting jeans by going through an online fitting process that first identifies her "curve" type: *slight* (straight figure), *demi* (evenly proportioned), *bold* (curvy figure, which experiences waist gapping in the back), and supreme (curviest shape, which needs a higher rise in the back). Oakley offers customized sunglasses, goggles, watches, and backpacks, while Mars, Inc. can make M&M's in any color the customer wants (say, school colors) as well as add text and pictures to the candy.[3]

Naturally, mass customization doesn't work for all types of goods. Most people don't care about customized detergents or paper products (although a customized Kleenex tissue box with your picture on it and a statement that says, "go ahead . . . cry over me!" might come in handy after a relationship breakup with your significant other.[4] And while many of us like the idea of customized clothes, footwear, or sunglasses from Levi's, Nike, or Oakley, we often aren't willing to pay the higher prices they command.

Facilities Decisions

After selecting the best production process, operations managers must then decide where the goods will be manufactured, how large the manufacturing facilities will be, and how those facilities will be laid out.

Site Selection

In choosing a location, managers must consider the following factors:

- To minimize shipping costs, both for raw materials coming into the plant and for finished goods going out, managers often want to locate plants close to suppliers, customers, or both.
- They generally want to locate in areas with ample numbers of skilled workers.
- They naturally prefer locations where they and their families will enjoy living.
- They want locations where costs for resources and other expenses—land, labor, construction, utilities, and taxes—are low.
- They look for locations with a favorable business climate—one in which, for example, local governments might offer financial incentives (such as tax breaks) to entice them to do business in their locales.

Managers rarely find locations that meet all these criteria. As a rule, they identify the most important criteria and aim at satisfying them. In deciding to locate in San Clemente, California, for instance, PowerSki was able to satisfy three important criteria: (1) proximity to the firm's suppliers, (2) availability of skilled engineers and technicians, and (3) favorable living conditions. These factors were more important than operating in a low-cost region or getting financial incentives from local government. Because PowerSki distributes its products throughout the world, proximity to customers was also unimportant.

Capacity Planning

Now that you know *where* you're going to locate, you have to decide on the quantity of products that you'll produce. You begin by *forecasting* demand for your product. As you may know, forecasting isn't easy. To estimate the number of units that you're likely to sell over a given period, you have to understand the industry that you're in and estimate your likely share of the market by reviewing industry data and conducting other forms of research.

Once you've forecasted the demand for your product, you can calculate the capacity requirements of your production facility—the maximum number of goods that it can produce over a given time under normal working conditions. In turn, having calculated your capacity requirements, you're ready to determine how much investment in plant and equipment you'll have to make, as well as the number of labor hours required for the plant to produce at capacity.

Like forecasting, capacity planning is difficult. Unfortunately, failing to balance capacity and projected demand can be seriously detrimental to your bottom line. If you set capacity too low (and so produce less than you should), you won't be able to meet demand, and you'll lose sales and customers. If you set capacity too high (and turn out more units than you should), you'll waste resources and inflate operating costs.

KEY TAKEAWAYS

- The job of **operations management** is to oversee the process of transforming resources into goods and services.
- The role of operations managers in the manufacturing sector includes production planning, production control, and quality control.
- During production planning, managers determine how goods will be produced (production process), where production will take place (site selection), and how manufacturing facilities will be laid out (layout planning).
- In selecting the appropriate production process, managers compare three basic methods: **make-to-order strategy** (goods are made to customer specifications), **mass production** or **make-to-stock strategy** (high volumes of goods are made and held in inventory for later sale), and **mass customization** (high volumes of customized goods are made).
- In choosing the site for a company's manufacturing operations, managers look for locations that minimize shipping costs, have an ample supply of skilled workers, provide a favorable community for workers and their families, offer resources at low cost, and have a favorable business climate.
- Managers estimate the quantity of products to be produced by forecasting demand for their product and then calculating the capacity requirements of the production facility—the maximum number of goods that it can produce over a given period under normal working conditions.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/216

1. Jetboard, (accessed October 19, 2011); Liquid Blue Features PowerSki Jetboards, YouTube video, 6:50, posted by "powerskijetboard," March 13, 2008, (accessed November 1, 2011); Jetboard, "Publicity," (accessed November 1, 2011). ↵
2. Cliff Gromer, "PowerSki Jetboard," *Popular Mechanics*, March 2000, (accessed June 1, 2008). ↵
3. See these websites for examples of customized products: Nike, Levi, Oakley, and Mars's M&M's (accessed November 2, 2011).↵
4. Anita Windisman, "*Personalized Packaging: Kleenex Offers Customizable Tissue Boxes*," One of a Kind Publishing, Inc., January 3, 2008, (accessed November 1, 2011).) ↵

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20.2: Reading- Facility Layouts

Facility Layouts

The next step, after planning the production process, is deciding on plant layout—how equipment, machinery, and people will be arranged to make the production process as efficient as possible. In this section, we'll examine four common types of facility layouts: process, product, cellular, and fixed position.

Process Layout

The process layout groups together workers or departments that perform similar tasks. *Goods in process* (goods not yet finished) move from one workstation to another. At each position, workers use specialized equipment to perform a particular step in the production process. To better understand how this layout works, we'll look at the production process at the Vermont Teddy Bear Company. Let's say that you just placed an order for a personalized teddy bear—a "hiker bear" with khaki shorts, a white T-shirt with your name embroidered on it, faux-leather hiking boots, and a nylon backpack with sleeping bag. Your bear begins at the fur-cutting workstation, where its honey-brown "fur" coat is cut. It then moves to the stuffing and sewing workstation to get its insides and have its sides stitched together. Next, it moves to the dressing station, where it's outfitted with all the cool clothes and gear that you ordered. Finally, it winds up in the shipping station and starts its journey to your house.

For a more colorful "Online Mini-Tour" of this process, log on to the Vermont Teddy Bear Web site.

Product Layout

Remember our Peeps at the start of the module? They were an example of a product layout. In a product layout, high-volume goods are produced efficiently by people, equipment, or departments arranged in an *assembly line*—that is, a series of workstations at which already-made parts are *assembled*. Just Born, a candy maker located in Bethlehem, Pennsylvania, makes a product called Marshmallow Peeps on an assembly line. First, the ingredients are combined and whipped in huge kettles. Then, sugar is added for color. At the next workstation, the mixture—colored warm marshmallow—is poured into baby-chick–shaped molds carried on conveyor belts. The conveyor-belt parade of candy pieces then moves forward to stations where workers add eyes or other details. When the finished candy reaches the packaging area, it's wrapped for shipment to stores around the world.

Both product and process layouts arrange work by *function*. At the Vermont Teddy Bear Company, for example, the cutting function is performed in one place, the stuffing-and-sewing function in another place, and the dressing function in a third place. If you are a cutter, you cut all day; if you're a sewer, you sew all day: that's your function. The same is true for the production of Marshmallow Peeps at Just Born: if your function is to decorate peeps, you stand on an assembly line and decorate all day; if your function is packing, you pack all day.

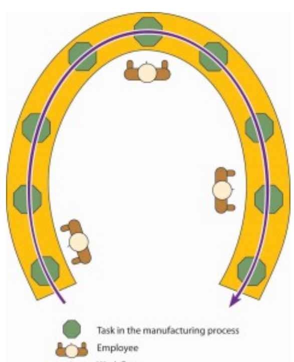

Figure 20.2.1: Cellular Layout

Cellular Layout

Arranging work by function, however, isn't always efficient. Production lines can back up, inventories can build up, workers can get bored with repetitive jobs, and time can be wasted in transporting goods from one workstation to another. To counter some of these problems, many manufacturers have adopted a cellular layout, in which small teams of workers handle all aspects of building a component, a "family" of components, or even a finished product. Each team works in a small area, or cell, equipped with everything that it needs to function as a self-contained unit. Machines are sometimes configured in a U-shape, with people working inside the U. Because team members often share duties, they're trained to perform several different jobs. Teams monitor both the quantity and the quality of their own output. This arrangement often results in faster completion time, lower inventory levels, improved quality, and better employee morale.

Cellular manufacturing is used by large manufacturers, such as Boeing, Raytheon, and Pratt & Whitney, as well as by small companies, such as Little Enterprise, which makes components for robots." Figure 1, "Cellular Layout," above, illustrates a typical cellular layout.

Fixed Position

It is easy to move teddy bears and marshmallow candies around the factory while you are making them, but what about airplanes or ships? In producing large items, manufacturers use fixed-position layout in which the product stays in one place and the workers (and equipment) go to the product. This is the arrangement used by General Housing Corporation in constructing modular homes. Each house is constructed at the company's factory in Bay City, Michigan, according to the customer's design. Because carpenters, electricians, plumbers, and others work on each building inside the climate-controlled factory, the process can't be hindered by weather. Once it's done, the house is transported in modules to the owner's building site and set up in one day. For a closer view of General Housing Corporation's production process, go to the General Housing Web site.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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20.3: Reading- The Technology of Goods Production

The Technology of Goods Production

PowerSki founder and CEO Bob Montgomery spent sixteen years designing the Jetboard and bringing it to production. At one point, in his efforts to get the design just right, he'd constructed *thirty different prototypes*. Needless to say, this process took a very long time, but even so, Montgomery thought that he could handle the designing of the engine without the aid of a computer. Before long, however, he realized that it was impossible to keep track of all the changes.

Computer-Aided Design

That's when Montgomery turned to computer technology for help and began using a computer-aided design (CAD) software package to design not only the engine but also the board itself and many of its components. The CAD program enabled Montgomery and his team of engineers to test the product digitally and work out design problems before moving to the prototype stage.

The sophisticated CAD software allowed Montgomery and his team to put their design paper in a drawer and to start building both the board and the engine on a computer screen. By rotating the image on the screen, they could even view the design from every angle. Having used their CAD program to make more than four hundred design changes, they were ready to test the Jetboard in the water. During the tests, onboard sensors transmitted data to portable computers, allowing the team to make adjustments from the shore while the prototype was still in the water. Nowadays, PowerSki uses *collaboration software* to transmit design changes to the suppliers of the 340 components that make up the Jetboard.

Computer-Aided Manufacturing

For many companies, the next step is to link CAD to the manufacturing process. A computer-aided manufacturing (CAM) software system determines the steps needed to produce the component and instructs the machines that do the work. Because CAD and CAM programs can "talk" with each other, companies can build components that satisfy exactly the requirements set by the computer-generated model. CAD/CAM systems permit companies to design and manufacture goods faster, more efficiently, and at a lower cost, and they're also effective in helping firms monitor and improve quality. CAD/CAM technology is used in many industries, including the auto industry, electronics, and clothing.

Watch the following video as a CNC carving machine uses a computer program to create an amazing woodcarving.

https://www.youtube.com/watch?v=OX_Pw8XPYMs

Computer-Integrated Manufacturing

By automating and integrating all aspects of a company's operations, c*omputer-integrated manufacturing (CIM)systems* have taken the integration of computer-aided design and manufacturing to a higher level—and are in fact revolutionizing the production process. CIM systems expand the capabilities of CAD/CAM. In addition to design and production applications, they handle such functions as order entry, inventory control, warehousing, and shipping. In the manufacturing plant, the CIM system controls the functions of industrial robots—computer-controlled machines used to perform repetitive tasks that are also hard or dangerous for human workers to perform. Watch this short video of the factory where the CIM is used on the factory production line to manufacture the Kia Sportage.

Flexible Manufacturing Systems

Finally, a CIM system is a common element in flexible manufacturing systems (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods. An FMS has immense advantages over traditional production lines in which machines are set up to produce only one type of good. When the firm needs to switch a production line to manufacture a new product, substantial time and money are often spent in modifying equipment. An FMS makes it possible to change equipment setups merely by reprogramming computer-controlled machines. Such flexibility is particularly valuable to companies that produce customized products.

3D Printing

3D printing (or additive manufacturing, AM) is any of various processes used to make a three-dimensional object. In 3D printing, additive processes are used, in which successive layers of material are laid down under computer control. These objects can be of almost any shape or geometry, and are produced from a 3D model or other electronic data source. A 3D printer is a type of industrial robot. Several different 3D printing processes have been invented since the late 1970s. The printers were originally large, expensive, and highly limited in what they could produce.

A large number of additive processes are now available. The main differences between processes are in the way layers are deposited to create parts and in the materials that are used. Some methods melt or soften material to produce the layers, while others cure liquid materials using different sophisticated technologies. With laminated object manufacturing (LOM), thin layers are cut to shape and joined together (e.g. paper, polymer, metal). Each method has its own advantages and drawbacks, which is why some companies consequently offer a choice between the material used to build the object. Other companies sometimes use standard, off-the-shelf business paper as the build material to produce a durable prototype. The main considerations in choosing a machine are generally speed, cost of the 3D printer, cost of the printed prototype, cost and choice of materials, and color capabilities. Printers that work directly with metals are expensive. In some cases, however, less expensive printers can be used to make a mould, which is then used to make metal parts.

KEY TAKEAWAYS

- In addition to creating high-quality products, companies must produce and deliver goods and services in an efficient, cost-effective manner.
- Sophisticated software systems, including **computer-aided design (CAD)**, **computer-aided manufacturing (CAM)**, **computer-integrated manufacturing (CIM)**, and **flexible manufacturing systems (FMS)**, are becoming increasingly important in this area.
- Computer-aided design software (CAD) is used to create models representing the design of a product.
- Many companies link CAD systems to the manufacturing process through computer-integrated manufacturing (CIM) systems that not only determine the steps needed to produce components but also instruct machines to do the necessary work.
- A CAD/CAM system can be expanded by means of computer-integrated manufacturing (CIM), which integrates various operations (from design through production) with functional activities ranging from order taking to shipping.
- A CIM system is a common element in a flexible manufacturing system (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods.
- **3D** printing is a form of computer aided design (CAD) that builds a 3 dimensional object by adding layers of material,one upon the other until an object is created according to the CAD design

Check Your Understanding

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20.4: Reading- Operations Management for Service Providers

Operations Management for Service Providers

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. Most of us now hold jobs in the service sector, which accounts for 77 percent of U.S. gross domestic product. 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.

Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations. Let's focus on the following three:

- *Intangibility*. Manufacturers produce tangible products—things that can be touched or handled, such as automobiles and appliances. Service companies provide intangible products, such as banking, entertainment, or education.
- *Customization*. Manufactured goods are generally standardized; one twelve-ounce bottle of Pepsi is the same as any other twelve-ounce bottle of Pepsi. Services, by contrast, are often customized to satisfy the specific needs of a customer. When you go to the barber or the hairdresser, you ask for a haircut that looks good on you because of the shape of your face and the texture of your hair. When you go to the dentist, you ask him or her to fill or pull the tooth that's bothering you.
- *Customer contact*. You could spend your entire working life assembling cars in Detroit and never meet a customer who bought a car that you helped to make. But if you were a waitress, you'd interact with customers every day. In fact, their satisfaction with your product would be determined in part by the service that you provided. Unlike manufactured goods, many services are bought and consumed at the same time.

Figure 20.4.1: One of the more than twelve thousand Burger King restaurants across the globe.

Not surprisingly, operational efficiency is just as important in service industries as it is in manufacturing. To get a better idea of the role of operations management in the service sector, we'll look closely at Burger King (BK), home of the Whopper, and the world's second-largest restaurant chain.[1] BK has grown substantially since selling the first Whopper (for $0.37) almost half a century ago. The instant success of the fire-grilled burger encouraged the Miami founders of the company to expand by selling franchises. Today, there are 12,200 BK company- and independently-owned franchised restaurants in seventy-three countries (seven thousand of which are in the United States), and they employ almost forty thousand people.[2] More than eleven million customers visit BK each day.[3]

Operations Planning

When starting or expanding operations, businesses in the service sector must make a number of decisions quite similar to those made by manufacturers:

- What services (and perhaps what goods) should they offer?
- How will they provide these services?
- Where will they locate their business, and what will their facilities look like?
- How will they forecast demand for their services?

Let's see how service firms like BK answer questions such as these.Information on Burger King was obtained from an interview with David Sell, former vice president of Central, Eastern, and Northern Europe divisions and president of Burger King France and Germany.

Operations Processes

Service organizations succeed by providing services that satisfy customers' needs. Companies that provide transportation, such as airlines, have to get customers to their destinations as quickly and safely as possible. Companies that deliver packages, such as FedEx, must pick up, sort, and deliver packages in a timely manner. Colleges must provide quality educations. Companies that provide both services and goods, such as Domino's Pizza, have a dual challenge: they must produce a quality good and deliver it satisfactorily.

Service providers that produce goods can, like manufacturers, adopt either a *make-to-order* or a *make-to-stock* approach to manufacturing them. BK, which encourages patrons to customize burgers and other menu items, uses a make-to-order approach. BK can customize products because it builds sandwiches one at a time rather than batch-process them. Meat patties, for example, go from the grill to a steamer for holding until an order comes in. Then the patty is pulled from the steamer and requested condiments are added. Finally, the completed sandwich chutes to a counter worker, who gives it to the customer. In contrast, many of BK's competitors, including McDonald's, rely on a make-to-stock approach in which a number of sandwiches are made at the same time with the same condiments. If a customer wants, say, a hamburger without onions, he or she has to wait for a new batch of patties to be grilled. The procedure could take up to five minutes, whereas BK can process a special order in thirty seconds.

Like manufacturers, service providers must continuously look for ways to improve operational efficiency. Throughout its sixty-year history, BK has introduced a number of innovations that have helped make the company (as well as the fast-food industry itself) more efficient. BK, for example, was the first to offer drive-through service (which now accounts for 70 percent of its sales[4]).

It was also a BK vice president, David Sell, who came up with the idea of moving the drink station from behind the counter so that customers could take over the time-consuming task of filling cups with ice and beverages. BK was able to cut back one employee per day at every one of its more than eleven thousand restaurants. Material costs also went down because customers usually fill cups with more ice, which is cheaper than a beverage. Moreover, there were savings on supply costs because most customers don't bother with lids, and many don't use straws. On top of everything else, most customers liked the system (for one thing, it allowed them to customize their own drinks by mixing beverages), and as a result, customer satisfaction went up, as well. Overall, the new process was a major success and quickly became the industry standard.

Facilities

When starting or expanding a service business, owners and managers must invest a lot of time in selecting a location, determining its size and layout, and forecasting demand. A poor location or a badly designed facility can cost customers, and inaccurate estimates of demand for products can result in poor service, excessive costs, or both.

Site Selection

People in the real estate industry often say that the three most important factors to consider when you're buying a home are location, location, location. The same principle applies when you're trying to locate a service business. To be successful in a service industry, you need to be accessible to your customers. Some service businesses, such as cable-TV providers, package-delivery services, and e-retailers, go to their customers. Many others, however—hotels, restaurants, stores, hospitals, and airports—have to attract customers to their facilities. These businesses must locate where there's a high volume of available customers. Let's see how BK decides where to place a restaurant.

"Through the light and to the right." This is a favorite catchphrase among BK planners who are looking for a promising spot for a new restaurant (at least in the United States). In picking a location, BK planners perform a detailed analysis of demographics and traffic patterns, yet the most important factor is usually *traffic count*—the number of cars or people that pass by a specific location in the course of a day. In the United States, where we travel almost everywhere by car, BK looks for busy intersections, interstate interchanges with easy off and on ramps, or such "primary destinations" as shopping malls, tourist attractions, downtown business areas, or movie theaters. In Europe, where public transportation is much more common, planners focus on subway, train, bus, and trolley stops.

Once planners find a site with an acceptable traffic count, they apply other criteria. It must, for example, be easy for vehicles to enter and exit the site, which must also provide enough parking to handle projected dine-in business. Local zoning must permit standard signage, especially along interstate highways. Finally, expected business must be high enough to justify the cost of the land and building.

Size and Layout

Because manufacturers do business out of plants rarely visited by customers, they base the size and layout of their facilities solely on production needs. In the service sector, however, most businesses must design their facilities with the customer in mind: they must accommodate the needs of their customers while keeping costs as low as possible. Performing this twofold task isn't easy. Let's see how BK has met the challenge.

For its first three decades, almost all BK restaurants were pretty much the same. They all sat on one acre of land (located "through the light and to the right"), had about four thousand square feet of space, and held seating for seventy customers. All kitchens were roughly the same size. As long as land was cheap and sites were readily available, this system worked well enough. By the early 1990s, however, most of the prime sites had been taken, if not by BK itself, then by one of its fast-food competitors or other businesses needing a choice spot, including gas stations and convenience stores. With everyone bidding on the same sites, the cost of a prime acre of land had increased from $100,000 to over $1 million in a few short years.

To continue growing, BK needed to change the way it found and developed its locations. Planners decided that they had to find ways to reduce the size of a typical BK restaurant. For one thing, they could reduce the number of seats, because the business at a typical outlet had shifted over time from 90 percent inside dining and 10 percent drive-through to a 50-50 split. BK customers tended to be in a hurry, and more customers preferred the convenience of drive-through "dining."

David Sell (the same executive who had recommended letting customers fill their own drink cups) proposed to save space by wrapping Whoppers in paper instead of serving them in the cardboard boxes that took up too much space in the back room of every restaurant. So BK switched to a single paper wrapper with the label "Whopper" on one side and "Cheese Whopper" on the other. To show which product was inside, employees just folded the wrapper in the right direction. Ultimately, BK replaced pallets piled high with boxes with a few boxes full of wrappers.

Ideas like these helped BK trim the size of a restaurant from four thousand square feet to as little as one thousand. In turn, smaller facilities enabled the company to enter markets that were once cost prohibitive. Now BK could locate profitably in airports, food courts, strip malls, center-city areas, and even schools. The company even designed 10-foot-by-10-foot kiosks that could be transported to special events, stadiums, and concerts.

Capacity Planning

Estimating capacity needs for a service business isn't the same thing as estimating those of a manufacturer. A manufacturer can predict overall demand, produce the product, store it in inventory, and ship it to a customer when it's ordered. Service providers, however, can't store their products for later use: hairdressers can't "inventory" haircuts, hospitals can't "inventory" operations, and amusement parks can't "inventory" roller-coaster rides. Service firms have to build sufficient capacity to satisfy customers' needs on an "as-demanded" basis. Like manufacturers, service providers must consider many variables when estimating demand and capacity:

- How many customers will I have?
- When will they want my services (which days of the week, which times of the day)?
- How long will it take to serve each customer?
- How will external factors, such as weather or holidays, affect the demand for my services?

Forecasting demand is easier for companies like BK, which has a long history of planning facilities, than for brand-new service businesses. BK can predict sales for a new restaurant by combining its knowledge of customer-service patterns at existing restaurants with information collected about each new location, including the number of cars or people passing the proposed site and the effect of nearby competition.

Managing Operations

Overseeing a service organization puts special demands on managers, especially those running firms, such as hotels, retail stores, and restaurants, that have a high degree of contact with customers. Service firms provide customers with personal attention and must satisfy their needs in a timely manner. This task is complicated by the fact that demand can vary greatly over the course of any given day. Managers, therefore, must pay particular attention to employee work schedules and (in some cases) inventory management. Let's see how BK deals with these problems.

Scheduling

In manufacturing, managers focus on scheduling the *activities* needed to transform raw materials into finished goods. In service organizations, they focus on scheduling *workers* so that they're available to handle fluctuating customer demand. Each week, therefore, every BK store manager schedules employees to cover not only the peak periods of breakfast, lunch, and dinner, but also the slower periods in between. If he or she staffs too many people, labor cost per sales dollar will be too high. If there aren't enough employees, customers have to wait in lines. Some get discouraged, and even leave, and many may never come back.

Scheduling is made easier by information provided by a point-of-sale device built into every BK cash register. The register keeps track of every sandwich, beverage, and side order sold by the hour, every hour of the day, every day of the week. Thus, to determine how many people will be needed for next Thursday's lunch hour, the manager reviews last Thursday's data, using sales revenue and a specific BK formula to determine the appropriate staffing level. Each manager can adjust this forecast to account for other factors, such as current marketing promotions or a local sporting event that will increase customer traffic.

Inventory Control

Businesses that provide both goods and services, such as retail stores and auto-repair shops, have the same inventory-control problems as manufacturers: keeping levels too high costs money, while running out of inventory costs sales. Technology, such as the point-of-sale registers used at BK, makes the job easier. BK's system tracks everything sold during a given time and lets each store manager know how much of everything should be kept in inventory. It also makes it possible to count the number of burgers and buns, bags and racks of fries, and boxes of beverage mixes at the beginning or end of each shift. Because there are fixed numbers of supplies—say, beef patties or bags of fries—in each box, employees simply count boxes and multiply. In just a few minutes, the manager knows whether the inventory is correct (and should be able to see if any theft has occurred on the shift).

KEY TAKEAWAYS

- Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations.
- While manufacturers produce tangible, generally standardized products, service firms provide intangible products that are often customized to satisfy specific needs. Unlike manufactured goods, many services are bought and consumed at the same time.
- Operational efficiency is just as important in service industries as it is in manufacturing.
- Operations managers in the service sector make many decisions that are similar to those made by manufacturers: they decide which services to offer, how to provide these services, where to locate their businesses, what their facilities will look like, and what the demand will be for their services.
- Service providers that produce goods can, like manufacturers, adopt either a make-to-order approach (in which products are made to customer satisfaction) or make-to-stock approach (in which products are made for inventory) to manufacturing them.
- Estimating capacity needs for a service business is more difficult than for a manufacturer. Service providers can't store their services for later use: services must be delivered on an as-needed basis.
- Overseeing a service organization puts special demands on managers, especially services requiring a high degree of contact with customers.
- Given the importance of personalized service, scheduling workers is more complex in the service industry than in manufacturing. In manufacturing, operations managers focus on scheduling the *activities* needed to produce goods; in service organizations, they focus on scheduling *workers* to ensure that enough people are available to handle fluctuating customer demand.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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1. "Press Room," Burger King, (accessed November 2, 2011). ↵
2. SEC, *10K SEC Filings*, Burger King Corporation, August 2010, (accessed November 3, 2011). ↵
3. "Press Room," Burger King, (accessed November 2, 2011). ↵

4. Bob Krummert, "Burger King: Headed For A Fast-Casual Flameout?," *Restaurant Hospitality*, (accessed November 3, 2011). ↵

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20.5: Reading- Graphical Tools- Gantt and PERT Charts

Gantt and PERT Charts

Because they need to control the timing of all operations, managers set up *schedules*: They select jobs to be performed during the production process, assign tasks to work groups, set timetables for the completion of tasks, and make sure that resources will be available when and where they're needed. There are a number of scheduling techniques. We'll focus on two of the most common: Gantt and PERT charts.

Gantt Charts

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/itbb/?p=162

A Gantt chart—named after the designer Henry Gantt—is an easy-to-use graphical tool that helps operations managers determine the status of projects. Let's say that you're in charge of making the "hiking bear" that we ordered earlier from the Vermont Teddy Bear Company. Figure 1, "Gantt Chart for Vermont Teddy Bear," below, is a Gantt chart for the production of one hundred of these bears. As you can see, it shows that several activities must be completed before the bears are dressed: the fur has to be cut, stuffed, and sewn; and the clothes and accessories must be made. Our Gantt chart tells us that by day six, all accessories and clothing have been made. The stuffing and sewing, however (which must be finished before the bears are dressed), isn't scheduled for completion until the end of day eight. As operations manager, you'll have to pay close attention to the progress of the stuffing and sewing operations to ensure that finished products are ready for shipment by their scheduled date.

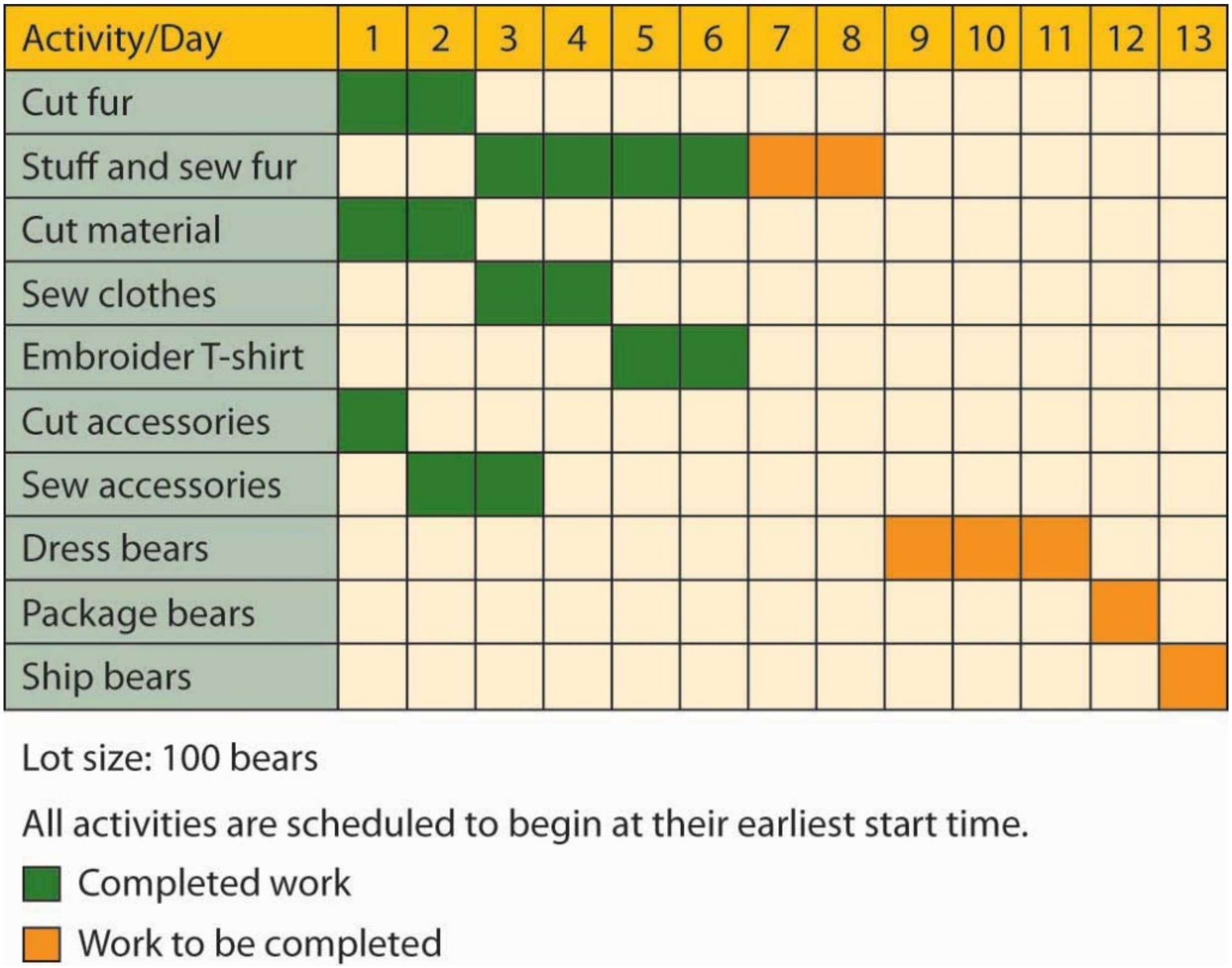

Figure 20.5.1: Gantt Chart for Vermont Teddy Bear

PERT Charts

Gantt charts are useful when the production process is fairly simple and the activities aren't interrelated. For more complex schedules, operations managers may use PERT charts. PERT (which stands for *Program Evaluation and Review Technique*) is designed to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence. It also identifies a *critical path*: the sequence of activities that will entail the greatest amount of time. Figure 2, "PERT Chart for Vermont Teddy Bear," below, is a PERT diagram showing the same process for producing one "hiker" bear at Vermont Teddy Bear.

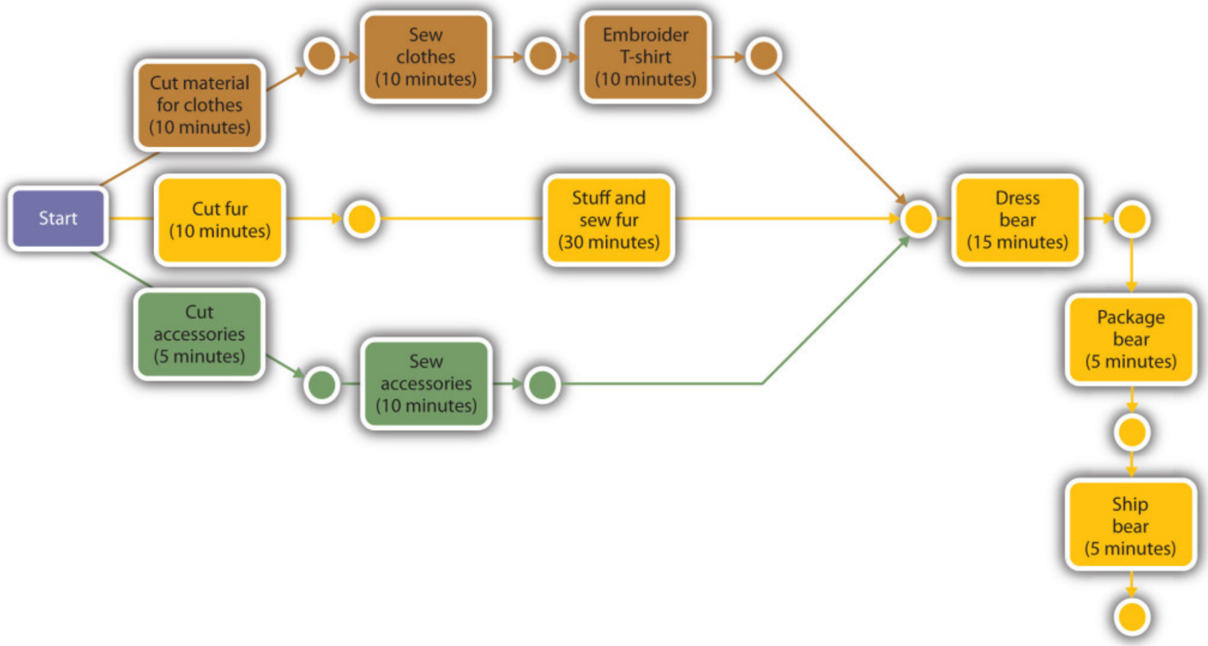

Figure 20.5.2: PERT Chart for Vermont Teddy Bear

Our PERT chart shows how the activities involved in making a single bear are related. It indicates that the production process begins at the cutting station. Next, the fur that's been cut for this particular bear moves first to the stuffing and sewing stations and then to the dressing station. At the same time that its fur is moving through this sequence of steps, the bear's clothes are being cut and sewn and its T-shirt is being embroidered. Its backpack and tent accessories are also being made at the same time. Note that fur, clothes, and accessories all meet at the dressing station, where the bear is dressed and outfitted with its backpack. Finally, the finished bear is packaged and shipped to the customer's house.

What was the critical path in this process? The path that took the longest amount of time was the sequence that included cutting, stuffing, dressing, packaging, and shipping—a sequence of steps taking sixty-five minutes. If you wanted to produce a bear more quickly, you'd have to save time on this path. Even if you saved the time on any of the other paths—say, the sequence of steps involved in cutting, sewing, and embroidering the bear's clothes—you still wouldn't finish the entire job any sooner: the finished clothes would just have to wait for the fur to be stuffed and sewn and moved to the dressing station. In other words, we can gain efficiency only by improving our performance on one or more of the activities along the critical path.

KEY TAKEAWAYS

- Gantt and PERT charts are two of the most common graphical tools used by operations managers to diagram the activities involved in producing goods.
- A Gantt chart is an easy-to-use graphical tool that helps operations managers determine the status of projects.
- PERT charts are used to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence.
- A PERT chart identifies a critical path—the sequence of activities that will entail the greatest amount of time.

Check Your Understanding

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20.6: Reading- Supply Chain Management

Supply Chain Management

Supply chain management is the management of the network of interconnected steps involved in the provision of product and service packages. The following video provides an overview of the importance of supply chain management, logistics, and some of the careers in this field.

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/itbb/?p=164

Supply chain management (SCM) is the management of a network of interconnected businesses involved in the provision of product and service packages required by the end customers in a supply chain. Supply chain management spans all movement and storage of raw materials, work-in-process inventory, and finished goods from point of origin to point of consumption.

Another definition is provided by the *APICS Dictionary,* when it defines SCM as the "design, planning, execution, control, and monitoring of supply chain activities with the objective of creating net value, building a competitive infrastructure, leveraging worldwide logistics, synchronizing supply with demand and measuring performance globally."

Supply chain management must address the following problems:

- Distribution network configuration: number, location and network missions of suppliers, production facilities, distribution centers, warehouses, cross-docks and customers.
- Distribution strategy: questions of operating control (centralized, decentralized or shared); delivery scheme (e.g., direct shipment, pool point shipping, or cross docking), DSD (direct store delivery), closed loop shipping; mode of transportation (e.g., motor carrier, including truckload, LTL, or parcel); railroad; intermodal transport, including TOFC (trailer on flatcar), and COFC (container on flatcar); ocean freight; airfreight; replenishment strategy (e.g., pull, push or hybrid); and transportation control (e.g., owner-operated, private carrier, common carrier, contract carrier, or 3PL).

Trade-offs in logistical activities: The above activities must be well coordinated in order to achieve the lowest total logistics cost. Trade-offs may increase the total cost if only one of the activities is optimized. For example, full truckload (FTL) rates are more economical on a cost per pallet basis than less than truckload (LTL) shipments. If, however, a full truckload of a product is ordered to reduce transportation costs, there will be an increase in inventory holding costs, which may increase total logistics costs. It is, therefore, imperative to take a systems approach when planning logistical activities. These trade offs are key to developing the most efficient and effective Logistics and SCM strategy.

- Information: Integration of processes through the supply chain to share valuable information, including demand signals, forecasts, inventory, transportation, potential collaboration, etc.
- Inventory management: Quantity and location of inventory, including raw materials, work-in-process (WIP), and finished goods.
- Cash-flow: Arranging the payment terms and methodologies for exchanging funds across entities within the supply chain.
- Supply chain execution means managing and coordinating the movement of materials, information, and funds across the supply chain. The flow is bi-directional.

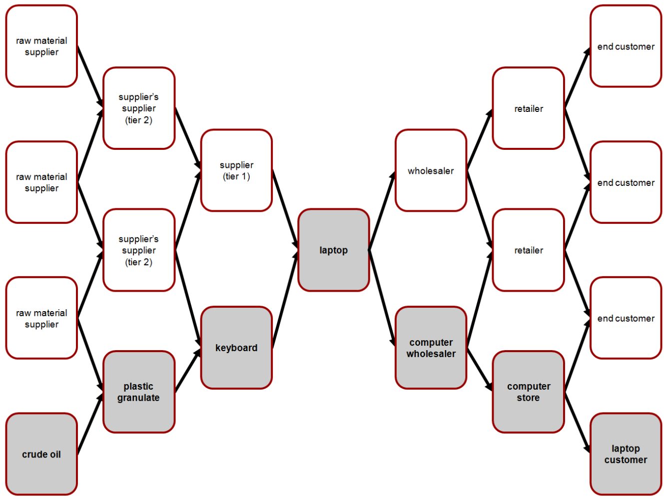

Figure 20.6.1: Supply Chain: A supply and demand network

KEY TAKEAWAYS

- Supply chain management spans all movement and storage of raw materials, work-in-process inventory, and finished goods from point of origin to point of consumption.
- Distribution Network Configuration: number, location, and network missions of suppliers; production facilities; distribution centers; warehouses; cross-docks; and customers.
- Supply chain management addresses the following issues: distribution network configuration, distribution strategy, logistical activities, information, and cash flow.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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20.7: Reading- Producing for Quality

Producing for Quality

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."[1] When you buy a DVD player, you expect it to play DVDs. When it doesn't, you question its quality. When you go to a drive-through window, you expect to be served in a reasonable amount of time. If you're forced to wait, you conclude that you're the victim of poor-quality service.

Quality Management

To compete today, companies must deliver quality goods and services that satisfy customers' needs. This is the objective of quality management. Total quality management (TQM), or quality assurance, includes all the steps that a company takes to ensure that its goods or services are of sufficiently high quality to meet customers' needs. Generally speaking, a company adheres to TQM principles by focusing on three tasks:

1. Customer satisfaction
2. Employee involvement
3. Continuous improvement

Let's take a closer look at these three principles.

Customer Satisfaction

Companies that are committed to TQM understand that the purpose of a business is to generate a profit by satisfying customer needs. Thus, they let their customers define *quality* by identifying and offering those product features that satisfy customer needs. They encourage customers to tell them how to make the right products, both goods and services, that work the right way.

Armed with this knowledge, they take steps to make sure that providing quality is a factor in every facet of their operations—from design, to product planning and control, to sales and service. To get feedback on how well they're doing, many companies routinely use surveys and other methods to monitor customer satisfaction. By tracking the results of feedback over time, they can see where they need to improve.

Employee Involvement

Successful TQM requires that everyone in the organization, not simply upper-level management, commits to satisfying the customer. When customers wait too long at a drive-through window, it's the responsibility of a number of employees, not the manager alone. A defective DVD isn't solely the responsibility of the manufacturer's quality control department; it's the responsibility of every employee involved in its design, production, and even shipping. To get everyone involved in the drive for quality assurance, managers must communicate the importance of quality to subordinates and motivate them to focus on customer satisfaction. Employees have to be properly trained not only to do their jobs but also to detect and correct quality problems.

In many companies, employees who perform similar jobs work as teams, sometimes called quality circles, to identify quality, efficiency, and other work-related problems, to propose solutions, and to work with management in implementing their recommendations.

Continuous Improvement

An integral part of TQM is continuous improvement: the commitment to making constant improvements in the design, production, and delivery of goods and services. Improvements can almost always be made to increase efficiency, reduce costs, and improve customer service and satisfaction. Everyone in the organization is constantly on the lookout for ways to do things better.

Statistical Process Control

Companies can use a variety of tools to identify areas for improvement. A common approach in manufacturing is called statistical process control. This technique monitors production quality by testing a sample of output to see whether goods in process are being made according to predetermined specifications.

Assume for a moment that you work for Kellogg's, the maker of Raisin Bran cereal. You know that it's the company's goal to pack two scoops of raisins in every box of cereal. How can you test to determine whether this goal is being met? You could use a statistical process control method called a *sampling distribution*. On a periodic basis, you would take a box of cereal off the production line and measure the amount of raisins in the box. Then you'd record that amount on a *control chart* designed to compare actual quantities of raisins with the desired quantity (two scoops). If your chart shows that several samples in a row are low on raisins, you'd shut down the production line and take corrective action.

Benchmarking

Sometimes it also helps to look outside the organization for ideas on how to improve operations and to learn how your company compares with others. Companies routinely use benchmarking to compare their performance on a number of dimensions with the performance of other companies that excel in particular areas. Frequent benchmark targets include L.L. Bean, for its superior performance in filling orders; 3M, for its record of introducing innovative products; Motorola, for its success in maintaining consistent quality standards; and Mary Kay Cosmetics, for its skills in inventory control.[2]

International Quality Standards

As a consumer, wouldn't you like to know which companies ensure that their products meet quality specifications? Some of us would like to know which companies take steps to protect the environment. Some consumers want to know which companies continuously improve their performance in both of these areas—that is, practice both quality management and environmental management. By the same token, if you were a company doing a good job in these areas, wouldn't you want potential customers to know? It might be worth your while to find out whether your suppliers were also being conscientious in these areas—and even your suppliers' suppliers.

ISO 9000 and ISO 14000

Through the International Organization for Standardization (ISO), a nongovernmental agency based in Switzerland, it's possible to find this kind of information. The resources of this organization will enable you to identify those organizations that have people and processes in place for delivering products that satisfy customers' quality requirements. You can also find out which organizations work to reduce the negative impact of their activities on the environment. Working with representatives from various countries, the organization has established the ISO 9000 family of international standards for quality management and the ISO 14000 family of international standards for environmental management.

ISO standards focus on the way a company does its work, not on its output (though there's certainly a strong correlation between the way in which a business functions and the quality of its products). Compliance with ISO standards is voluntary, and the certification process is time-consuming and complex. Even so, hundreds of thousands of organizations around the world are ISO 9000 and ISO 14000 certified.[3] ISO certification has become an internationally recognized symbol of quality management and is almost essential to be competitive in the global marketplace.

Six Sigma

Another approach to quality management in the United States was formulated at Motorola in 1986 and was named Six Sigma (6σ). The Six Sigma practices were based on W. Edwards Deming's work, TQM, and others and had similarities regarding continuous efforts at improvement involving everyone at the company. It emphasized a clear focus on achieving quantifiable financial returns from any Six Sigma project. To determine the financial return on a quality initiative, the **cost of quality (COQ)** must be determined. The cost of quality has two parts: the cost of prevention and the cost of failure (or nonconformance). The cost of quality is the sum of the cost of prevention and the cost of failure. If spending more on prevention reduces the cost of failure by an even greater amount, the total cost of quality is reduced.

- Cost of prevention
  - *Cost of conformance*. Cost to improve quality
  - *Cost of appraisal*. Cost to measure and evaluate quality

- Cost of failure
  - *Internal costs*. Repairing bad parts before shipment or retooling a manufacturing line to reduce failures
  - *External costs*. Managing returns, lawsuits, product recalls

Six Sigma identified individuals as experts in quality and awarded titles like Champion and Master Black Belt. The name Six Sigma refers to a process that has six standard deviations from the mean to either control limit that would ensure virtually zero defects. (In practice, the Six Sigma approach allows for a 1.5 sigma drift, so it is really a 4.5 sigma standard that allows approximately 3.4 defects per million products.) This approach was adopted by Jack Welch at General Electric with great success. By the late 1990s, about two-thirds of the top five hundred companies in the United States had begun Six Sigma projects, including Ford, which had allowed its quality programs to slip. To provide encouragement and a consistent standard, the U.S. government created the Malcolm Baldrige National Quality Award in 1987 to encourage companies to improve quality; the award was named for Malcolm Baldrige who was the U.S. secretary of commerce from 1981 to 1987.[4] The criteria used to determine award winners are as follows:

1. Leadership of senior executives
2. Strategic planning
3. Customer and market focus
4. Measurement, analysis, and knowledge management
5. Workforce focus
6. Process management
7. Results

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1. "Basic Concepts, Definitions," American Society of Quality, (accessed November 3, 2011). ↵
2. Charles J. Nuese, *Building the Right Things Right* (New York: Quality Resources, 1995), 102. ↵
3. "ISO Survey of Certifications," 2009 International Organization for Standardization, (accessed November 2, 2011). ↵
4. National Institute of Standards and Technology, "Frequently Asked Questions about the Malcolm Baldrige National Quality Award," November 25, 2008, (accessed August 14, 2009). ↵

Contributors and Attributions

20.8: Reading- Outsourcing

Outsourcing and Quality

PowerSki's Web site states that "PowerSki International has been founded to bring a new watercraft, the PowerSki Jetboard, and the engine technology behind it, to market."[1] That goal was reached in May 2003, when the firm emerged from a lengthy design period. Having already garnered praise for its innovative product, PowerSki was ready to begin mass-producing Jetboards. At this juncture, the management team made a strategic decision that's not uncommon in manufacturing today.

Rather than producing Jetboards in-house, they opted for outsourcing: having outside vendors manufacture the engines, fiberglass hulls, and associated parts. Assembly of the final product took place in a manufacturing facility owned by All American Power Sports in Moses Lake, Washington. This decision does not mean that the company relinquished control over quality; in fact, every component that goes into the PowerSki Jetboard is manufactured to exact specifications set by PowerSki.

One advantage of outsourcing its production function is that the management team can thereby devote its attention to refining its product design and designing future products. However, as processes or pieces of a process are outsourced companies have legitimate concerns about quality standards being met and maintained at the outsourced location. The decision whether or not to outsource often comes down to identifying organizations that can meet and maintain the standards set by the company and the customer.

Outsourcing in the Manufacturing Sector

Figure 20.8.1: Outsourcing the production of its engines, hulls, and other components enables PowerSki to reduce the cost of producing each Jetboard through manufacturing efficiencies and lower labor costs. All components that go into the Jetboard are made to PowerSki's specifications and are inspected upon arrival to ensure that they meet the company's high-quality standards.

Understandably, outsourcing is becoming an increasingly popular option among manufacturers. For one thing, few companies have either the expertise or the inclination to produce everything needed to make a product. Today, more firms, like PowerSki, want to specialize in the processes that they perform best—and outsource the rest. Like PowerSki, they also want to take advantage of outsourcing by linking up with suppliers located in regions with lower labor costs.

Outsourcing in the Service Sector

Outsourcing is by no means limited to the manufacturing sector. Service companies also outsource many of their noncore functions. Your school, for instance, probably outsources such functions as food services, maintenance, bookstore sales, printing, groundskeeping, security, information-technology (IT) support, and even residence operations.

KEY TAKEAWAYS

- Today, companies that compete in both the manufacturing and service sectors must deliver **quality** goods and services that satisfy customers' needs. Many companies achieve this goal by adhering to principles of **total quality management (TQM)**.
- Companies using a TQM approach focus on customer satisfaction, engage all members of the organization in quality efforts, and strive for **continuous improvement** in the design, production, and delivery of goods and services. They also **benchmark** other companies to find ways to improve their own performance.
- To identify areas for improvement, companies can use a technique called **statistical process control (SPC)**, which monitors quality by testing to see whether a sample of output is being made to predetermined specifications.
- The Deming award is given by Japan to companies doing business in Japan for high-quality standards. Similarly, the Baldrige National Quality Award is given to U.S. companies and individuals for their contribution to quality.
- Six Sigma identifies specialists within the organization and assigns titles like Master Black Belt. Each quality project must evaluate the cost of quality to gain approval.
- The International Standards Institute devises guidelines for establishing practices. The ISO 9000 group are guidelines for establishing practices that are likely to create quality products.
- The cost of quality has two parts: the cost of prevention and the cost of failure. The cost of prevention includes costs to establish quality practices and the costs to verify them. The cost of failure includes internal costs before the product is sold, such as waste and fixing products, while external costs include those that occur after the product is sold, such as returns and lawsuits.
- Another cost-saving approach is **outsourcing**—having outside vendors manufacture components or even entire products or provide services, such as information-technology support or service center operations.
- Outsourcing is an appealing option for companies without the expertise in producing everything needed to make a product or those that want to take advantage of low labor costs in developing countries.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. "About PowerSki International," PowerSki, (accessed November 3, 2011). ↵

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CHAPTER OVERVIEW

21: Module 9- Management

21.1: Why It Matters- Management

Why describe the primary functions, responsibilities, and skills of effective leadership and management?

You go out for dinner to your favorite restaurant for a special occasion—let's say graduation. It took a month or more to save up the money, and your date/spouse bought a new outfit just for this outing. Maybe, if you have children, you splurged and got a babysitter for the entire evening. Whatever the circumstances, you have planned an evening to remember. As the night progresses, things are not turning out as you hoped. The hostess has no record of your reservation, so there's a delay. When your waiter finally appears, he's grouchy and unhelpful. You place your order and anxiously await what Yelp* describes as a "5-star dining experience." By the time your food comes, you have devoured the bread on your table, a pack of mints rummaged from your purse, and you're eying the leftovers on the neighboring table. When your steak finally arrives, it's overcooked and sits beside a heap of steamed broccoli instead of the baked potato you ordered. You hate broccoli. So, who do you call?

No, not Ghostbusters! You want to speak to the *manager*, because the manager has the responsibility and authority to resolve the problem (or at least try). But managers do more than just listen to customers complain. As you will discover in this section, whether they interact with customers, employees, suppliers, contractors or the general public, managers and leaders play an important, multidimensional role in all business organizations.

Contributors and Attributions

21.2: Introduction to Managers

What you'll learn to do: describe the three levels of management and the key skills needed by managers

This sections serves as an introduction to the management function, describing the roles and responsibilities of management at different levels and associated management skills. The three primary categories of management skill—technical, conceptual and human—are defined and illustrated, with comments regarding the relative importance of each skill at different levels of management. This section also mentions the implications of trends such as the thinning of management ranks and globalization.

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21.3: Managerial Levels

Learning Objectives

- Differentiate between the functions of top managers, middle managers, and first-line managers

Figure 21.3.1: Being a successful manager can seem like a juggling act—keeping many balls in the air while keeping one's composure.

All industries need management, and the managers who perform that function need to possess certain skills. Before we talk about those skills, though, it's important to understand that the title of manager actually refers to three distinct groups of people within an organization: top-level or executive managers, middle managers, and first-line managers. Each level has a different area of managerial responsibility and reporting structure.

Top Managers

These are the highest level of managers within an organization, and they are tasked with setting organizational objectives and goals. These managers scan the external environment for opportunities, help develop long-range plans and make critical decisions that affect the entire organization. They represent the smallest percentage of the management team. Many times these managers have titles such as chief executive, operations manager, or general manager.

Middle Managers

Mid-level or middle managers allocate resources to achieve the goals and objectives set by top managers. Their primary role is to oversee front-line managers and report back to top-level managers about the progress, problems, or needs of the first-line managers. Middle managers span the distance between production operations and organizational vision. While top managers set the organization's goals, middle managers identify and implement the activities that will help the organization achieve its goals.

First-Line Managers

The primary responsibility of first-line managers is to coordinate the activities that have been developed by the middle managers. These managers are responsible for supervising non-managerial employees who are engaged in the tasks and activities developed by middle managers. They report back to middle managers on the progress, problems, or needs of the non-managerial employees. These managers are on the front lines, so to speak, where they are actively involved in the day-to-day operations of the business.

Practice Question

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21.4: Managerial Skills

Learning Objectives

- Describe technical skills in relation to management
- Describe conceptual skills in relation to management
- Describe human skills in relation to management

The skills needed to succeed at each level of management vary somewhat, but there are certain skills common to all. Robert Katz identifies three critical skill sets for successful management professionals: **technical skills, conceptual skills, and human skills**. While these three broad skill categories encompass a wide spectrum of capabilities, each category represents a useful way of highlighting the key capabilities and their impact on management at different levels.

Technical Skills

Of the three skill sets identified by Katz, technical skills are the broadest, most easily defined category. A **technical skill** is defined as a learned capacity in just about any given field of work, study, or even play. For example, the quarterback of a football team must know how to plant his feet and how to position his arm for accuracy and distance when he throws—both are technical skills. A mechanic, meanwhile, needs to be able to take apart and rebuild an engine, operate various machinery (lifts, computer-scanning equipment, etc.), and know how to install a muffler, for example.

Managers also need a broad range of technical abilities. Front-line managers, in particular, often need to use technical skills on a daily basis. They need to communicate up the chain of command while still speaking the language of the workers who are executing the hands-on aspects of the industry. A technical skill for a front-line manager might include a working understanding of a piece of equipment: the manager must be able to coach the employee on its operation, but also be able to explain the basic functions of the machinery to upper managers. Managers in other corporate roles and at higher levels also require technical skills. These can include office-based competencies such as typing, programming, Web-site maintenance, writing, giving presentations, and using software such as Microsoft Office or Adobe.

Practice Question

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Conceptual Skills

Conceptual skills are also crucial to managerial success. **Conceptual skills** enable one to generate ideas creatively and intuitively and also show comprehensive understanding of contexts or topics. Conceptual skills tend to be most relevant to upper-level thinking and broad strategic situations (as opposed to lower-level and line management). As a result, conceptual skills are often viewed as critical success factors for upper-managerial functions.

The key to this type of skill is **conceptual thinking**. Although conceptual thinking is difficult to define, it is generally considered to be the ability to formulate ideas or mental abstractions. When combined with information and a measure of creativity, conceptual thinking can result in new ideas, unique strategies, and innovative solutions. While all levels of management benefit from conceptual thinking, upper management spends the most time with this mindset, since it is largely tasked with identifying and drafting a strategy for the broader operational and competitive approach of an organization. Because this kind of strategic planning includes generating organizational values, policies, mission statements, ethics, procedures, and objectives, upper managers need to possess strong conceptual skills.

While upper management may use the conceptual skill set most, middle managers and front-line managers must also both understand and participate in the company objectives and values. Of particular importance is the ability to communicate these critical concepts to subordinates and decide which information to convey to upper management.

Tracking and collecting the results of conceptual thinking are parts of a feedback loop. Conceptual skills are important in empowering managers in all levels of an organization to observe the operations of an organization and frame them conceptually as an aspect of that organization's strategy, objectives, and policies. Conceptual thinking allows for accurate and timely feedback and organizational adaptability.

? Practice question

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Human Skills

The development of human skills— a combination of social, interpersonal, and leadership skills—is central to the success of any manager.

Over the years, the conventional definition of management has become less specific, as managerial functions can include staffing, directing, and reporting. Modern companies have fewer layers of management, as these companies now tend to delegate (rather than concentrate) responsibilities and authority to achieve goals. As a result, businesses often expect managers to lead or guide people, rather than giving out instructions for every action or task. The ability to lead people is therefore a central component of human skills.

Realistically, most organizations need managers who can view their teams analytically and objectively, evaluate inefficiencies, and make unpopular choices. However, it's misguided to think that a manager has to be distant from or disliked by subordinates to execute these responsibilities. Creating a healthy work environment that's conducive to development, constructive criticism, and achievement simply requires strong human skills—especially in the realm of communication.

Good managers understand not only what they are trying to say but also the broader context and implications of saying it. A sender communicating a message to a receiver is not simply transmitting factual information. Other dimensions of the exchange are just as important: empathy, self-reflection, situational awareness, and charisma all play integral roles in communicating effectively and positively.

? Practice question

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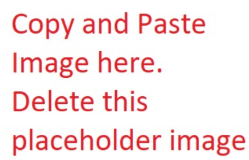
Using Your Skills

The degree to which each type of skill is used depends upon the level of the manager's position as seen in Figure 1. Additionally, in an increasingly global marketplace, it pays for managers to develop a special set of skills to deal with global management issues.



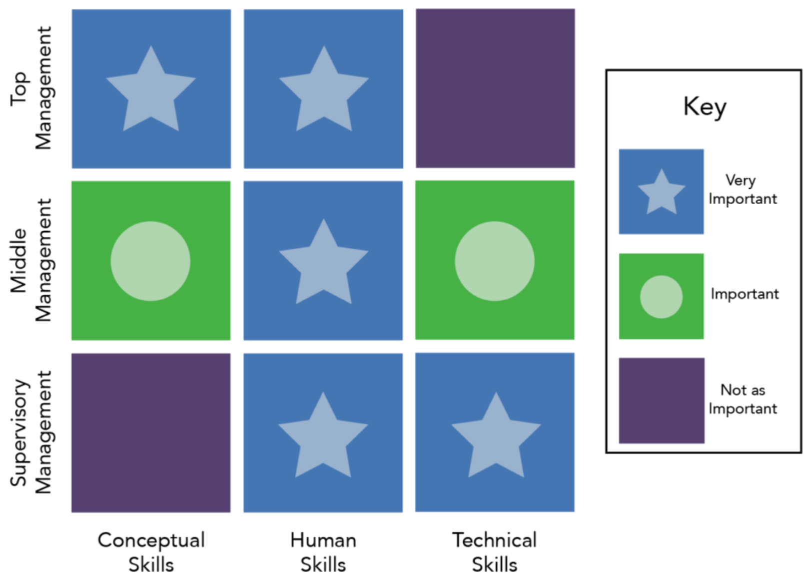


Figure 21.4.1: The Importance of Managerial Skills at Different Management Levels

In sum, technical, conceptual, and human skills are all needed to be an effective manager. As a manager moves up the organizational ladder, he or she may find that success requires fewer or different technical skills and a heavier reliance on interpersonal and human skills.

Contributors and Attributions

21.5: Introduction to Management Theory

What you’ll learn to do: summarize the development of management theory and the key functions of management today

Management theory got its start during the Industrial Revolution when companies were interested in maximizing the productivity and efficiency of their workers in a scientific way. In this section you’ll learn about the major contributors to the field of management theory and how their ideas are used today.

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21.6: Scientific Management Theory

> **Learning Objectives**
> - Summarize the four principles of Frederick Taylor's scientific management theory
> - Summarize the contributions of Frank and Lillian Gibreth to scientific management

Just over one hundred years ago Frederick Taylor published *Principles of Scientific Management*, a work that forever changed the way organizations view their workers and their organization. At the time of Taylor's publication, managers believed that workers were lazy and worked slowly and inefficiently in order to protect their jobs. Taylor identified a revolutionary solution:

The remedy for this inefficiency lies in systematic management, rather than in searching for some unusual or extraordinary man.

You might think that a century-old theory wouldn't have any application in today's fast-paced, technology-driven world. You'd be wrong, though! In fact much of what you've already learned in this course is based on Taylor's work, and plenty of what you'll experience in the workplace will be indebted to him, too. If you recognize any of the following, you have already seen his principles of scientific management in action: organizational charts, performance evaluations, quality measurements and metrics, and sales and/or production goals.

Scientific management is a management theory that analyzes work flows to improve economic efficiency, especially labor productivity. This management theory, developed by Frederick Winslow Taylor, was popular in the 1880s and 1890s in U.S. manufacturing industries.

While the terms "scientific management" and "Taylorism" are often treated as synonymous, a more accurate view is that Taylorism is the first form of scientific management. Taylorism is sometimes called the "classical perspective," meaning that it is still observed for its influence but no longer practiced exclusively. Scientific management was best known from 1910 to 1920, but in the 1920s, competing management theories and methods emerged, rendering scientific management largely obsolete by the 1930s. However, many of the themes of scientific management are still seen in industrial engineering and management today.

Frederick Winslow Taylor

Figure 21.6.1: Frederick Taylor (1856–1915) is called the Father of Scientific Management.

Taylor was a mechanical engineer who was primarily interested in the type of work done in factories and mechanical shops. He observed that the owners and managers of the factories knew little about what actually took place in the workshops. Taylor believed that the system could be improved, and he looked around for an incentive. He settled on money. He believed a worker should get "a fair day's pay for a fair day's work"—no more, no less. If the worker couldn't work to the target, then the person shouldn't be working at all. Taylor also believed that management and labor should cooperate and work together to meet goals. He was the first to suggest that the primary functions of managers should be planning and training.

A significant part of Taylorism was time studies. Taylor was concerned with reducing process time and worked with factory managers on scientific time studies. At its most basic level, time studies involve breaking down each job into component parts, timing each element, and rearranging the parts into the most efficient method of working. By counting and calculating, Taylor sought to transform management into a set of calculated and written techniques.

Taylor proposed a "neat, understandable world in the factory, an organization of men whose acts would be planned, coordinated, and controlled under continuous expert direction. " Factory production was to become a matter of efficient and scientific management—the planning and administration of workers and machines alike as components of one big machine.

In 1909, Taylor published *The Principles of Scientific Management*. In this book, he suggested that productivity would increase if jobs were optimized and simplified. He also proposed matching a worker to a particular job that suited the person's skill level and then training the worker to do that job in a specific way. Taylor first developed the idea of breaking down each job into component parts and timing each part to determine the most efficient method of working.

One of Taylor's most famous studies was from his time at the Bethlehem Steel Company in the early 1900s. He noticed that workers used the same shovel for all materials, even though the various materials differed in weight. By observing the movements of the workers and breaking the movements down into their component elements, Taylor determined that the most efficient shovel load was 21½ lb. Accordingly, he set about finding or designing different shovels to be used for each material that would scoop up that amount.

Scientific management has at its heart four core principles that also apply to organizations today. They include the following:

- Look at each job or task scientifically to determine the "one best way" to perform the job. This is a change from the previous "rule of thumb" method where workers devised their own ways to do the job.
- Hire the right workers for each job, and train them to work at maximum efficiency.
- Monitor worker performance, and provide instruction and training when needed.
- Divide the work between management and labor so that management can plan and train, and workers can execute the task efficiently.

? Practice Question

https://assessments.lumenlearning.co...essments/14413

Frank and Lillian Gilbreth

While Taylor was conducting his time studies, Frank and Lillian Gilbreth were completing their own work in motion studies to further scientific management. The Gilbreth name may be familiar to anyone who has read the book *Cheaper By The Dozen* (or seen the movie the book inspired). The book is a biographical novel about the Gilbreth family, their twelve children, and the often humorous attempts of the Gilbreths to apply their efficiency methods in their own household.

The Gilbreths made use of scientific insights to develop a study method based on the analysis of work motions, consisting in part of filming the details of a worker's activities while recording the time it took to complete those activities. The films helped to create a visual record of how work was completed, and emphasized areas for improvement. Secondly, the films also served the purpose of training workers about the best way to perform their work.

This method allowed the Gilbreths to build on the best elements of the work flows and create a standardized best practice. Time and motion studies are used together to achieve rational and reasonable results and find the best practice for implementing new work methods. While Taylor's work is often associated with that of the Gilbreths, there is a clear philosophical divide between the two scientific-management theories. Taylor was focused on reducing process time, while the Gilbreths tried to make the overall process more efficient by reducing the motions involved. They saw their approach as more concerned with workers' welfare than Taylorism, in which workers were less relevant than profit. This difference led to a personal rift between Taylor and the Gilbreths, which, after Taylor's death, turned into a feud between the Gilbreths and Taylor's followers.

? Practice Question

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Even though scientific management was pioneered in the early 1900s, it continued to make significant contributions to management theory throughout the rest of the twentieth century. With the advancement of statistical methods used in scientific management, quality assurance and quality control began in the 1920s and 1930s. During the 1940s and 1950s, scientific management evolved into operations management, operations research, and management cybernetics. In the 1980s, total quality management became widely popular, and in the 1990s "re-engineering" became increasingly popular. One could validly argue that Taylorism laid the groundwork for these large and influential fields that we still practice today.

Contributors and Attributions

21.7: Field of Management Theory

Learning Objectives

- Summarize Henri Fayol's contributions to the field of management theory
- Summarize the key functions of management today

Henri Fayol and Administrative Theory

Henri Fayol, ca. 1900

Figure 21.7.1: Henri Fayol, ca. 1900

Henri Fayol was born in Turkey in 1841. Fayol was a mining engineer who became the head of a large mining company. He wanted managers to be responsible for more than just increasing production. The story goes that he came to this insight when a mine was shut down after a horse broke a leg and no one at the mine had authority to purchase another. Fayol saw this as a direct failure of management to plan and organize the work. Following this, Fayol began experimenting with different management structures.

He condensed his ideas and experiences into a set of management duties and principles, which he published in 1916 in the book *General and Industrial Management*. Fayol incorporated some of Weber's ideas in his theories. However, unlike Weber, Fayol was concerned with how workers were managed and how they contributed to the organization. He felt that successful organizations, and therefore successful management, were linked to satisfied and motivated employees.

Fayol's five duties of management were as follows:

- **Foresight:** Create a plan of action for the future.
- **Organization:** Provide resources to implement the plan.
- **Command:** Select and lead the best workers through clear instructions and orders.
- **Coordinate:** Make sure the diverse efforts fit together through clear communication.
- **Control:** Verify whether things are going according to plan and make corrections where needed.

These duties evolved into the four functions of management: planning (foresight), organizing (organization), leading (command and coordinate), and controlling (control).

Fayol also proposed a set of fourteen principles that he felt could guide management behavior, but he did not think the principles were rigid or exhaustive. He thought management principles needed to be flexible and adaptable and that they would be expanded through experience and experimentation. Some of Fayol's principles are still included in management theory and practice, including the following:

- **Scalar chain:** An unbroken chain of command extends from the top to the bottom of the organization.
- **Unity of command:** Employees receive orders from only one superior.
- **Unity of direction:** Activities that are similar should be the responsibility of one person.
- **Division of work:** Workers specialize in a few tasks to become more proficient.

? Practice Question

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Key Functions of Management Today

Over the years, management theorists have built upon and refined Fayol's original work and, more recently, have combined the "command" and "coordinate" functions into one function: leading. Today, the key functions of management are considered to be the following: planning, organizing, staffing, leading, controlling, and motivating.

- **Planning:** Deciding what needs to happen in the future (today, next week, next month, next year, over the next five years, etc.) and generating plans for action.
- **Organizing:** Implementing a pattern of relationships among workers and making optimum use of the resources required to enable the successful carrying out of plans.
- **Staffing:** Job analysis, recruitment, and hiring of people with the necessary skills for appropriate jobs. Providing or facilitating ongoing training, if necessary, to keep skills current.
- **Leading/directing:** Determining what needs to be done in a situation and getting people to do it.
- **Controlling/monitoring:** Checking current outcomes against forecast plans and making adjustments when necessary so that goals are achieved.
- **Motivating:** Motivation is a basic function of management because without motivation, employees may feel disconnected from their work and the organization, which can lead to ineffective performance. If managers do not motivate their employees, they may not feel their work is contributing to the overall goals of the organization (which are usually set by top-level management).

All levels of management perform these functions; however, as with the skills required for effective management, the amount of time a manager spends on each function depends on the level of management and the needs of the organization. In the next readings we will explore each of these functions in greater depth.

? Practice Question

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21.8: Introduction to Planning

What you’ll learn to do: identify the types of planning and decision making managers engage in, and explain how these help organizations reach their goals

In this section, we’ll introduce the concept of planning, including the foundational documents—vision and mission—that need to be in place prior to developing a plan. We will identify the 3 levels of planning—strategic, tactical and operational (plus contingency)—and the role of each in achieving the business goals and objectives. This section also introduces the SWOT Analysis, a planning tool that provides a framework for analyzing an organization’s strengths, weaknesses, opportunities and threats.

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21.9: Planning

Learning Objectives

- Differentiate between strategic plans, tactical plans, operational plans, and contingency plans
- Explain the components of a SWOT analysis
- Explain how planning helps organizations reach their goals

Planning is a process of thinking about and organizing the activities needed to achieve a desired goal. By now you are familiar with the most encompassing of all organizational planning: the business plan. The business plan provides the foundation for ongoing planning activities, but as the business grows and develops, it's the manager's responsibility to make adjustments and take the plans to the next level. A business without solid strategic, operational, and contingency plans will have a hard time meeting its organizational goals—unless it intends to survive by luck alone.

The Foundation of Planning

When managers begin to plan, they need to strategize based on something – an idea, an opportunity, or a dream. The company vision and mission statements create the foundation for planning by summarizing a company's business strategy in a form that can be communicated and understood easily by stakeholders.

- **Vision Statement**: A vision statement gives employees something to rally behind, and for those businesses that choose to make their vision statement public, it lets the world know where the company is going. Ikea, the Swedish multinational group of companies that designs and sells ready-to-assemble furniture, is driven by its corporate vision. This is the IKEA vision: "To create a better everyday life for the many people."
- **Mission Statement**: A mission statement outlines how the business will turn its vision into reality and becomes the foundation for establishing specific goals and objectives. Ikea's mission is "to offer a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them." It is this mission that will enable them to realize the vision of "better everyday life."

Until a business has determined what its mission is, planning cannot begin. Furthermore, one plan cannot possibly encompass everything necessary to achieve the organization's mission, so managers are tasked with developing sets of plans that, together, guide the organization's activities.

Strategic Plans

Strategic plans translate the company mission into a set of long-term goals and short-term objectives. In the process of determining a company's strategic plan, top-level managers set out to answer the following questions:

1. Where are we now?
2. Where do we want to be?
3. How do we get there?

Tactical Plans

Tactical plans translate high-level strategic plans into specific plans for actions that need to be taken up and down the layers of an organization. They are short-range plans (usually spanning less than one year) that emphasize the current operations of various parts of the organization. As a company refines or alters its strategic plans, the tactics must also be adjusted to execute the strategy effectively.

A tactical plan answers the following questions:

1. What is to be done?
2. Who is going to do it?
3. How is it to be done?

Operational Plans

Operational plans establish detailed standards that guide the implementation of tactical plans and establish the activities and budgets for each part of the organization. Operational plans may go so far as to set schedules and standards for the day-to-day operations of the business and name responsible supervisors, employees, or departments.

Contingency Plans

Unforeseen events or disasters can be especially harmful to a business. For example, a fire, an earthquake, a wide-spread illness, or a flood may make it impossible to continue normal business operations. A contingency plan lays out the course of action a business will take in response to possible future events.

Practice Question

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Example: Boeing Takes Off in New Direction

Boeing and Airbus have been locked in fierce competition for the world's airplane business for decades. What characterized most of that time period was a focus on designing larger and larger airplanes. Since its development in the 1970s, Boeing revamped its pioneering B747 numerous times and at one time boasted over 1,300 of the jumbo jets in operation around the world. As part of this head-to-head competition for bragging rights to the largest jet in the air, Boeing was working on a 747X, a super-jumbo jet designed to hold 525 passengers. In what seemed to be an abrupt change of strategy, Boeing conceded the super-jumbo segment of the market to its rival and killed plans for the 747X. Instead of trying to create a plane with more seats, Boeing engineers began developing planes to fly fewer people at higher speeds. Then, as the rising price of jet fuel surpassed the airlines' ability to easily absorb its increasing cost, Boeing again changed its strategy, this time focusing on developing jets that use less fuel. In the end, Boeing's strategy changed from plane capacity to jet efficiency.

The new strategy required new plans. Boeing managers identified gaps in Airbus's product line and immediately set out to develop planes to fill them. Boeing announced a new 787 "Dreamliner," which boasted better fuel efficiency thanks to lightweight composite materials and next-generation engine design. Even though the 787 has less than half the seating of the Airbus A380, Boeing's Dreamliner is a hit in the market. Orders for the new plane have been stronger than anticipated, forcing Boeing to change its production plans to meet demand. The company decided to accelerate its planned 787 production rate buildup, rolling out a new jet every two days or so.

Airbus was not so lucky. The company spent so much time and energy on its super-jumbo that its A350 (the plane designed to compete with Boeing's 787) suffered. The 787 uses 15 percent less fuel than the A350, can fly nonstop from Beijing to New York, and is one of the fastest-selling commercial planes ever.

The battle for airline supremacy continues to switch between the two global giants. In 2017, Boeing beat Airbus on commercial jet orders at the Paris Air Show and continues to push forward. A spokesperson has hinted at a hybrid fuselage for midrange planes, which could carry passengers farther at lower costs. If successful, Boeing will regain market share lost to the Airbus A321.

Critical Thinking Questions

1. What seems to be the difference in how Boeing and Airbus have approached planning?
2. Do you think Airbus should change its strategic plans to meet Boeing's or stick with its current plans? Explain.

Sources

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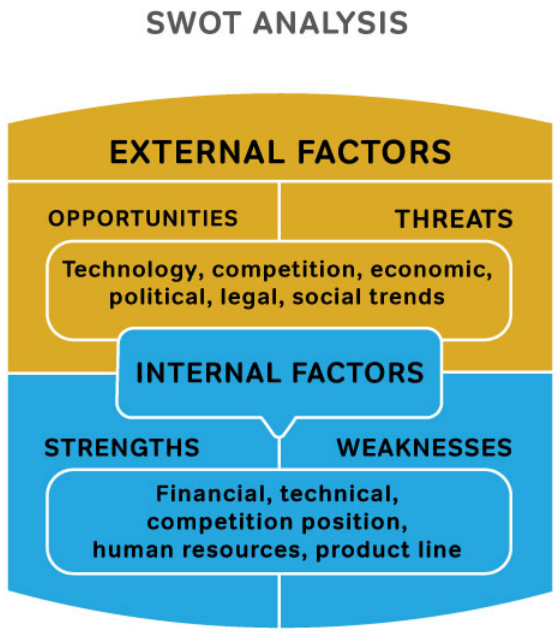
SWOT Analysis

One of the key planning tools managers have at their disposal is the situation analysis, or SWOT analysis. SWOT stands for *strengths*, *weaknesses*, *opportunities*, and *threats*. Conducting such an analysis provides a means of projecting expectations, anticipating problems, and guiding decision making. As shown in the graphic, below, a SWOT analysis is an examination of the internal and external factors that impact the organization and its plans.



The external factors include opportunities and threats that are outside of the organization. These are factors that the company may be able to influence—or at least anticipate—but not fully control. Examples of external factors are technology innovations and changes, competition, economic trends, government policies and regulations, legal judgments, and social trends.

The internal factors include strengths and weaknesses within the organization currently. Examples of internal factors are financial resources, technical resources and capabilities, human resources, and product lines. Since the company has the most control over internal factors, it can develop strategies and objectives to exploit strengths and address weaknesses.

The benefit of a SWOT analysis is that it gives managers a clear picture of the "situation" in which it operates and helps them develop realistic plans. Managers must continually scan the internal and external business environment for signs of change that may require alterations to their plans. The organization's strengths and weaknesses evolve over time, and new threats and opportunities can appear out of the blue. Ignoring signals that technology, consumer demands, resource availability or legal requirements are changing can leave the business in an inferior position relative to the competition and can very well mean the end of the business. For this reason, effective managers should use SWOT analysis as a tool to inform decision making and planning on a regular basis.

You can see how pervasive planning is within a business and that plans can run the gamut from the broad and general (as with the strategic plan, for example) to the narrow and specific (as with operational plans), but each type of plan is important to the overall success of an organization. Furthermore, planning is crucial to fulfilling the other functions of management. Without plans, effective organizing, leading, and controlling won't happen. Failure to plan—or postponing it—can be a real liability for labor-oriented, hands-on managers.

? PRactice Questions

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21.10: Introduction to Organizing

What you'll learn to do: describe the organizing function of management and common types of organizational structure

Organizing is not only a critical management function, it's critical to effective execution of a business's plan. In this section, we'll discuss when organization occurs, what the organization function entails and benefits of organizing. Recalling Henri Fayol, we'll discuss the role of specialization and division of labor. Finally, we'll discuss and illustrate types of organization structures, defining the terms organization chart and span of control and presenting the three most common business structures: divisional, functional and matrix, including advantages and disadvantages of each.

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21.11: Organizing

Learning Objectives

- Describe the organizing function of management
- Differentiate between divisional, functional, and matrix structures

The Nature of Organizing

Once a plan has been created, a manager can begin to organize. Organizing involves assigning tasks, grouping tasks into departments, delegating authority, and allocating resources across the organization. During the organizing process, managers coordinate employees, resources, policies, and procedures to facilitate the goals identified in the plan. Organizing is highly complex and often involves a systematic review of human resources, finances, and priorities.

Before a plan can be implemented, managers must organize the assets of the business to execute the plan efficiently and effectively. Understanding specialization and the division of work is key to this effort, since many of the "assets" are employees. Recall what Henri Fayol wrote about the division of work:

The specialization of the workforce according to the skills of a person, creating specific personal and professional development within the labour force and therefore increasing productivity, leads to specialization which increases the efficiency of labour. By separating a small part of work, the workers speed and accuracy in its performance increases. This principle is applicable to both technical as well as managerial work. [1]

Where workers are specialists, managers can group those employees into departments so their work is appropriately directed and coordinated. In short, work should be divided, and the right people should be given the right jobs to reduce redundancy and inefficiency.

Benefits of Organizing

While the planning function of managers is essential to reaching business goals, lots of careful planning can go to waste if managers fail to organize the company's assets and resources adequately. Some of the benefits of organizing include the following:

- Organization harmonizes employees' individual goals with the overall objectives of the firm. If employees are working without regard for the big picture, then the organization loses the cohesion necessary to work as a unit.
- A good organizational structure is essential for the expansion of business activities. Because organizational structure improves tracking and accountability, that structure helps businesses determine the resources it needs to grow. Similarly, organization is essential for product diversification, such as the development of a new product line.
- Organization aids business efficiency and helps reduce waste. In order to maximize efficiency, some businesses centralize operations while others arrange operations with customer or regional demands in mind.
- A strong organizational structure makes "chain of command" clear so employees know whose directions they should follow. This in turn improves accountability, which is important when outcomes are measured and analyzed.

This is a short list of the benefits managers (and businesses) realize when they take the time to organize. When it comes to the particular organizational structure a business follows, a variety of factors, such as size, industry, and manager preference come into play.

PRactice Question

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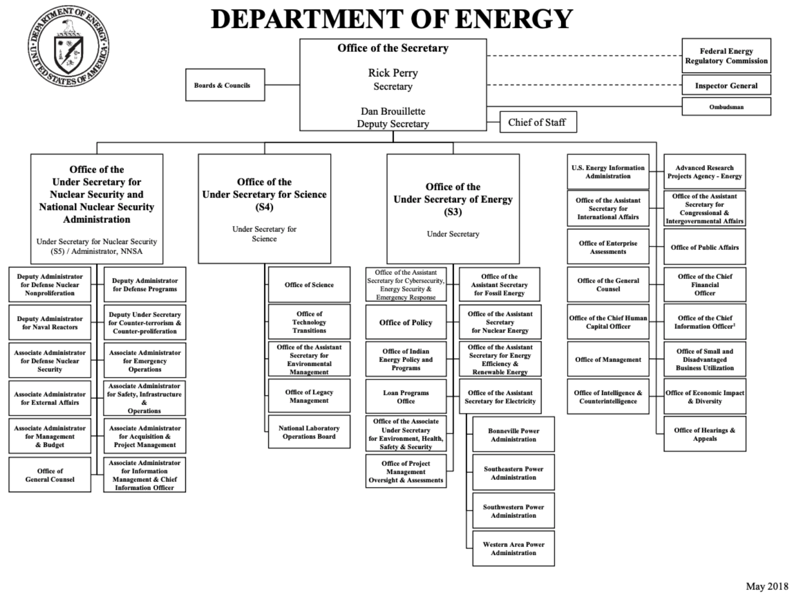
Types of Organizational Structure

Organizations can be structured in various ways, with each structure determining the manner in which the organization operates and performs. An organization's structure is typically represented by an **organization chart** (often called simply an "org chart")—a diagram showing the interrelationships of its positions. This chart highlights the chain of command, or the authority relationships among people working at different levels. It also shows the number of layers between the top and lowest managerial levels. Organizational structure also dictates the **span of control** or the number of subordinates a supervisor has. An organization with few layers has a wide span of control, with each manager overseeing a large number of subordinates; with a narrow span of control, only a limited number of subordinates reports to each manager. The structure of an organization determines how the organization will operate and perform.

Divisional Structure

One way of structuring an organization is by division. With this structure, each organizational function has its own division.



U.S. Department of Energy organization chart: The DOE organization chart shows a divisional structure with different divisions under each of three under-secretaries for energy. Each of the three divisions is in charge of a different set of tasks: environmental responsibilities, nuclear-energy responsibilities, or research responsibilities.

Each division can correspond to products or geographies of the organization. Each division contains all the necessary resources and functions within it to support that particular product line or geography (for example, its own finance, IT, and marketing departments). Product and geographic divisional structures may be characterized as follows:

- **Product departmentalization**: A divisional structure organized by product departmentalization means that the various activities related to the product or service are under the authority of one manager. If the company builds luxury sedans and SUVs, for example, the SUV division will have its own sales, engineering, and marketing departments, which are separate from the departments within the luxury sedan division.
- **Geographic departmentalization**: Geographic departmentalization involves grouping activities based on geography, such as an Asia/Pacific or Latin American division. Geographic departmentalization is particularly important if tastes and brand responses differ across regions, as it allows for flexibility in product offerings and marketing strategies (an approach known as localization).

Functional Structure

In a **functional structure**, a common configuration, an organization is divided into smaller groups by areas of specialty (such as IT, finance, operations, and marketing). Some refer to these functional areas as “silos”—entities that are vertical and disconnected from one another. Accordingly, the company’s top management team typically consists of several functional heads (such as the chief financial officer and the chief operating officer). Communication generally occurs within each functional department and is transmitted across departments through the department heads.

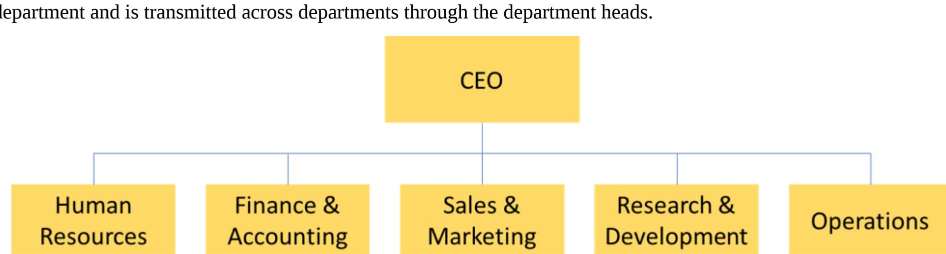


Figure 21.11.1: Functional structure organizational chart.

Functional departments are said to offer greater operational efficiency because employees with shared skills and knowledge are grouped together according to the work they do. Each group of specialists can therefore operate independently, with management acting as the point of cross-communication between functional areas. This arrangement allows for increased specialization.

One disadvantage of this structure is that the different functional groups may not communicate with one another, which can potentially decrease flexibility and innovation within the business. Functional structures may also be susceptible to tunnel vision, with each function seeing the organization only from within the frame of its own operation. Recent efforts to counteract these tendencies include using teams that cross traditional departmental lines and promoting cross-functional communication.

Functional structures appear in a variety of organizations across many industries. They may be most effective within large corporations that produce relatively homogeneous goods. Smaller companies that require more adaptability and innovation may feel that communication and creativity is limited by the silos that result from functional structures.

Matrix Structure

The **matrix structure** is a type of organizational structure in which individuals are grouped by two different operational perspectives at the same time; this structure has both advantages and disadvantages but is generally best employed by companies large enough to justify the increased complexity.

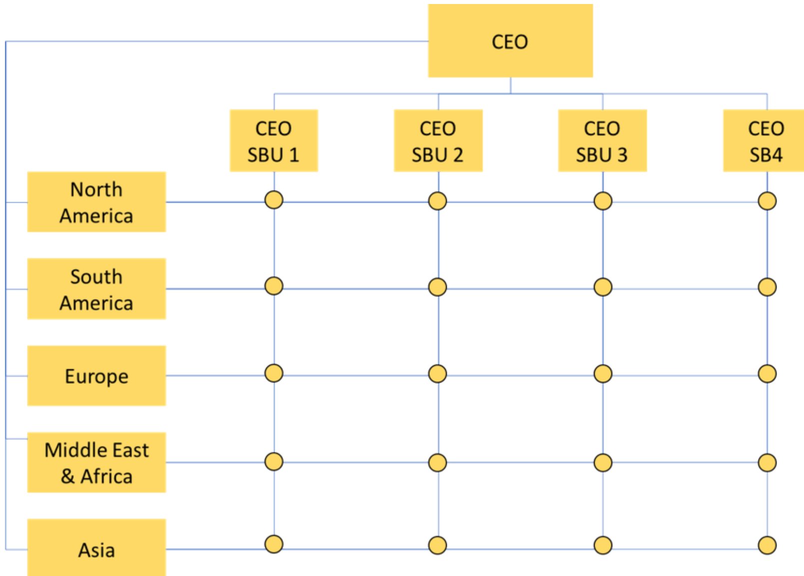


Figure 21.11.2: Matrix structure with geographic and product (SBU) structure.

In a matrix structure, the company is organized by both product and function. Product lines are managed horizontally and functions are managed vertically. This means that each function—e.g., research, production, sales, and finance—has separate internal divisions for each product. In matrix organizations, the company is grouped by the perspectives it deems most appropriate. Common organizational perspectives include function and product, function and region, or region and product. In an organization grouped by function and product, for example, each product line will have management that corresponds to each function. If the organization has three functions and three products, the matrix structure will have nine (3×3) potential managerial interactions. This example illustrates how inherently complex matrix structures are compared to other, more linear structures.

Proponents of matrix management argue that this structure allows team members to share information more readily across task boundaries, which addresses the silo problem of functional management. Matrix structures also allow for specialization, which can increase depth of knowledge and and enable individuals to be assigned according to project needs.

A disadvantage of the matrix structure is the increased complexity in the chain of command when employees are assigned to both functional and project managers. This arrangement can result in a higher manager-to-worker ratio, which, in turn, can increase costs or lead to conflicting employee loyalties. It can also create a gridlock in decision making if a manager on one end of the matrix disagrees with another manager. Blurred authority in a matrix structure can hamper decision making and conflict resolution.

Matrix structures should generally only be used when the operational complexity of the organization warrants it. A company that operates in various regions with various products may require interaction between product development teams and geographic marketing specialists—suggesting a matrix may be beneficial. Larger companies with a need for a great deal of cross-departmental communication generally benefit the most from this model.

? Practice Question

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1. Fayol, H. (1949). *General and Industrial Management* (C. Storrs, Trans.). London: Sir Isaac Pitman & Sons ↵

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21.12: Introduction to Leading

What you'll learn to do: describe common management and leadership styles, and identify the circumstances under which they are most effective

In this section, we'll discuss the concept and purpose of leadership and explore common management and leadership styles. Specifically, we'll discuss autocratic, laissez-faire and democratic management styles, when each is most effective and the importance of being able to adapt your style to the situation. Finally, we'll discuss three common leadership styles—transformational, transactional and narcissistic—and the implications for a company's culture.

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21.13: Different Management Styles

Learning Objectives

- Differentiate between authoritarian, laissez-faire, and democratic management styles
- Differentiate between transformational, transactional, and narcissistic leadership styles

Regardless of their position within an organization, managers need to act as leaders. Some people think leadership means guiding others to complete a particular task, while others believe it means motivating the members of your team to be their best selves. Whatever the differences in emphasis or wording, the following is probably a fair definition: Leaders are people who know how to achieve goals and inspire people along the way.[1] In a business setting, leadership also means being able to share a clear vision of where the company is heading while providing the knowledge, information, and methods needed to get there.

A manager can take a number of different approaches to leading and overseeing an organization. A manager's style of giving direction, setting strategy, and motivating people is the result of his or her personality, values, training, and experience. Let's examine some of the most common management styles and the circumstances under which each is most appropriate.

Autocratic/Authoritarian Management Style

Under an autocratic management style, decision-making power is concentrated in the manager. Autocratic managers don't entertain any suggestions or consider initiatives from subordinates. This style of management is effective for quick decision making but is generally not successful in fostering employee engagement or maintaining worker satisfaction. When do managers tend to use this style?

- In crisis situations, when it's impractical to solicit employee input, managers may become autocratic. For example, a manager might order employees to vacate the building because of fire or another emergency. Taking the time to seek advice or opinions is not only impractical but could endanger lives.
- Traditionally, if the workforce is comprised of low-skill workers, employee input isn't encouraged because it's considered to be of limited value or importance. However, more forward-thinking managers regard all worker input as valuable, regardless of skill level.

Laissez-Faire/Free-Rein Management Style

The laissez-faire style is sometimes described as "hands-off" management because the manager delegates the tasks to the followers while providing little or no direction. If the laissez-faire manager withdraws too much, it can sometimes result in a lack of productivity, cohesion, and satisfaction. Under this type of management, subordinates are given a free hand in deciding their own policies and methods.When do managers employ this approach?

- When workers have the skills to work independently, are self-motivated, and are held accountable for results (physicians are a good example), laissez-faire management may be effective. Highly skilled employees require less frequent instruction, and managers must rely on them to use their professional expertise to make sound decisions.
- Managers of creative or innovative employees often adopt this approach in order to foster creativity. For example, computer programmers, artists, or graphic designers can benefit from a hands-off management style. Managers step out of the way to make room for new ideas, creative problem-solving, and collaboration.

Participative/Democratic Management Style

Under a participative or democratic style of management, the manager shares the decision-making authority with group members. This approach values individual interests and perspectives while also contributing to team cohesion. Participative management can help employees feel more invested in decisions, outcomes, or the choices they've made, because they have a say in them. When is this an appropriate managerial choice?

- When an organization enters a transitional period—a merger or acquisition, expanding into a new market, closing a facility, or adding new products, for example—managers need to guide the workforce through the change. Such circumstances involve adjustments and adaptations for a large group of people, so managers may find that a participative management style is most effective.
- Businesses often encounter new or unexpected challenges. During tough times, resourceful managers will solicit input from employees at many levels within the organization. A democratic approach can uncover people with invaluable experience, advice, and solutions.

Each style of management can be effective if matched with the needs of the situation and used by a skilled, versatile manager. The best managers are adept at several styles and able to exercise good judgement about which one is suited to the task at hand.

? Practice Question

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Transformational Leadership Style

Transformational leaders work with subordinates to identify needed change, create and share an inspiring vision, and bring about change together with committed members of a group. Transformational leadership serves to enhance the motivation, morale, and job performance of followers through a variety of mechanisms. These include connecting the follower's sense of identity and self to a project and to the collective identity of the organization; being a role model for followers in order to inspire them and to raise their interest in the project; challenging followers to take greater ownership for their work; and understanding the strengths and weaknesses of followers, allowing the leader to align followers with tasks that enhance their performance. Transformational leaders are often idealized and viewed as moral exemplars for their contributions to a team, an organization, or a community.

Transactional Leadership Style

Transactional leadership was first described by Max Weber in 1947 and later by Bernard Bass in 1981. This kind of leadership, also known as managerial leadership, focuses on supervision, organization, and performance. Unlike transformational leaders, those using the transactional approach are not looking to change the future—they value the status quo. Transactional leaders pay attention to their followers' work in order to find fault or deviation and gain their compliance through a system of rewards and punishments. There are two factors that form the basis for this reward/punishment system: contingent reward and management by exception. Contingent reward provides rewards (material or psychological) for effort and recognizes good performance. Management by exception allows the leader to maintain the status quo; the leader intervenes when subordinates do not meet acceptable performance levels and initiates corrective action to improve performance.

Narcissistic Leadership Style

Narcissistic leaders are visionary and charismatic, with a keen ability to attract and inspire followers. Anthropologist and psychoanalyst Michael Maccoby observes that "one reason we look to productive narcissists in times of great transition is that they have the audacity to push through the massive transformations that society periodically undertakes. Productive narcissists are not only risk takers willing to get the job done but also charmers who can convert the masses with their rhetoric."[2] Narcissism exists on a continuum from normal to pathological. To Maccoby's point, narcissistic leaders can be viewed as either productive or unproductive. Although narcissistic leaders can be transformational leaders, they can also be toxic to an organization. Narcissists tend to listen only to information and advice that supports their view, regardless of the reality. Their sense of supreme self-worth, combined with a continual need for affirmation, eliminates independent thought and creates a culture of yes people. Organizations led by narcissists are typically characterized by fierce internal competition and changing alliances. This culture can be energizing or, if everyone and everything is perceived as a threat, destructive.

PRactice Question

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In reality, leaders come in as many flavors as ice cream. There are many more types than the three described above. Some leaders are directing; others are more relaxed—acting more like a coach than a boss. Leaders might not lead with the same style all the time, either. There are occasions when managers must take a firm stand, making critical decisions on their own, and other times when they work with their employees to build a consensus before acting. Each style has its place and time, and each manager has his or her own preferred approach. Consider the CEO of Japan Airlines profiled in the following video and what his actions say about his management and leadership style.

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/afm/?p=466

You can view the transcript for "Humble CEO" (opens in new window).

Corporate Culture

The leadership style of managers in an organization is usually indicative of the underlying philosophy, or values, of the organization. The set of *attitudes*, *values*, and *standards of behavior* that distinguishes one organization from another is called corporate culture. A corporate culture evolves over time and is based on the accumulated history of the organization, including the vision of the founders. It is also influenced by the dominant leadership style within the organization. Evidence of a company's culture is seen in its heroes (e.g., the late Andy Grove of Intel[3], myths (stories about the company passed from employee to employee), symbols (e.g., the Nike swoosh), and ceremonies. The culture at Google, working in teams and fostering innovation, sometimes is overlooked while its employee perks are drooled over. But both are important to the company's corporate culture. Since 2007 Google has been at or near the top of *Fortune*'s list of the "100 Best Companies to Work For," an annual list based on employee survey results tabulated by an independent company: Great Place to Work®.[4] "We have never forgotten since our startup days that great things happen more frequently within the right culture and environment," a company spokesperson said in response to the company first taking over the top spot.[5]

Culture may be intangible, but it has a tremendous impact on employee morale and a company's success. Google approaches morale analytically. When it found that mothers were leaving the company in higher rates than other employee groups, the company improved its parental-leave policies. The result was a 50 percent reduction in attrition for working moms. An analytical approach along with culture-building activities such as town halls led by black employees and allies, support for transgender employees, and unconscious-bias workshops are why employees say Google is a safe and inclusive place to work.[6] Clearly Google leaders recognize culture is critical to the company's overall success.

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2. Maccoby, Michael. "Narcissistic Leaders: The Incredible Pros, the Inevitable Cons." Harvard Business Review. January 2004. Accessed June 25, 2019. https://hbr.org/2004/01/narcissistic-leaders-the-incredible-pros-the-inevitable-cons. ↵
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5. Oscar Raymundo, "5 Reasons Googlers Think It's the Best Place to Work," *Inc.*, https://www.inc.com, accessed November 11, 2017. ↵
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21.14: Different Leadership Styles

Learning Objectives

- Identify the circumstances under which different management and leadership styles are effective

There was a time when the role of a manager and a leader could be separated. A foreman in a shoe factory during the early 1900s didn't give much thought to what he was producing or to the people who were producing it. His or her job was to follow orders given to him by a superior, organize the work, assign the right people to the tasks, coordinate the results, and ensure the job got done as ordered. The focus was on efficiency.

In the new economy, however, where value increasingly comes from knowledge—as opposed to skill—and where workers are no longer undifferentiated cogs in an industrial machine, management and leadership are not easily separated. People look to their managers not just to assign them a task but to articulate a purpose, too. Managers are expected to organize workers not just as a means of maximizing efficiency but to nurture abilities, develop talent, and inspire results.

The late management guru Peter Drucker was one of the first to recognize this shift in the roles and relationships of managers and employees. He identified the emergence of the "knowledge worker" and the profound impact that would have on the way business is organized. With the rise of the knowledge worker, "one does not 'manage' people," Drucker wrote. "The task is to lead people. And the goal is to make productive the specific strengths and knowledge of every individual."[1]

With Drucker's idea of "leading people" in mind, let's examine the types of leaders most commonly encountered in business. Keep in mind that the management styles described above are not separate from leadership, but rather are another dimension to the manager as an individual. Managers don't put on an autocratic manager hat one day and a transformational leader hat the next. Instead, every individual fulfilling a managerial role within an organization must be able to adapt his or her style to the situation at hand. This adds considerable complexity to the role of a manager and is one of the reasons that a manager may leave a company—it just wasn't a good "fit." A poor fit may be the result of a tug-of-war between management styles, personality, and leadership qualities.

Practice Question

https://assessments.lumenlearning.co...essments/14424

1. "What Is the Difference Between Management and Leadership?" The Wall Street Journal. Accessed June 25, 2019. http://guides.wsj.com/management/developing-a-leadership-style/what-is-the-difference-between-management-and-leadership/. ↵

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21.15: Introduction to Controlling

What you'll learn to do: explain why control is an essential part of effective management, and outline the steps of the control process

In this section, we'll define the control function of management, including what it entails at various levels of management, and illustrate how it impacts both the employee experience and an organization's achievement of its goals and objectives. We'll also introduce related concepts, processes and tools, including the five-stage control process, SMART criteria and the balanced scorecard model.

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21.16: Controlling

Learning Objectives

- Explain why control is an essential part of effective management
- Explain what SMART objectives are
- Outline the steps of the control process

What Is Control?

Figure 1. Parking lot control

Figure 21.16.1: Parking lot control

Consider the two images in Figure \(\PageIndex{1}\) of two parking lots. Think of the two parking lots as two different organizations. What you can see is that one has management controls in place, and the other does not. In the second photo no one is in charge of controlling the actions and activities of the employees within the company—it's a free-for-all.

It might seem attractive, at first, to work for a company where people aren't telling you what to do, how to do it, or when things are due. But it wouldn't take too long, probably, for all that freedom to feel like chaos. In this section we'll focus on the control function of management to better understand how it helps people and organizations achieve goals and objectives.

In business or management context, control is the activity of observing a given organizational process, measuring performance against a previously established metric, and improving it where possible. Organizations are made up of operational processes and systems, each of which can be iterated upon and optimized. At the upper-managerial level, control revolves around setting strategic objectives for the short and long term, as well as measuring overall organizational success. Developing methods for optimizing operational processes is often done at the mid-managerial level. The mid-level manager measures success within his or her span of control—which could be a division, a region, or a particular product. The line manager is then responsible for controlling the actions of the workers to ensure that activities are carried out in a way that optimizes outcomes and outputs. He or she will measure the success of individual workers, work teams, or even a shift. What managers up and down the organizational chart have in common is that they all use the same process for carrying out the control function of management.

As Figure \(\PageIndex{1}\) shows, controlling can be visualized as a cyclical process made up of five stages:

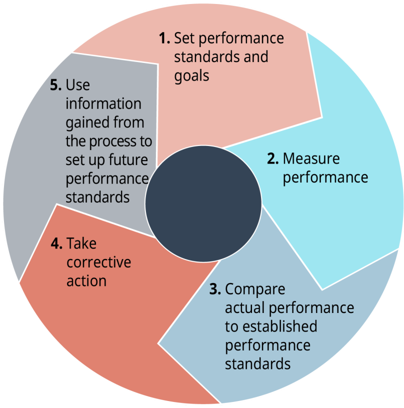

Figure 21.16.2: The control process

Performance standards are the levels of performance the company wants to attain. These goals are based on its strategic, tactical, and operational plans. The most effective performance standards state a measurable behavioral objective that can be achieved in a specified time frame. For example, the performance objective for the sales division of a company could be stated as "$200,000 in gross sales for the month of January." Each individual employee in that division would also have a specified performance goal. Actual firm, division, or individual performance can be measured against desired performance standards to see if a gap exists between the desired level of performance and the actual level of performance. If a performance gap does exist, the reason for it must be determined and corrective action taken.

Feedback is essential to the process of control. Most companies have a reporting system that identifies areas where performance standards are not being met. A feedback system helps managers detect problems before they get out of hand. If a problem exists, the managers take corrective action. Toyota uses a simple but effective control system on its automobile assembly lines. Each worker serves as the customer for the process just before his or hers. Each worker is empowered to act as a quality control inspector. If a part is defective or not installed properly, the next worker won't accept it. Any worker can alert the supervisor to a problem by tugging on a rope that turns on a warning light (i.e., feedback). If the problem isn't corrected, the worker can stop the entire assembly line.

Why is controlling such an important part of a manager's job? First, it helps managers to determine the success of the other three functions: planning, organizing, and leading. Second, control systems direct employee behavior toward achieving organizational goals. Third, control systems provide a means of coordinating employee activities and integrating resources throughout the organization.

Take special note of the language that we use when we talk about the control function—*process!* Controlling the activities within an organization is a continuous process that resembles navigation. In order to reach a destination, a ship navigator sets a course and then constantly checks the headings—if the ship has drifted off course, the navigator makes the necessary corrections. This cycle of check-and-correct, check-and-correct happens over and over to keep the ship on course and get it to where it's going. Similarly, the controlling function in business is a process of repeatedly checking and correcting until standards and objectives are met.

Another feature of the control process is that it's designed to be proactive. The idea is for managers to intervene before costly or damaging problems occur, rather than waiting and hoping for the best. It's better to take corrective action when you're drifting off course than try to salvage your ship after you've crashed into a rock. The benefit to managers and organizations of a forward-looking, proactive approach is that it reduces customer complaints, employee frustration, and waste.

? Practice Question

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Setting Standards and Objectives

Organizational standards and objectives are important elements in any plan because they guide managerial decision making. Performance standards and objectives may be stated in monetary terms—such as revenue, costs, or profits—but they may also be set in other terms, such as units produced, number of defective products, levels of quality, or degree of customer satisfaction.

Peter Drucker suggests that operational objectives should be SMART, which means specific, measurable, achievable, realistic, and time constrained. An operational objective should be:

- **Specific.** A focused, well defined, and clear enough that employees know what is expected. A specific objective should identify the expected actions and outcomes. This helps employees stay on track and work toward appropriate goals.
- **Measurable** and quantifiable so people can assess whether it has been met or not. For example, "increase annual sales revenue by 10 percent" is a measurable objective.
- **Achievable.** It's important for all the stakeholders—especially the employees doing the work—to agree that the objective can be met. Unachievable objectives can be damaging to employee trust and morale.
- **Realistic** as well as ambitious. It should take into account the available resources and time.
- **Time constrained**. Having a deadline can help increase productivity and prevent the work from dragging on.

It's important to get employee input during the process of developing operational objectives, as it may be challenging for employees to understand or accept them after they're set. After determining appropriate operational objectives for each department, plans can be made to achieve them.

? PRactice Question

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Measuring Performance

Performance measurement is the process of collecting, analyzing, and/or reporting information regarding the performance of an individual, group, organization, system, or component. The ways in which managers and organizations measure performance vary greatly—there is no single systemic approach that fits all companies or conditions. The most important element of measuring performance is to do them at regular intervals and/or when particular milestones are reached. The best processes for measuring performance provide information in time for day-to-day decisions.

The rubric for measuring organizational performance is called a **performance metric**. The American Society for Quality (ASQ) defines performance metrics as "data representative of an organization's actions, abilities, and overall quality."[1] Note that the metrics relevant to a business's performance vary significantly across industries. Because it's impossible to track all available data regarding an organization's performance, it's important to identify the key performance metrics – often referred to as KPIs or key performance indicators – that are most relevant to a specific business's success. Once defined, the process of measurement and reporting KPI must be clearly documented and communicated so that results are consistent and comparable over time.

In order to be effective, metrics should reflect a range of stakeholder perspectives, including those of customers, shareholders, and employees. Metrics may be finance based or they may focus on some other measure of performance, such as customer service, customer perceptions of product value or employee satisfaction. Typical financial metrics include revenue or sales growth, gross and net profit, stock price and market share. Operating metrics generally focus on productivity and quality, including customer satisfaction. For example, Amazon tracks and enforces a number of seller performance metrics including on-time delivery, order defect rate, cancellation rate and customer service dissatisfaction rate.

The performance metric development process can be summarized as follows:

- Describe the target objective(s)
- Evaluate possible measurements
- Identify the correct metric for each objective
- Set targets and determine how data will be interpreted – for example, setting a range around a target value and defining levels of performance.
- Define and document the performance metric and related processes and procedures.[2]

Analyzing Performance

Once performance has been measured, managers must analyze the results and evaluate whether objectives have been met, efficiencies achieved, or goals obtained. The means by which performance is analyzed vary among organizations; however, one tool that has gained widespread adoption is the **balanced scorecard.** A balanced scorecard is a semi-standardized strategic management tool used to analyze and improve key performance indicators within an organization. The original design of this balanced scorecard has evolved over the last couple decades and now includes a number of other variables—mostly where performance intersects with corporate strategy. Corporate strategic objectives were added to allow for a more comprehensive strategic planning exercise. Today, this second-generation balanced scorecard is often referred to as a "strategy map," but the conventional "balanced scorecard" is still used to refer to anything consistent with a pictographic strategic management tool.

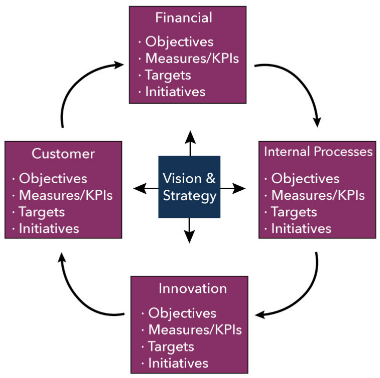

Figure 21.16.3: The balanced scorecard: On a standard balanced scorecard, each "perspective" reminds the user to articulate attributes necessary for an effective scorecard: the financial perspective, the customer's perspective, innovation, and internal processes, all of which come together to form an organization's vision and strategy.

The following four perspectives are represented in a balanced scorecard:

1. **Financial**: includes measures focused on the question "How do we look to shareholders?"
2. **Customer**: includes measures focused on the question "How do customers perceive us?"
3. **Internal business processes**: includes measures focused on the question "What must we excel at?"
4. **Learning and growth**: includes measures focused on the question "How can we continue to improve and create value?"

Managers generally use this tool to identify areas of the organization that need better alignment and control vis-à-vis the broader organizational vision and strategy. The balanced scorecard brings each of an organization's moving parts into one view in order to improve synergy and continuity between functional areas.

? Try It

Check out this video for a visual summary of a balanced scorecard

You can view the transcript for “Balanced Scorecard” (opens in new window).

Taking Corrective Action

Once the cause of nonperformance or underperformance has been identified, managers can take corrective action. **Corrective action** is essentially a planned response aimed at fixing a problem. At this stage of the controlling process, problem-solving is key.

The first step managers must take is to accurately identify the problem, which can sometimes be hard to distinguish from its symptoms or effects. Collecting information and measuring each process carefully are important prerequisites to pinpointing the problem and taking the proper corrective action. Attempts at corrective action are often unsuccessful because of failures in the problem-solving process, such as not having enough information to isolate the real problem, or the presence of a manager or decision maker who has a stake in the process and doesn’t want to admit that his department made a mistake. Another reason why the problem-solving process can run aground is if the manager or decision maker was nevery properly trained to analyze a problem.

Once the problem is identified, and a method of corrective action is determined, it needs to be implemented as quickly as possible. A map of checkpoints and deadlines, assigned to individuals in a clear and concise manner, facilitates prompt implementation. In many ways, this part of the control process is very much a process itself. Its steps can vary greatly depending on the issue being addressed, but in all cases it should be clear how the corrective actions will lead to the desired results.

Next, it’s important to schedule a review and evaluation of the solution. This way, if the corrective action doesn’t bring the desired results, further action can be taken swiftly—before the organization falls even further behind in meeting its goals. Organizations may also decide to discuss a problem and potential solutions with stakeholders. It’s useful to have some contingency plans in place, as employees, customers, or vendors may have unique perspectives on the problem. Gaining a broader view can sometimes help management arrive at a more effective solution.

? Practice Question

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A manager must use a wide range of skills to navigate the management process well. This journey begins with sound planning, based on a set of SMART goals and objectives. The manager leads both people and processes, using a blend of leadership and management styles appropriate to the situation. If the manager has done a good job of placing the right people in the right places, and has implemented sound standards and performance metrics, then she is well-positioned to take corrective action where needed. Regardless of whether the task is to get a customer’s order assembled and shipped on time or expand into a new market, the functions of the manager remain unchanged.

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1. "What Are Performance Metrics?" ASQ. Accessed June 25, 2019. https://asq.org/quality-resources/metrics. ↵
2. "How to Develop KPIs / Performance Measures." Kpi.org. Accessed June 25, 2019. https://kpi.org/KPI-Basics/KPI-Development. ↵

Contributors and Attributions

21.17: Putting It Together- Management

Synthesis

Ship captains, jugglers, parking lots . . . Why have we used so many different analogies to describe managers and management? Because all of them are appropriate given the diversity of roles and responsibilities that managers have on any given day. They must truly possess a broad range of skills in order to react, adapt, plan, and change course swiftly to stay ahead of changes inside and outside of the organization. Perhaps the best way to sum it up is that managers and leaders need to be prepared because . . .

You can view the transcript for "Life is like a box of chocolates" (link opens in new tab) or the text alternative for "Life is Like a Box of Chocolates" opens in new window).

Summary

Managers

Managers wear many hats and must bring with them an entire toolkit of skills—ranging from interpersonal to technical skills—in order to reach organizational goals and objectives effectively. Without the proper skill set, managers can find themselves unable to gain the trust and support of those around them, making their job more difficult and, in some cases, impossible.

Management Theory

Although the world of business has changed tremendously over time, the functions of management originally identified by Fayol in the early 1900s still hold. Fayol's original five functions have evolved into the six key functions of management today, including planning, organizing, staffing, leading, controlling and motivating. What has changed is where and how managers perform these four primary functions.

Planning

Planning within a business ranges from the big picture to the very granular, from the organization's foundational plan (for example, its vision and mission) and set of strategic plans to its daily operations plans. Each one builds upon the other, and without a well-developed set of plans that management can implement, an organization will likely drift from one venture or problem to another without ever really achieving success.

Organizing

The structure of an organization can have a tremendous impact on the organization's ability to react to both internal and external forces. Organizational structure also determines the managers' span of control, communication channels, and operational responsibilities. The organization should be structured in such a way that it reflects the company's mission and supports its customer and product/services goals to the greatest advantage.

Leading

From autocratic to laissez-faire, leadership styles run the entire spectrum. Some of the most effective leaders are those who can adopt different styles to fit the situation at hand.

Controlling

The control function of management has two aims: to make order out of chaos and to evaluate whether the company's efforts and resources are being maximized. Remember that the "control function" doesn't give management license to be manipulative or autocratic. Instead it refers to the importance of control through *evaluation*, since evaluation is the key to knowing whether a company is producing the desired results or not.

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21.18: Discussion- How Great Leaders Inspire Action

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

This discussion is based on a TED Talk by Simon Sinek, as well as drawing on readings from the management module. Fascinated by leaders with the capacity to inspire and have an impact in the world, Sinek has discovered some remarkable patterns in how these leaders think, act, and communicate. He wrote *Start With Why: How Great Leaders Inspire Everyone to Take Action* to explore the idea of the "golden circle," which is what he calls "a naturally occurring pattern, grounded in the biology of human decision-making, that explains why we are inspired by some people, leaders, messages, and organizations over others."

Watch Sinek's TED Talk, below:

You can access the transcript for "Simon Sinek: How great leaders inspire action" on the TED website (opens in new window) or the text alternative for "Simon Sinek: How Great Leaders Inspire Action" (opens in new window).

For Discussion

1. Select the portion of Sinek's TED Talk that made the greatest impact on you *personally* as you listened. You can read the transcript to find his exact words and make sure you capture his message. Why did you select this portion?
2. Thinking about what you learned from the readings in this module, answer the following question: How important is it for managers and leaders in business to understand Sinek's concluding statement, below?

Because there are leaders and there are those who lead. Leaders hold a position of power or authority, but those who lead inspire us. Whether they're individuals or organizations, we follow those who lead, not because we have to, but because we want to. We follow those who lead, not for them, but for ourselves.

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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21.19: Assignment- One Owner, Many Hats

Scenario

Wanda finally decides to move her business out of her home and rent a small building in town that has space for a commercial kitchen as well as enough room for some retail sales. She knows that her business is going to have more "moving parts" that will need to be managed, but she isn't sure what that will entail. When you press Wanda for details, she says that if she does expand, she will add the following positions to the company:

- A full-time dog treat baker;
- One part-time baking assistant;
- A retail sales clerk who will also handle the Web site and Etsy sales;
- One part-time administrative assistant, who will help Wanda with day-to-day operations and paperwork.

She also anticipates that if her sales projections are correct, within the next twelve months she will add the following:

- One part-time bookkeeper;
- A full-time e-commerce manager who will handle all of the Web site traffic and Etsy orders;
- One part-time marketing manager to promote the Salty Pawz brand and help develop new products.

Your Task

1. Prepare an organizational chart for Wanda that shows what her role as a manager will look like if she expands as outlined above.
2. In addition to the chart, for each direct and indirect report, provide details regarding what management functions Wanda will be performing. Be sure to explain how each management function will specifically affect her, those she is managing, and the business in general.

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Prepare an organizational chart for Wanda that shows what her role, as a manager will look like if she expands as outlined above.	0 points	11 points	16 points	20 points	20%
Explain the functions of management that Wanda will need to engage in if Salty Pawz expands.	0 points	16.5 points	24 points	30 points	30%
Explain how each function of management identified may impact Wanda and Salty Pawz.	0 points	16.5 points	24 points	30 points	30%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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21.20: Assignment- Are Leaders Born or Made?

Preparation

Shakespeare made the following observation about leaders: “Some are born great, some achieve greatness, and some have greatness thrust upon them.” For this assignment, you will select a leader and then decide whether he or she was “born” or “made.”

Your Task

1. Select a leader from the twentieth or twenty-first century (1901–today).
2. Using reliable sources, research this individual’s life, accomplishments, work, and/or contributions to society.
3. You’ll need to find and cite a minimum of two different sources for your paper.
4. Your written assignment should contain three sections, organized as follows:
   - (75–150 words): Introduce your chosen leader. Provide background biographical information, and explain why you chose this person.
   - (300–500 words): State whether you believe this person was born to be a leader or something or someone made them a leader. Then, support your positions with facts from his/her life, work, and achievements. You can include what other authorities have said or written about this person. Remember, your goal is to give evidence to support your claim that this leader was either “made” or “born.”
   - (50–75 words): For your conclusion, explain what can be learned from this leader.

Please refer to the Guidelines for Written Assignments for additional requirements.

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CHAPTER OVERVIEW

22: Module 9 Readings - Teamwork and Communication

22.1: Reading- The Team and the Organization

What Is a Team? How Does Teamwork Work?

A team (or a *work team*) is a group of people with complementary skills who work together to achieve a specific goal. In the case of Motorola's RAZR team, the specific goal was to develop (and ultimately bring to market) an ultrathin cell phone that would help restore the company's reputation as a designer of stylistically appealing, high-function phones. The team achieved its goal by integrating specialized but complementary skills in engineering and design and by making the most of its authority to make its own decisions and manage its own operations.

Teams vs. Groups

"A group," suggests Bonnie Edelstein, a consultant in organizational development, "is a bunch of people in an elevator. A team is also a bunch of people in an elevator, but the elevator is broken." This distinction may be a little oversimplified, but as our tale of teamwork at Motorola reminds us, a *team* is clearly something more than a mere *group* of individuals. In particular, members of a group—or, more accurately, a *working group*—go about their jobs independently and meet primarily to share information. A group of department-store managers, for example, might meet monthly to discuss their progress in cutting plant costs, but each manager is focused on the goals of his or her department because each is held accountable for meeting only those goals. Teams, by contrast, are responsible for achieving specific common goals, and they're generally empowered to make the decisions needed to complete their authorized tasks.

Some Key Characteristics of Teams

To keep matters in perspective, the following lists five key characteristics of work teams:

1. *Teams are accountable for achieving specific common goals*. Members are collectively responsible for achieving team goals, and if they succeed, they're rewarded collectively.
2. *Teams function interdependently*. Members cannot achieve goals independently and must rely on each other for information, input, and expertise.
3. *Teams are stable*. Teams remain intact long enough to finish their assigned tasks, and each member remains on board long enough to get to know every other member.
4. *Teams have authority*. Teams possess the decision-making power to pursue their goals and to manage the activities through which they complete their assignments.
5. *Teams operate in a social context*. Teams are assembled to do specific work for larger organizations and have the advantage of access to resources available from other areas of their organizations.

Why Organizations Build Teams

Why do major organizations now rely more and more on teams to improve operations? Executives at Xerox have reported that team-based operations are 30 percent more productive than conventional operations. General Mills says that factories organized around team activities are 40 percent more productive than traditionally organized factories. According to in-house studies at Shenandoah Life Insurance, teams have cut case-handling time from twenty-seven to two days and virtually eliminated service complaints. FedEx says that teams reduced service errors (lost packages, incorrect bills) by 13 percent in the first year.[1]

Today it seems obvious that teams can address a variety of challenges in the world of corporate activity. Before we go any further, however, we should remind ourselves that data like those we've just cited aren't necessarily definitive. For one thing, they may not be objective—companies are more likely to report successes than failures. As a matter of fact, teams *don't* always work. Indeed, according to one study, team-based projects fail 50 to 70 percent of the time.[2]

The Effect of Teams on Performance

Research shows that companies build and support teams because of their effect on overall workplace performance, both organizational and individual. If we examine the impact of team-based operations according to a wide range of relevant criteria—including product quality, worker satisfaction, and quality of work life, among others—we find that overall organizational performance improves. Below, Table $22.1.1$ lists several areas in which we can analyze workplace performance and indicates the percentage of companies that have reported improvements in each area.

Table $22.1.1$. Effect of Teams on Workplace Performance[3]

Area of Performance	Percent of Firms Reporting Improvement
Product and service quality	70
Customer service	67
Worker satisfaction	66
Quality of work life	63
Productivity	61
Competitiveness	50
Profitability	45
Absenteeism/turnover	23

Types of Teams

Teams, then, can improve company and individual performance in a number of areas. Not all teams, however, are formed to achieve the same goals or charged with the same responsibilities. Nor are they organized in the same way. Some, for instance, are more *autonomous* than others—less accountable to those higher up in the organization. Some depend on a team leader who's responsible for defining the team's goals and making sure that its activities are performed effectively. Others are more or less self-governing: though a leader lays out overall goals and strategies, the team itself chooses and manages the methods by which it pursues its goals and implements its strategies.[4] Teams also vary according to their membership. Let's look at several categories of teams.

Manager-Led Teams

As its name implies, in the manager-led team the manager is the team leader and is in charge of setting team goals, assigning tasks, and monitoring the team's performance. The individual team members have relatively little autonomy. For example, the key employees of a professional football team (a manager-led team) are highly trained (and highly paid) athletes, but their activities on the field are tightly controlled by a head coach. As team manager, the coach is responsible both for developing the strategies by which the team pursues its goal of winning games and for the final outcome of each game (not to mention the season). He's also solely responsible for interacting with managers above him in the organization. The players are responsible only for executing plays.[5]

Self-Managing Teams

Self-managing teams (also known as *self-directed* or *self-regulating teams*) have considerable autonomy. They are usually small and often absorb activities that were once performed by traditional supervisors. A manager or team leader may determine overall goals, but the members of the self-managing team control the activities needed to achieve the goals, such as planning and scheduling work, sharing tasks, meeting quality standards, and handling day-to-day operations.

Self-managing teams are the organizational hallmark of Whole Foods Market, the largest natural-foods grocer in the United States. Each store is run by ten teams (produce, prepared foods, and so forth), and virtually every store employee is a member of a team. Each team has a designated leader and its own performance targets. (Team leaders also belong to a store team, and store-team leaders belong to a regional team.) To do its job, every team has access to the kind of information—including sales and even salary figures—that most companies reserve for the eyes of traditional managers.[6]

Needless to say, not every self-managed team enjoys the same degree of autonomy. Companies vary widely in choosing which tasks teams are allowed to manage and which ones are best left to upper-level management only. As you can see below in Figure 22.1.1, for example, self-managing teams are often allowed to schedule assignments, but they are rarely allowed to fire coworkers.

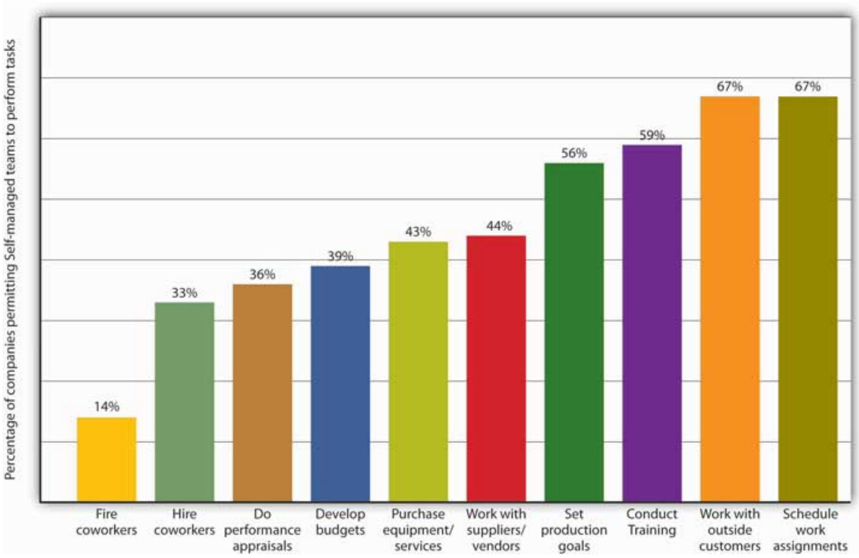

Figure 22.1.1: What Teams Do (and Don't) Manage

Cross-Functional Teams

Many companies use cross-functional teams—teams that, as the name suggests, cut across an organization's *functional areas* (operations, marketing, finance, and so on). A cross-functional team is designed to take advantage of the special expertise of members drawn from different functional areas of the company. When the Internal Revenue Service, for example, wanted to study the effects on employees of a major change in information systems, it created a cross-functional team composed of people from a wide range of departments. The final study reflected expertise in such areas as job analysis, training, change management, industrial psychology, and even ergonomics.[7]

Cross-functional teams figure prominently in the product-development process at Nike, where they take advantage of expertise from both inside and outside the company. Typically, team members include not only product designers, marketing specialists, and accountants but also sports-research experts, coaches, athletes, and even consumers. Likewise, Motorola's RAZR team was a cross-functional team: Responsibility for developing the new product wasn't passed along from the design team to the engineering team but rather was entrusted to a special team composed of both designers and engineers.

We can also classify the RAZR team as a *product-development* or *project team*. *Committees* and *task forces*, both of which are dedicated to specific issues or tasks, are often cross-functional teams. *Problem-solving teams*, which are created to study such issues as improving quality or reducing waste, may be either intradepartmental or cross-functional.[8]

Virtual Teams

"Teamwork," said someone (we're not sure who), "doesn't tolerate the inconvenience of distance." Indeed, technology now makes it possible for teams to function not only across such organizational boundaries as functional areas, departments, and divisions but also across time and space, as well. Working in virtual teams, geographically dispersed members interact electronically in the process of pursuing a common goal. Such technologies as videoconferencing, instant messaging, and electronic meetings, which allow people to interact simultaneously and in real time, offer a number of advantages in conducting the business of a virtual team.[9] Among other things, members can participate from any location or at any time of day, and teams can "meet" for as long as it takes to achieve a goal or solve a problem—a few days, a few weeks, or a few months.

Nor does team size seem to be an obstacle when it comes to calling virtual-team meetings: In building the F-35 Strike Fighter, U.S. defense contractor Lockheed Martin staked the $225 billion project on a virtual product-team of unprecedented global dimension, drawing on designers and engineers from the ranks of eight international partners ranging from Canada and the United Kingdom to Norway and Turkey.[10]

KEY TAKEAWAYS

- Teamwork brings diverse areas of expertise to bear on organizational problems and projects.
- Reaching teamwork goals requires skills in negotiating trade-offs, and teamwork brings these skills into play at almost every step in the process.

- To be successful, teams need a certain amount of autonomy and authority in making and implementing their decisions.
- A **team** (or a *work team*) is a group of people with complementary skills who work together to achieve a specific goal. Members of a *working group* work independently and meet primarily to share information.
- Work teams have five key characteristics:
  - They are accountable for achieving specific common goals.
  - They function interdependently.
  - They are stable.
  - They have authority.
  - They operate in a social context.
- Companies build and support teams because of their effect on overall workplace performance, both organizational and individual.
- Work teams may be of several types:
  - In the traditional manager-led team, the leader defines the team's goals and activities and is responsible for its achieving its assigned goals.
  - The leader of a self-managing team may determine overall goals, but employees control the activities needed to meet them.
  - A cross-functional team is designed to take advantage of the special expertise of members drawn from different functional areas of the company.
  - On virtual teams, geographically dispersed members interact electronically in the process of pursuing a common goal.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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3. *Source*: Adapted from Edward E. Lawler, S. A. Mohman, and G. E. Ledford, *Creating High Performance Organizations: Practices and Results of Employee Involvement and Total Quality in Fortune 1000 Companies* (San Francisco: Wiley, 1992). ↵
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6. Charles Fishman, "Whole Foods Is All Teams," Fast Company.com, December 18, 2007, http://www.fastcompany.com/node/26671/print (accessed October 11, 2011). ↵
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10. "Lockheed Martin Chooses Mathcad as a Standard Design Package for F-35 Joint Strike Fighter Project," *Adept Science*, September 23, 2003, (accessed October 11, 2011). ↵

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22.2: Reading- Stages of Team Development

Stages of Team Development

Teams move through a series of stages, beginning when they are formed and ending when they are disbanded. Bruce Tuckman identified four distinct phases of team development: *forming*, *storming*, *norming*, and *performing*. Each has a primary purpose and a common set of interpersonal dynamics among team members. Tuckman proposed that all are inevitable and even necessary parts of a successful team's evolution.

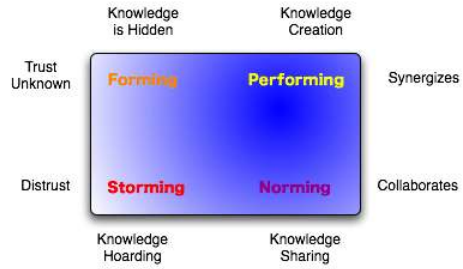

Figure 22.2.1: Stages of Team Building

The Forming Stage

The first step in a team's life is bringing together a group of individuals. Individuals focus on defining and assigning tasks, establishing a schedule, organizing the team's work, and other startup matters. In addition to focusing on the scope of the team's purpose and how to approach it, individuals in the formation stage are also gathering information and impressions about each other. Since people generally want to be accepted by others, during this period they usually avoid conflict and disagreement. Team members may begin to work on their tasks independently, not yet focused on their relationships with fellow team members.

The Storming Stage

Once their efforts are under way, team members need clarity about their activities and goals, as well as explicit guidance about how they will work independently and collectively. This leads to a period known as storming—because it can involve brainstorming ideas and also because it usually causes disruption. During the storming stage members begin to share ideas about what to do and how to do it that compete for consideration. Team members start to open up to each other and confront one another's ideas and perspectives.

Because storming can be contentious, members who are averse to conflict will find it unpleasant or even painful. This can decrease motivation and effort by drawing attention away from tasks. In some cases storming (i.e., disagreements) can be resolved quickly. Other times a team never leaves this stage and becomes stuck and unable to do its work. Patience and consideration toward team members and their views go a long way toward avoiding this.

The Norming Stage

Successfully moving through the storming stage means that a team has clarified its purpose and strategy for achieving its goals. It now transitions to a period focused on developing shared values about how team members will work together. These norms of collaboration can address issues ranging from when to use certain modes of communication, such as e-mail versus telephone, to how team meetings will be run and what to do when conflicts arise. Norms become a way of simplifying choices and facilitating collaboration, since members have shared expectations about how work will get done.

The Performing Stage

Once norms are established and the team is functioning as a unit, it enters the performing stage. By now team members work together easily on interdependent tasks and are able to communicate and coordinate effectively. There are fewer time-consuming distractions based on interpersonal and group dynamics. For this reason, motivation is usually high and team members have confidence in their ability to attain goals.

While these four stages—forming, storming, norming, and performing—are distinct and generally sequential, they often blend into one another and even overlap. A team may pass through one phase only to return to it. For example, if a new member joins the team there may be a second brief period of formation while that person is integrated. A team may also need to return to an earlier stage if its performance declines. Team-building exercises are often done to help a team through its development process.

KEY TAKEAWAYS

- Teams move through a series of four phases—from when they are formed to when their work is complete.
- During the forming stage, a the team discusses it purpose, defines and assigns tasks, establishes timelines, and begins forming personal relationships.
- The often-contentious storming stage is the period when team members clarify their goals and the strategy for achieving them.
- The norming stage is when the team establishes its values for how individuals will interact and collaborate.
- Performing is the stage of team development when team members have productive relationships and are able to communicate and coordinate effectively and efficiently.
- While teams move through the four stages in sequence, the phases may overlap or be repeated.

GLOSSARY

Performing:
The stage of group development when team members have productive relationships and are able to communicate and coordinate effectively and efficiently.

Norming:
The stage of group development when the team establishes its values for how individuals will interact and collaborate.

Forming:
The stage of group development when the team discusses its purpose, defines and assigns tasks, establishes timelines, and begins forming personal relationships.

Storming:
The stage of group development when the team clarifies its goals and its strategy for achieving them.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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22.3: Reading- Why Teamwork Works

Factors in Effective Teamwork

Now that we know a little bit about *how* teams work, we need to ask ourselves *why* they work. Not surprisingly, this is a fairly complex issue. In this section, we'll answer these closely related questions: Why are teams often effective? Why are they sometimes *in*effective?

First, let's begin by identifying several factors that, in practice, tend to contribute to effective teamwork. Generally speaking, teams are effective when the following factors are met:[1]

- *Members depend on each other*. When team members rely on each other to get the job done, team productivity and efficiency are high.
- *Members trust one another*. Teamwork is more effective when members trust each other.
- *Members work better together than individually*. When team members perform better as a group than alone, collective performance exceeds individual performance.
- *Members become boosters*. When each member is encouraged by other team members to do his or her best, collective results improve.
- *Team members enjoy being on the team*. The more that team members derive satisfaction from being on the team, the more committed they become.
- *Leadership rotates*. Teams function effectively when leadership responsibility is shared over time.

Most of these explanations probably make pretty clear intuitive sense. Unfortunately, because such issues are rarely as clear-cut as they may seem at first glance, we need to examine the issue of group effectiveness from another perspective—one that considers the effects of factors that aren't quite so straightforward.

Group Cohesiveness

The idea of group cohesiveness refers to the *attractiveness* of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it. The principle of group cohesiveness, in other words, is based on the simple idea that groups are most effective when their members like being members of the group.[2]

What Makes a Team Cohesive?

Numerous factors may contribute to team cohesiveness, but in this section, we'll focus on five of the most important:

1. *Size*. The bigger the team, the less satisfied members tend to be. When teams get too large, members find it harder to interact closely with other members; a few members tend to dominate team activities, and conflict becomes more likely.
2. *Similarity*. People usually get along better with people like themselves, and teams are generally more cohesive when members perceive fellow members as people who share their own attitudes and experience.
3. *Success*. When teams are successful, members are satisfied, and other people are more likely to be attracted to their teams.
4. *Exclusiveness*. The harder it is to get into a group, the happier the people who are already in it. Status (the extent to which outsiders look up to a team, as well as the perks that come with membership) also increases members' satisfaction.
5. *Competition*. Members value membership more highly when they're motivated to achieve common goals—especially when those goals mean outperforming other teams.

There's such a thing as too much cohesiveness. When, for instance, members are highly motivated to collaborate in performing the team's activities, the team is more likely to be effective in achieving its goals. Clearly, when those goals are aligned with the goals of the larger organization, the organization, too, will be happy. If, however, its members get too wrapped up in more immediate team goals, the whole team may lose sight of the larger organizational goals toward which it's supposed to be working.

Groupthink

Likewise, it's easier for leaders to direct members toward team goals when members are all on the same page—when there's a basic willingness to conform to the team's rules and guidelines. When there's too much conformity, however, the group can become ineffective: It may resist change and fresh ideas and, what's worse, may end up adopting its own dysfunctional tendencies as its way of doing things. Such tendencies may also encourage a phenomenon known as groupthink—the tendency to conform to group pressure in making decisions, while failing to think critically or to consider outside influences. Groupthink is often cited as a factor in the explosion of the space shuttle *Challenger* in January 1986: Engineers from a supplier of components for the rocket booster warned that the launch might be risky because of the weather but were persuaded to reverse their recommendation by NASA officials who wanted the launch to proceed as scheduled.[3]

Why Teams Fail

Teams don't always work. To learn why, let's take a quick look at four common obstacles to success in introducing teams into an organization:[4]

- *Unwillingness to cooperate*. Failure to cooperate can occur when members don't or won't commit to a common goal or set of activities. What if, for example, half the members of a product-development team want to create a brand-new product and half want to improve an existing product? The entire team may get stuck on this point of contention for weeks or even months.
- *Lack of managerial support*. Every team requires organizational resources to achieve its goals, and if management isn't willing to commit the needed resources—say, funding or key personnel—a team will probably fall short of those goals.
- *Failure of managers to delegate authority*. Team leaders are often chosen from the ranks of successful supervisors—first-line managers who give instructions on a day-to-day basis and expect to have them carried out. This approach to workplace activities may not work very well in leading a team—a position in which success depends on building a consensus and letting people make their own decisions.
- *Failure of teams to cooperate*. If you're on a workplace team, your employer probably depends on teams to perform much of the organization's work and meet many of its goals. In other words, it is, to some extent, a team-based organization, and as such, reaching its overall goals requires a high level of cooperation *among teams*.[5] When teams can't agree on mutual goals (or when they duplicate efforts), neither the teams nor the organization is likely to meet with much success.

Motivation and Frustration

Finally, remember that teams are composed of people, and whatever the roles they happen to be playing at a given time, people are subject to psychological ups and downs. As members of workplace teams, they need motivation; when motivation is down, so are effectiveness and productivity. As you can see below in Figure 1, "Sources of Frustration," the difficulty of maintaining a high level of motivation is the chief cause of frustration among members of teams. As such, it's also a chief cause of ineffective teamwork, and that's one reason why more employers now look for the ability to develop and sustain motivation when they're hiring new managers.[6]

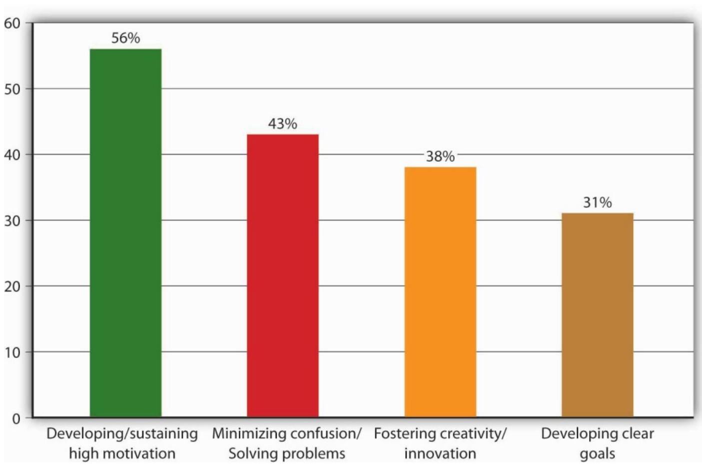

Figure 22.3.1: Sources of Frustration

KEY TAKEAWAYS

- Generally speaking, teams are effective when the following are true:
  - Members are interdependent.
  - Members work better together than individually.
  - Teams work well enough to satisfy members.
  - Leadership rotates.
  - Members help one another.

- Members become boosters.
- Members trust one another.

- Group cohesiveness refers to the *attractiveness* of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it.
- Common obstacles to team success include the following:
  - Unwillingness to cooperate
  - Lack of managerial support
  - Failure of managers to delegate authority
  - Failure of teams to cooperate

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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1. This section is based on David A. Whetten and Kim S. Cameron, *Developing Management Skills*, 7th ed. (Upper Saddle River, NJ: Pearson Education, 2007), 497. ↵
2. This section is based mostly on Jennifer M. George and Gareth R. Jones, *Understanding and Managing Organizational Behavior*, 5th ed. (Upper Saddle River, NJ: Pearson Education, 2008), 371–77. See Leon Festinger, "Informal Social Communication, *Psychological Review* 57 (1950): 271–82. ↵
3. See Em Griffin, "Groupthink of Irving Janis," 1997, (accessed October 11, 2011). ↵
4. This section is based on Jerald Greenberg and Robert A. Baron, *Behavior in Organizations*, 9th ed. (Upper Saddle River, NJ: Pearson Education, 2008), 317–18. ↵
5. See Leigh L. Thompson, *Making the Team: A Guide for Managers* (Upper Saddle River, NJ: Pearson Education, 2008), 323–24. ↵
6. See Leigh L. Thompson, *Making the Team: A Guide for Managers* (Upper Saddle River, NJ: Pearson Education, 2008), 18–19. ↵

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22.4: Reading- Effective Communication in Business

Effective Communication in Business

Consider the following:

- A text message
- A voicemail
- A passing comment
- A Facebook post
- An unreturned phone call

Have you ever had one of these communications be misinterpreted? You meant one thing, but your friend thought you meant something else? Sometimes the miscommunication can result in confusion about a meeting time or place. Or worse, it can be entirely misunderstood and have a negative impact on your relationship.

Communication, the exchange of information or ideas between sender and receiver, can be challenging in one's personal life, at school, and especially in business. Today, it's even more complex because business is conducted on a global basis 24/7, often using different languages and different communication methods. In this constant, high-speed business environment, communication blunders can cost more than you might think. Did you ever hear the saying "You only have one chance to make a good first impression"? It couldn't be truer when it comes to communication: The first two seconds of communication are so important that it takes another four minutes to add 50 percent more information to an impression—positive or negative—within that communication.[1] Communication has often been referred to as a soft skill, which includes other competencies such as social graces, personality traits, language abilities, and the ability to work with other people. Soft skills also encompass emotional intelligence, which Adele B. Lynn, in her book *The EQ Interview: Finding Employees with High Emotional Intelligence*, defines as "a person's ability to manage herself as well as her relationship with others so she can live her intentions."[2] But in today's business world, communication has become part of the new "hard skills" category, a technical job requirement, because of the critical role that it plays in business.[3] According to Peter Post, great-grandson of the late Emily Post, "Your skills can get you in the door; your people skills are what can seal the deal."[4]

Misunderstood = Miscommunicated

It is almost impossible to be in business without developing relationships inside your organization and with your customers. Your relationship skills build trust, allow you to be a true partner, and help solve your customers' problems; both internal trust and external communication are keys to your ability to deliver on your promises. How are these qualities intrinsically related? The way in which you communicate can determine the level of trust that your colleagues or customers have in you.[5]

In the same way that relationships are the cornerstone of trust, communication is the foundation of relationships. But it's difficult to establish and develop relationships; it takes work and a lot of clear communication. You might think that sounds simple, but consider this: Nearly 75 percent of communications that are received are interpreted incorrectly. At the same time, interestingly, many people consider themselves good communicators. The telling disconnect occurs because people tend to assume that they know what other people mean, or people assume that others know what they mean. This is compounded by the fact that people tend to hear what they want to hear—that is, a person may interpret elements of a conversation in such a way that the taken meanings contribute to his already established beliefs. When you put these assumptions together, communication can easily become "miscommunication."[6]

The Communication Model

The standard model of communication has evolved based on two parties—the sender and the receiver—exchanging information or ideas. The model includes major processes and functions categorized as encoding, decoding, response, and feedback. In addition, the model accounts for noise, which symbolizes anything that might disrupt the sending or receiving of a message.[7] The communication model is shown below in Figure $22.4.1$:

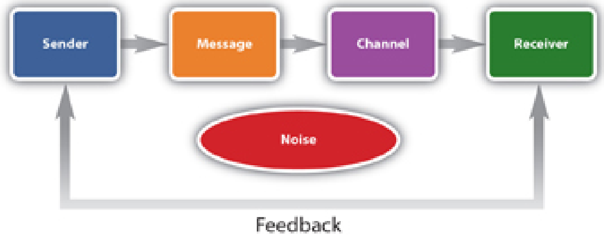

Figure 22.4.1: Traditional Communication Process. Adapted from Michael R. Solomon, Greg W. Marshall, and Elnora W. Stewart, Marketing: Real People, Real Choices, 5th ed. (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 378.

The model helps describe exactly how communication takes place. For example, if you send a text message to your friend to ask him if he wants to go a movie, you are the source, or sender, of the message. You translated or encoded your message into text characters. A personal digital assistant (PDA) such as a BlackBerry, iPhone, or cell phone is the channel, or the method by which you communicated your message. Chances are, if your friend does not have his PDA or cell phone with him, your message will not reach him, and you might miss the movie. So in this example, the PDA or cell phone is the channel. When your friend, the receiver, reads the message, he decodes it or determines what you meant to communicate, and then he responds. If he was talking to another friend while he was reading your text message and didn't see the time the movie started, that conversation would be considered noise because it would be interfering with the communication of your message. Noise interferes with communication or causes distraction, whether it is heard or seen. When your friend responds to you by saying that he wants to go see the movie, he is providing feedback (or a response to your message). Figure 22.4.2below shows this example applied to the communication model.

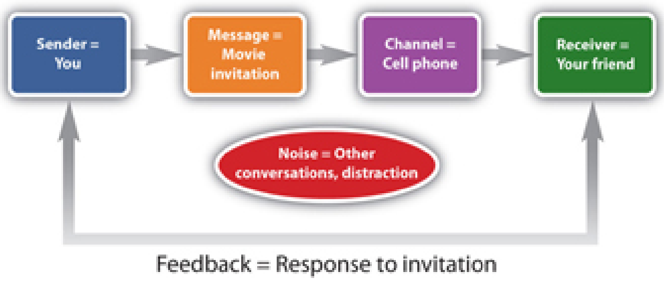

Figure 22.4.2: Communication Process Example

The same thing can happen in business situations. For example, if you call a prospect to set up a meeting, you are the sender. The message is the meeting information (e.g., date, time, and place) that you encode into words. The channel is the telephone, and the receiver is the prospect. It sounds easy enough. Assume, however, that the prospect responds to you and agrees to the meeting. But because he was checking his e-mails while he was talking to you (which is noise), he puts the wrong time on his calendar. When you come for the appointment, he's out of the office, and your sales call doesn't take place. Now you have to start the communication process all over again. This is an example of simply setting up a meeting. Now imagine the challenges if you started explaining the features and benefits of a complex product or negotiating a contract. You can see why understanding the communication process is so important in selling.

Did You Know . . . ?

- Positive e-mail messages are likely to be interpreted as neutral.
- Neutral e-mail messages are likely to be perceived as negative.
- People who send e-mails overrate their ability to communicate feelings.
- There is a gap between how a sender *feels* when he writes the e-mail and the way the emotional content is communicated, which can cause an error in decoding on the part of the receiver.
- One simple e-mail can lead to a communication debacle if the e-mail is not clearly written and well thought out from the recipient's point of view.[8]

Effective Communication

How do you avoid the pitfalls of poor communication and build productive business relationships? It's best to always communicate in a timely manner and in the method that your customer prefers. That may be easier said than done. Here are six tips that can help you increase your chances of making your communications effective.

Tip 1: Empathy Is Essential

One of the key elements of being a good communicator is having empathy. That means thinking about your communication from the receiver's point of view. It's focusing on what *she* wants to learn as a result of your communication, not what you want to tell her. Empathy is about demonstrating that you care about the other person's situation. Think about when you received your acceptance letter from your college; the letter probably mentioned what an exciting time it is in your life. The author of the letter demonstrated empathy because she focused on the situation from your perspective. A purely factual letter, without empathy, might have said that you were accepted and that now the school can make their budget since they met their enrollment goal. That would be quite a different letter and would make you feel very different (and probably not very welcome). Although it's always best to be candid, you should deliver information from the receiver's point of view and address her concerns.[9]

Empathy is an integral part of emotional connections. It is especially important to have an emotional connection and empathy when apologizing to customers. Chances are the customer is already angry, or at least disappointed, when you are not able to deliver as expected. You can express empathy in your communications by saying or writing, "You have every right to be upset. I understand how you must feel. I apologize for the late delivery. Let's work on a new process that will help prevent it from happening again."[10] Some of the best brands have disappointed their customers but showed empathy when they apologized.

Tip 2: Think Before You Communicate

Quick responses, whether verbal or via electronic methods, can be less effective than those that are considered. Although a timely response is critical, it's worth a few minutes to think about exactly what you want to say before you say it (or type it).

Tip 3: Be Clear

It seems obvious, but not everyone is clear in his communications. Sometimes, people are trying to avoid "bad news" or trying to avoid taking a stand on a topic. It's always best to avoid confusion and clearly say what you mean by framing your message in a way that is easily understood by all receivers. It's also a good idea to avoid buzz words (or jargon)—those words, phrases, or acronyms that are used only in your company. If they can't be avoided, explain them in the same communication terms. You should also avoid jargon on your résumé and cover letter—help your reader see your brand story at a glance without needing a decoder ring.

Tip 4: Be Brief

Business communication should be short and to the point. Your customers are busy and need information—whether it's a proposal, report, or follow-up to a question—in a clear, concise way. It's best to avoid being verbose, especially in any business plans, proposals, or other significant documents.[11]

Tip 5: Be Specific

If you go to dinner at Cheesecake Factory and there is a wait to get a table, the hostess will hand you a portable pager and tell you that the wait will be twenty to twenty-five minutes. Perfect. You have just enough time to run a quick errand at a nearby store at the mall and be back in time to get your table. If, on the other hand, she told you that you will be seated shortly, you might have an expectation of being seated in five to ten minutes. Meanwhile, "shortly" might mean twenty to twenty-five minutes for her. You would probably forgo running your errand because you think you are going to be seated soon but end up waiting for twenty-five minutes and being frustrated. Being specific in your communication not only gives clarity to your message but also helps set your customer's expectations. In other words, your customer won't expect something you can't deliver if you are clear about what exactly you *can* deliver and when. The same is true for prices. For example, if you order from the menu at the Cheesecake Factory, you know precisely what you will get to eat and how much it will cost. However, if there is a menu special that you heard about tableside, but you weren't told how much the dish was, you might be surprised (and disappointed) when you receive the check. Specificity avoids surprises and sets expectations. Below, in Table 22.4.1, "General vs. Specific Statements," are some examples of general statements that can be communicated more effectively when turned into specific statements:

Table 22.4.1. General vs. Specific Statements

General Statement	Specific Statement
I'll get back to you shortly.	I'll get back to you by Tuesday.
It will only take a few minutes.	It will take less than 5 minutes.
It will cost about $5,000 plus installation.	The cost is $4,800 plus $200 for installation.

General Statement	Specific Statement
Everything is included.	It includes your choice of entrée, vegetable, dessert, and coffee.

Tip 6: Be Timely

Timing is everything in life and most certainly in selling. It's best to be proactive with communication, and if you owe someone a response, do it sooner rather than later. If you are slow to respond to questions and communication, it will be difficult to develop trust, as prolonged responses may seem to imply that you are taking action without informing the customer what it is you are doing. Timing is especially important when you are communicating a negative response or bad news. Don't put it off; do it as soon as possible and give your customer the benefit of complete information.

Rules of Engagement

At the beginning of each business relationship, ask your customer how she prefers to communicate. Getting the answers to the following simple questions will save time and confusion throughout your relationship and help ensure good communication:

- How do you prefer to receive regular communication (e-mail, text, phone, in person, hard copy)?
- What can I expect as a standard turnaround time for response to questions and issues?
- How do you prefer to receive urgent communication (e-mail, text, phone)?
- Who else (if anyone) in the organization would you like to also receive communication from me?
- When is the best time to touch base with you (early morning, midday, or later in the afternoon)?
- How frequently would you like a status update and in what format (e-mail, phone, in person)?

Listen Up

While you may think you are ready to communicate, it's a good idea to stop and listen first. Creating your message is only half of communication; listening is the other half. But it's difficult to listen because we listen faster than we speak—that is, based on what the other person is saying, we are already constructing responses in our minds before they have even finished. As a result, many people are guilty of "listening too fast."[12] Cicero once said that it is good thing that humans were given one mouth and two ears, in light of the way we use them.[13]

Listening, in fact, is so important that companies like Starbucks believe that it may directly improve profits. According to Alan Gulick, a Starbucks Corporation spokesperson, if every Starbucks employee misheard one $10 order each day, it would cost the company one billion dollars in a year. That's why Starbucks has a process to teach their employees how to listen. Although listening may seem passive, it is actively linked to success: One study conducted in the insurance industry found that better listeners held higher positions and got promoted more than those who did not have developed listening skills.[14] So it's worth it to hone your listening skills *now* so that when you get into the business world you can be successful. The following are a few tips:

- **Use active listening**. Confirm that you heard the sender correctly by saying something like, "Just to be sure I understand, we are going to move forward with twelve cases for your initial order, then revisit your inventory in five days." Review the communication model above and take notice of the importance of decoding. If you decode a message from your customer incorrectly, the communication is ineffective and could even be costly. In the example above, the customer might have said in response, "I meant that the initial order should be five cases, and we'll revisit the inventory in twelve days." That's a big difference.
- **Ask questions**. Questions are a way to gather more information and learn about your customer and their business. They are also an excellent way to demonstrate that you are communicating by listening. Asking the *right* questions is critical to being successful. Focus on listening and asking the right questions, and you'll be rewarded with great information.
- **Focus**. Although multitasking has seemingly become a modern virtue, focus actually helps create more effective communication. Stop and focus on your customer when he is speaking. This is a sign of respect, and this concentration allows you to absorb more information. Take notes to remember exactly what you discussed. There's nothing more important than what your customer has to say.[15]
- **Take notes**. While it may seem like you will remember everything that is said at a meeting or during a conversation, taking notes signals that you are listening, and it provides you with an accurate record of what was said. "The palest ink is better than the best memory."[16]

There's More to Communication Than Meets the Eye . . . or Ear

It's important to remember that you will be communicating with many different people about many different topics in selling. Sometimes, you will be communicating one-on-one and sometimes you will be communicating with a group. Just as people have varying social styles, it's important to know that people also absorb information differently. Research conducted in the 1970s indicates that people comprehend information in the following four distinct ways:

- **Why**. They want to know the reasons for doing something.
- **What**. They want to know the facts about it.
- **How**. They want to know only the information they need to get it done.
- **What if**. They want to know the consequences of doing it.

This can be a helpful road map of the elements you will want to include in your communications, especially if you are communicating with a group, since you may not know everyone's best method of absorbing information. It's been proven that if people don't receive the type of communication they prefer, they tend to tune out or reject the information.

You've probably noticed that both people and brands communicate the same message multiple times and usually in multiple ways. Creative repetition is key to successful communication. Think about the advertising Pepsi ran when it launched its new logo in early 2009; you most likely saw the television commercial during the Super Bowl, noticed a billboard in a high-traffic area of a major city, received an e-mail, saw banner ads on the Internet, reviewed the commercial on YouTube, and saw the new logo on the packaging. Pepsi's ad campaign illustrates the "three-times convincer" concept, which claims that 80 percent of people need to be exposed a message three times to buy into it, 15 percent need to be exposed to it five times, and 5 percent need to be exposed to it up to twenty-five times.[17] You may have seen the message so many times that it's hard to remember what the old logo even looked like.

Types of Communication

It is important to use multiple types of communication so that repetition does not become boring like a broken record. There are three types of communication: verbal, which involves speaking to one or many people to convey a message; nonverbal, which includes body language and other observations about people; and written, which includes a message that is read in hard copy, e-mail, text message, instant message, Facebook, Twitter, blog, or other Internet-based written communication. Varying the usage of these mediums can help ensure your customer's attention, but you must carefully develop each skill separately to communicate effectively.

Verbal Communication

An introduction, a presentation, a telephone conversation, a videoconference call: these are all examples of verbal communication because information is transmitted orally. Despite the ubiquitous use of technology in the business world, verbal communication is the most common method of exchanging information and ideas. Verbal communication is powerful, fast, and natural and includes voice inflections that help senders and receivers understand the message more clearly. The downside to verbal communication is that once it is spoken, the words are essentially gone; they are preserved only in the memory of those present, and sometimes the memories of the specific words spoken vary dramatically. The he-said-she-said argument is an example of this. No one really knows who said what unless the words are recorded. Recall is rarely exactly the same between two or more people.

Voice inflection, the verbal emphasis you put on certain words, can have a significant impact on the meaning of what you say. In fact, the same words can take on completely different meaning based on the inflection you use. For example, if you say the sentence "I borrowed your book" with an inflection on a different word each time, the sentence communicates something completely different each time.

Verbal communication may take place face-to-face, such as an in-person conversation or group meeting, speech, or presentation. It could also take place by phone in an individual conversation, a conference call, or even a voice mail. Other forms of verbal communication include video conferences, podcasts, and Webinars, which are increasingly common in business. All these methods allow you to use inflection to communicate effectively. Face-to-face meetings also provide the opportunity to use and interpret other visual cues to increase the effectiveness of your communication.

Verbal communication is especially important throughout the steps of the selling process. Your choice of words can make the difference in someone's decision to first hear your sales presentation, and your presentation can determine whether that person will purchase your product or service.

Nonverbal Communication

Imagine that you are in a retail store buying a suit for an interview. When the salesperson approaches you, she smiles, makes eye contact, and shakes your hand. You respond positively. You notice that she is dressed professionally, so she makes you feel as if you will receive good fashion advice from her. When you make your choice, the tailor comes over wearing a tape measure around his neck. You know he is a professional and you can trust him to alter your new suit properly. On the other hand, if the salesperson waits on you only after you interrupt her personal phone call, doesn't make eye contact or shake your hand, acts as if she is bored being at work, and is dressed in worn jeans and flip-flops, it's unlikely that you trust her to help you choose your suit.

You have, no doubt, used and noticed nonverbal communication in virtually every personal encounter you have had. Think about it: A gesture, a smile, a nod, eye contact, what you are wearing, the fact that you are frequently checking your cell phone for text messages, and how close you stand to someone are all examples of nonverbal communication.

Nonverbal communication is extremely powerful. In fact, some studies indicate that the influence from nonverbal communication such as tone and visuals can have a greater impact than the spoken words. Dr. Albert Mehrabian, a famed psychologist and professor emeritus of psychology at University of California, Los Angeles, is considered a pioneer in the area of body language and nonverbal communication. His research includes an equation, called the Mehrabian formula,[18] that is frequently used to define the relative impact of verbal and nonverbal messages based on experiments of communication of feelings and attitudes. Dr. Mehrabian developed the formula shown below, in Figure $22.4.3$, to define how communication takes place:

Total liking = 7% verbal liking + 38% vocal liking + 55% facial liking

Figure 22.4.3: The Mehrabian Formula

The Mehrabian formula is used to explain situations in which verbal communication and nonverbal communication do not match. In other words, when facial expressions contradict words, people tend to believe the facial expressions.[19]

Types of Nonverbal Communication

- Handshake
- Body language
- Gestures
- Nodding or shaking your head
- Eye contact (or lack of eye contact)
- Eye roll
- Facial expressions
- Touch
- Space or proximity
- Dress
- Multitasking (e.g., texting while listening to someone, earphones in ears while working)

Your Handshake Says It All

In some countries, you might bow when you meet someone; in others you might kiss; but when you meet someone for a business meeting in the United States, it's best to shake hands.[20] Although fist bumps and high fives may be trendy as friendly greetings, neither is appropriate in a business setting.

The exact history of the handshake is unknown; however, at one time it was used as method to prove that you had no weapons in your hands.[21] A good handshake is essential in business; it is the first nonverbal cue that you give to the person with whom you are meeting. It's so important to have a good handshake that a recent study conducted at the University of Iowa showed that during mock interviews, those students who scored as having a better handshake were also considered more hirable by interviewers. According to Greg Stewart, a business professor who conducted the study said, "We found that the first impression begins with a handshake and sets the tone for the rest of the interview."[22]

Do you think you have a good handshake? Believe it or not, it's worth practicing your handshake. Here are five tips for a good handshake:

1. Extend your right hand when you are approximately three feet away from the person with whom you want to shake hands.[23]
2. Keep your wrist straight and lock hands connecting your hand with the same part of the other person's hand.[24] Apply appropriate pressure; don't crush the person's hand.
3. Shake up and down three or four times.[25]
4. Avoid the "wet fish" handshake.[26] This is where practice is really important. The more you shake hands, the less nervous you will be.
5. Smile and make eye contact.[27] This is your opportunity to use multiple types of nonverbal communication to get your meeting or interview off to a good start.

Body Language

Do you use your hands when you talk? If so, you are using body language to help make your point. But body language includes more than talking with your hands. Body language is what we say without words; nonverbal communication using your body includes elements such as gestures, facial expressions, eye contact, a head tilt, a nod, and even where and how you sit. Body language can indicate an unspoken emotion or sentiment that a person might be feeling either consciously or subconsciously. Body language can indicate if you are listening to someone and are engaged in what he is saying, disagreeing with him, or getting bored. (You might want to think twice about the body language you are using in class.) It's important that you are aware of what you communicate with *your* body language and to understand and respond to the cues you are getting from *someone else's* body language.

- Crossed arms: discomfort
- Spreading fingers: territorial display
- Mirroring (i.e., mimicking your body position to another's): comfort
- Drumming or tapping fingers: frustration
- Hands on hips: there is an issue
- Hands behind the back: "leave me alone"
- Hands clasped, thumbs up: positive
- Thumbs down: don't like
- Hands clasped with fingers forming a steeple: confidence
- Touch neck: insecurity
- Crossed legs: comfort
- Glancing at watch: concerned about time or bored

Body language is not just an interesting topic to consider; it's a proven science that can help you improve your communication. If you would like to see how body language is used in everyday life, watch the following video featuring Tonya Reiman, national television commentator and author of *The Power of Body Language:*

Here are some tips to remember about your body language to be sure you are sending the right nonverbal message to your customer or interviewer.

- **Make eye contact** with the person to whom you are speaking. Eye contact avoidance can be distracting and can prevent you from establishing a relationship as shown in this video.
- **Smile** when you meet someone and throughout the conversation. A smile is a positive response to another person and has a significant impact on how people perceive you. A smile can break the ice and help you start a conversation.
- **Dress for success** at all times, which means always dressing appropriately for the situation. But it's best to keep in mind that even after you get the job you want, it's a good idea to dress a little better than the position. Even in very casual work environments, what you wear is a nonverbal communication about who you are. If you don't dress for the next promotion, chances are you won't be considered for it. Be aware of the company policy and dress code, and if in doubt, dress more conservatively.

Written Communication

Although verbal and nonverbal communications usually take place in real time, written communication has a longer consideration period. The sender must encode the message in words to be communicated on paper or a screen. Business reports, proposals, memos, e-mails, text messages, Web sites, blogs, wikis, and more are all examples of written communication. Each of them is created over a period of time and can include collaboration from multiple people. Collaboration is especially important for communicating, planning, and creating documents so many people use tools such as wikis to share documents.

Written communication is preferred to verbal communication when careful consideration is important or the information needs to be permanent, such as a company policy, sales presentation, or proposal. Written communication can also take place when verbal communication isn't an option, like when you need to respond to an e-mail or text message at 1:00 a.m.

Although verbal communication is faster and more natural than written communication, each has its pros and cons. Generally, written communication is better at conveying facts, while verbal communication is better at conveying feelings. Verbal communication has another significant drawback: consider the fact that humans listen much faster than they speak. For example, the average public speaker speaks at about 125 words per minute. Although this sounds natural, the average person can listen at 400 to 500 words per minute. That means that listeners' minds have time and space to wander, which can impact the effectiveness of verbal communication. (You may have noticed your mind wandering during a class lecture—even if you found the topic interesting.)

Written communication requires a good command of the English language, including the rules of grammar and spelling. If you think that business exists solely on quick instant messages and text messages, you might be surprised to learn that they are only a portion of the communication within a company and between the company's vendors and other partners. Because the nature of written communication is such that it allows time for consideration and composition, the standards for writing are much higher than for a casual conversation. Customers and colleagues alike expect clear, concise written communications with proper grammar and spelling. And because written communication is long lasting—whether on paper or on the Internet—errors or misstatements exist for an irritatingly long time. So whether you are writing a proposal, a presentation, a report, a meeting recap, or a follow-up e-mail, it's best to take the time to think about your communication and craft it so that it is effective. Consider using the following tips:

- **Be short and sweet**. Shorter is always better when it comes to business correspondence. It's best to include all pertinent facts with concise information. If you write your communication with the receiver in mind, it will be easier to make it shorter and more effective.
- **Grammar, please**. Sentences should be structured correctly and use proper grammar, including a subject and a verb in each sentence. Business correspondence should always include uppercase and lowercase letters and correct punctuation.[28] If writing is not your strong suit, visit your campus student services office or learning center to provide information about upcoming writing clinics and access to other tools that can help improve your writing skills.
- **Check spelling**. Use the spell-check tool on your computer. There is no excuse for a misspelled word. Text abbreviations are not acceptable in business correspondence.
- **Read before you send**. Reread your document or electronic communication before it goes out. Is everything complete? Is it clear? Is it something you will be proud of days or weeks later? Take the extra time to review before you send. It's difficult to revise a communication as revisions cause confusion.
- **Just the facts**. Stick to the facts to maximize the impact of your written communications; leave the emotional topics for verbal dialogue. For example, send an e-mail to confirm meeting time, date, and location; use a verbal communication for the content

of the meeting to be discussed, such as a negotiation.

Which Is Best?

Although verbal, nonverbal, and written communication all play a role in your communication with your customers, you might be wondering which one is best. It depends on your customer and on the situation. Some customers want to work day to day using all the latest technology tools, including text messaging, social networking, Web conferences, wikis, and more. Other customers prefer more traditional face-to-face meetings, phone calls, and some e-mail correspondence. Adapt to the method of communication that your customer prefers and not the other way around. In some situations, a face-to-face meeting is best—for instance, if you wish to discuss a complex issue, negotiate, or meet some additional members of the team. Sometimes, a face-to-face meeting isn't feasible, so other verbal communication methods such as a videoconference, phone call, or conference call can be efficient and effective if used properly.

Chances are you will use a combination of communication types with each customer tailored to his particular preferences and situation. Be guided by the fact that you want to keep your communication personal in meaning and professional in content. Think about it from the receiver's point of view, and deliver bad news verbally whenever possible.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/212

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Contributors and Attributions

22.5: Reading- Appropriate Business Communications

Appropriate Business Communications

You probably learned about table manners, thank-you notes, and other forms of etiquette when you were younger. The way you conduct yourself says a lot about who you are in life and, by extension, in business. Although many companies have a casual dress code, don't be quick to assume that protocol and established practices aren't important. It would be easy to misinterpret lack of formality as lack of professionalism.

Letters and Memos

Despite the use of electronic devices in business, formal written communication such as letters, memos, proposals, reports, and presentations are still major methods of communication in selling. These more official methods of communication reflect factual statements that you are making on behalf of the company. Here are some tips for writing business communications:

Use company letterhead where appropriate. For example, letters are always written on letterhead, whether in hard copy or in an electronic format that can be sent via e-mail.

Use the formal elements of a business letter shown below in Figure $22.5.1$.

Moore Manufacturing Group 575 Parkland Avenue Lake Forest, IL 60515

August 28, 2009

Ms. Janice Lee
Buyer
Universal Parts, Inc.
101 Corporate Drive
Deerfield, IL 60511

Dear Ms. Lee,

Productivity and cost savings are even more critical today than ever before. But you can't afford to give up customer service for reduced costs. You deserve impeccable service from a supplier who also keeps costs among the lowest in the industry.

Based on the research I have done on Universal Parts, it appears that switching to Moore Manufacturing could save you as much as 12% on your annual purchases. In addition, you would have a dedicated customer service expert available to you 24/7 for any questions or issues you may have.

I'd like the opportunity to meet with you and learn more about your priorities and business challenges. I will call you on Tuesday to set up a time that is convenient for you.

In the meantime, you might find it interesting to review the attached audit that was conducted on your current offering. It reflects where you can potentially realize savings.

Sincerely,

Rachel Grossman

Rachel Grossman
Account Manager

Attachment

Figure 22.5.1: Business Letter Format

For a company memo, use the company format. Most companies have a set format for hard copy and electronic memos. See an example of a company memo below in Figure $22.5.2$


Good to be Green.com
Internal Memo

TO: Jason Sedgewick
FROM: Abe Forte
RE: September 12 Sales Meeting

The quarterly sales meeting will be held on September 12 at the Radisson City Center. You are cordially invited to participate in the interactive planning session at 10:00 a.m. Your insights will be extremely valuable as the sales team frames the plan for next year.

Please confirm your attendance by Friday by calling me at x5432 or by e-mailing me at aforte@goodtobegreen.com.

Thanks in advance for your participation.

CC: Alena Adamonis

BCC: Justin Jankowski

Figure 22.5.2: Company Memo Example

Spell-check and proofread your document carefully before you send it. Be sure it is complete and factually correct and does not include any grammar or spelling errors.

Use CC to indicate the names of other people who should also receive a copy of the letter or memo. The term “CC” is short for “carbon copy,” which dates back to the days of typewriters when carbon paper was used to make multiple copies of a document. It can also mean “courtesy copy”: an additional copy provided to someone as a courtesy.[1]

Conversations, Meetings, and Presentations

Although common sense should prevail in all business communications, here are some tips that will help make your conversations, meetings, and presentations more effective forms of communication:

- Be prepared; don’t waste anyone’s time or focus.
- Prepare a written agenda and hand it out at the start of the meeting to keep the group focused on the desired topics.
- Speak clearly and at a volume that is easy to hear, but not too loud so as to be distracting.
- Be professional and respectful; don’t interrupt when others are speaking.
- Use eye contact.
- At the end, recap your key points and identify next steps.
- In business, time is money so conducting effective and efficient meetings is critical to your success.

High Tech, High Touch

The year was 1982, and the world was just beginning to realize the amazing potential of computer technology. John Naisbitt wrote a book called *Megatrends: Ten New Directions Transforming Our Lives*, in which he coined the term “high tech, high touch,” which he defined as the contradictory state in which people are driven by technology yet long for human interaction. [2] In his 1999 book, *High Tech/High Touch*, he wrote about how the United States has been transformed from being comfortable with technology to being intoxicated with technology, a state he calls the “Technologically Intoxicated Zone.” You probably can’t imagine living without your cell phone or personal digital assistant (PDA), iPod, computer, or other electronic devices. In fact, it’s likely you can’t even remember what communication was like before the Internet.

Technology, with all of its efficiency and benefits, cannot, however, become a substitute for old-fashioned human efforts. “Technology makes tasks easier, but it does not make our lives easier,” July Shapiro said in an article in *Advertising Age*.[3] Shapiro’s observation is true, especially as it relates to business; sometimes, the crush of technology takes precedence over business etiquette. However, people have begun to rethink the lack of personal interaction and its corresponding etiquette in the workplace. Yes, “there’s even an app for that”; a firm named Etiquette Avenue has recently launched an iPod app for business etiquette. The fact is, technology isn’t personal and can’t behave in the right way at the right time with your customer or on an interview; that’s completely up to you.

Now, we’re seeing a bit of a reverse movement: Technology is so pervasive people are actually pushing back on their managers and asking them for more face time and less gadget time.

Being Connected vs. Being Addicted

In a recent pitch to a potential client, a marketing executive in Manhattan thought it was strange that his potential customer was so engaged with his iPhone that he hardly looked up from it during the meeting. After ninety minutes, someone peeked over the customer's shoulder and saw that he was playing a racing game on his iPhone. This was disappointing, but not shocking according to the marketing firm that was doing the presentation; they continued with their pitch because they wanted the business. Some are not as tolerant. Billionaire Tom Golisano, a power broker in New York politics, recently announced that he wants to have State Senate majority leader Malcolm A. Smith removed from office because Smith was focused on his iPhone during a budget meeting with him. Recently, in Dallas, Texas, a student lost his opportunity for an internship at a hedge fund when he checked his phone to check a fact during an interview and took an extra minute to check his text messages at the same time. [4] According to Maggie Jackson, author of *Distracted: The Erosion of Attention and the Coming Dark Age*, we are living in "an institutionalized culture of interruption, where our time and attention is being fragmented by a never-ending stream of phone calls, e-mails, instant messages, text messages, and tweets."[5]

The need to be connected should not overwhelm respect for colleagues and customers. Although texting has become a national pastime, especially among teenagers, it's important to know the appropriate etiquette for the use of handheld electronic devices in the business environment.

First, it's best to turn off your electronic devices before you enter every meeting. If you think you can't live without checking your text messages, think about how you would feel if you went on a job interview and the person with whom you were meeting was checking his electronic device during your interview. Just because some people demonstrate bad behavior and check their electronic devices for messages during a meeting doesn't make it appropriate. In fact, it will help you stand out as a good listener.

Telephone, Cell Phone, Voice Mail, and Conference Calls

Sometimes, however, the use of technology is entirely necessary to conduct business when personal interaction is impossible. It's important that verbal communication that is not face-to-face is effective and professional. Because you don't have the benefit of using or seeing the receiver's nonverbal communication, the challenges for effective and appropriate communication are even greater.

Here are some dos and don'ts of telephone etiquette:

- Do be aware of the volume of your voice when you are speaking on the phone in the office or on a cell phone.[6]
- Do, when using a speakerphone, conduct the call in an enclosed or isolated area such as a conference room or office to avoid disturbing others in the area.
- Do, when leaving a voice mail message, speak slowly, enunciate, spell your name, and leave your number (this makes it much easier for the recipient to hear your message the first time).[7]
- Do, when you leave a voice mail message, be specific about what you want: make it easier for the caller to get back to you and include what time you will be available for a callback to avoid playing telephone tag.[8]
- Do customize your voice mail message: create a different message for each of your customers or prospective customers so the message is personal and relevant.[9]
- Do speak with enthusiasm: it's best to convey a smile in your voice, especially if it is the first time you are calling or leaving a message for someone.[10]
- Don't take another phone call during a meeting.[11]
- Don't discuss confidential or personal issues during business calls.
- Don't discuss confidential issues in public areas—you never know who might overhear a conversation in the hallway, on a train, or in other public areas.[12]
- Don't leave a long, rambling voice mail message: be prepared with a message that is no longer than sixty seconds.[13]
- Don't multitask during a long phone call or conference call—give the other person or people the courtesy of your full attention.

E-mails, Text Messages, Instant Messages, and Social Networks

Written communication has evolved to include multiple methods, all of which have appropriate places in selling. Notice the operative word here is appropriate. E-mail has become an accepted method of communication in most businesses, whereas text messages, instant messages, and social networks are commonplace for only some companies. That's why etiquette is especially important when using any of these methods of communication, and you should take time to choose your method carefully. Letters, memos, proposals, and other written communication are considered formal, whether they are sent on paper or transmitted via e-mail. However, text messages, instant messages, and social networking are considered informal methods of communication and should be used only to communicate less formal information, such as a meeting time when schedules have been adjusted during a factory tour. Text and instant messages should never be used to communicate company policies, proposals, pricing, or other information that is important to conduct business with customers. It's also worth noting that in all these methods your communication is permanent, so it's a good idea to know the following dos and don'ts of electronic communication:

- Do use an e-mail subject line that clearly tells the recipient about the content of the e-mail.
- Do create a short, concise message that uses proper grammar and spelling—use spell-check to be sure all words are spelled correctly.[14]
- Do, in all electronic communications, use uppercase and lowercase letters as grammar dictates.[15]
- Do use e-mail, text messages, and instant messages when appropriate, according to your company's practices, and with your customers to communicate factual information such as to confirm meeting date, time, and location.[16]
- Do use social networking sites to join the conversation and add value—you can build your personal brand by creating a blog or joining a professional conversation on social networking sites such as Twitter or Facebook.[17]
- Don't use all capital letters in an e-mail; it appears that you are shouting or angry.[18]
- Don't use "Reply to All" unless it's absolutely necessary that all the recipients see your response—be selective to avoid mailbox overload.
- Don't send an e-mail, text message, or instant message when you are angry: take the time to think about what you send because you can't take it back after it's sent.[19]
- Don't use abbreviations like "ur," "2b," and others—this is not appropriate business communication.[20]
- Don't use company e-mail, text message, or instant message accounts to send personal correspondence, and don't check your personal accounts or pages during company time, as all communication that takes place on company hardware and servers is property of the company.
- Don't use electronic communication to transmit bad news: talk to the person first, and if follow-up is necessary, reiterate the information in written form.
- Don't use text messages, instant messages, or social networks to communicate information such as pricing, proposals, reports, service agreements, and other company information that should be sent using a more formal method.

Music to Your Ears

When is an iPod or other MP3 player or a handheld gaming device appropriate at work? Only when it is used for business purposes. "You're isolating yourself," says Dale Chapman Webb, founder of The Protocol Centre in Coral Gables, Florida. "You are sending a message that my music is more important than the work at hand."

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Contributors and Attributions

22.6: Reading- Communication Channels

What Is *Organizational* Communication?

Clearly, the task of preparing and submitting a finished sales report doesn't require the same kinds of communication skills as talking on the phone with a classmate. No matter what your "workstation" happens to be—whether your workplace office or your kitchen table—you're performing the task of preparing that sales report in an *organizational setting*. You're still a sender transferring information to a receiver, but the organizational context of the task requires you to consider different factors for success in communicating effectively (including barriers to success). A report, for example, must be targeted for someone in a specific position and must contain the information necessary to make a specific set of decisions.[1]

Communication Flows

Here's another way of thinking about communication in an organizational setting. Let's assume that you and the classmate you called on the phone are on roughly equal footing—you're both juniors, your grades in the class are about the same, and so forth. Your phone conversation, therefore, is "lateral": You belong to the same group (your accounting class), and your group activities take place on the same level.

Communication may also flow laterally in organizational settings (as it does between you and your classmate), but more often it flows up or down. Take a look at Figure 1, "Formal Communication Flows," below, which shows the three directions in which communications can flow in a typical organization. [2]

- As the term suggests, downward communication flows from higher organizational levels (supervisors) to lower organizational levels (subordinates).
- Upward communication flows from lower to higher organizational levels.
- Lateral (or horizontal) communication flows across the organization, among personnel on the same level.

Your boss's request for a sales report is an instance of downward communication, and when you've finished and submitted it, you will have completed a task of upward communication.

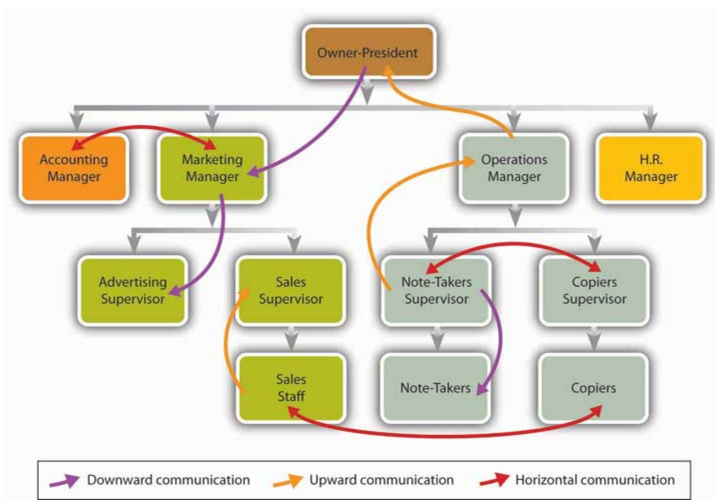

Figure 22.6.1: Formal Communication Flows

Advantages of Communication Flows

Naturally, each of these different directional flows has its functions and advantages. Downward communication, for example, is appropriate for giving instructions or directions—telling people what to do. (As a goal of communication, by the way, giving orders isn't as one-sided as it may seem. One of the things that employees—the receivers—most want to know is: What, exactly, does my job entail?)[3] Like a sales report, upward communication usually provides managers with information that they need for making decisions, but it's also the vehicle for new ideas, suggestions, and complaints. Horizontal communication supports efforts to coordinate tasks and otherwise help people work together.

Disadvantages of Communication Flows

And, of course, each type of flow has its disadvantages. As information seeps downward, for instance, it tends to lose some of its original clarity and often becomes distorted or downright wrong. (This is especially true when it's delivered orally.) In addition, unlike Donald Trump, most people who are responsible for using downward communication don't like delivering bad news (such as "You're fired" or, more commonly, "Your job is being phased out"); as a result, bad news—including bad news that happens to be important news—is often ignored or disguised. The same thing may happen when bad news—say, a negative status report—must be sent upward.

Finally, while horizontal flows are valuable for promoting cooperation, they can also be used to engage in conflict—for instance, between two departments competing for the same organizational resources. The problem is especially bad when such horizontal communications breach official upward or downward lines of communication, thus bypassing managers who might be able to resolve the conflict.

Channels of Communication

Table \(\PageIndex{1}\ summarizes two additional sets of characteristics of organizational communication—*internal and external channels* and *formal and informal channels*.[4]Internal communication is shared by people at all levels within a company. External communication occurs between parties inside a company and parties outside the company, such as suppliers, customers, and investors. Both internal and external forms of communication include everything from formal e-mail and official reports to face-to-face conversations and casual phone calls. External communication also takes such forms as customer and supplier Web sites, news releases, and advertising.

Table \(\PageIndex{1}\. Channels of Communication

	Internal	**External**
Formal	**Planned communications following the company's chain of command among people inside the organization**—*email, memos, conference calls, reports, presentations, executive blogs*	**Planned communications with people outside the organization**—*letters, instant messages, reports, speeches, news releases, advertising, websites, executive blogs*
Informal	**Casual communications among employees that do not follow the chain of command**—*email, instant messages, phone calls, face-to-face conversations, team blogs*	**Casual communications with outsiders (e.g. suppliers, customers, investors)**—*email, instant messages, phone calls, face-to-face conversations, customer-support blogs*

Note that Table \(\PageIndex{1}\ takes the form of a grid, thus creating four dimensions in which communication can take place. Informal communication, for example, can take place either among people within the company (internally) or between insiders and outsiders (externally). By and large, though you can use the same set of tools (memos, reports, phone calls) to communicate in any of these four situations, some tools (team blogs, news releases, supplier Web sites) are useful only in one or two.

The Formal Communication Network

An organization's formal communication network consists of all communications that flow along its official lines of authority. Look again at Figure \(\PageIndex{1}\ Because it incorporates the *organization chart* for the company Notes-4-You, it also shows the company's lines of authority—what we call its *reporting relationships*. Here we can see that the reporting relationships in question consist of *upward communication* from subordinates to superiors. In reporting to the operations manager, for example, the notetakers' supervisor communicates upward. Conversely, when the notetakers' manager needs to give direction to notetakers, she will use *downward communication*. If the notetakers' manager and the copiers' manager must get together to prepare a joint report for the operations manager, they'll engage in *lateral communication*. In short, an organization's formal communication network is basically the same thing as its network of reporting relationships and lines of authority.[5]

The Informal Communication Network

Every company also has an informal communication network (or grapevine), which goes to work whenever two or more employees get together and start talking about the company and their jobs. Informal communication can take place just about anywhere (in one person's cubicle, in the cafeteria, on the golf course) and by just about any means (phone, e-mail, instant messaging, face-to-face conversation).

Though it's sometimes called the *grapevine*, an informal network is an extremely important communication channel. Why? For the simple reason that it's typically widespread and can rarely be prevented, even if it's not officially sanctioned by the company—indeed, even when the company tries to discourage or bypass it. Unofficial information crosses virtually every boundary drawn by a firm's organization chart, reaching out and touching everyone in the organization, and what's more, it travels a lot faster than official information.

Problems with the Flow of Information through Informal Channels

The downside of "unofficial" information should be obvious. Because much of it is communicated orally, it's likely to get distorted and often degenerates into outright misinformation. Say, for example, that a rumor about layoffs gets started in your workplace. As more than one manager will verify, such rumors can do more damage than the reality. Morale may plummet and productivity won't be far behind. Valuable employees may abandon ship (needlessly, if the rumors are false).[6]

And imagine what can happen if informal information gets outside the organization. In the 1970s, Chicago-area McDonald's outlets found themselves fighting rumors about worms in their hamburgers. Over the years, Coca-Cola has had to fight rumors about terrorists joining its organization, subversive messages concealed in its label, and hyperacidity (false rumors that Coke causes osteoporosis and makes a good pesticide and an equally good spermicide).[7]

What to Do about Informal Information Flows

On the upside, savvy managers can tap into the informal network, either to find out what sort of information is influencing employee activities or to circulate more meaningful information, including new ideas as well as corrective information. In any case, managers have to deal with the grapevine, and one manager has compiled a list of suggestions for doing so effectively:[8]

- *Learn to live with it*. It's here to stay.
- *Tune into it*. Pay attention to the information that's circulating and try to learn something from it. Remember: The more you know about grapevine information, the better you can interact with employees (who, in turn, will probably come to regard you as someone who keeps in touch with the things that concern them).
- *Don't participate in rumors*. Resist the temptation to add your two cents' worth, and don't make matters worse.
- *Check out what you hear*. Because it's your job to replace bad information with good information, you need to find out what's really going on.
- *Take advantage of the grapevine*. Its only function is to carry information, so there's no reason why you can't pump some useful information through it.

Perhaps most important, when alert managers notice that the grapevine is particularly active, they tend to reach a sensible twofold conclusion:

1. The organization's formal lines of communication aren't working as well as they should be.
2. The best way to minimize informal communication and its potential damage is to provide better formal communication from the outset—or, failing that, to provide whatever formal communication will counteract misinformation as thoroughly as possible.

Let's go back to our example of a workplace overwhelmed by layoff rumors. In a practical sense, what can a manager—say, the leader of a long-term product-development team—do to provide better communication? One manager suggests at least three specific responses:[9]

1. Go to your supervisor or another senior manager and try to find out as much as you can about the organization's real plans.
2. Ask a senior manager or a human resources representative to meet with your team and address members' concerns with accurate feedback.
3. Make it a priority to keep channels open—both between yourself and your team members and between team members and the human resources department.

Because actions of this sort send a message, they can legitimately be characterized as a form of formal communication. They also reflect good leadership: Even though the information in this case relates only indirectly to immediate team tasks, you're sharing information with people who need it, and you're demonstrating integrity (you're being honest, and you're following through on a commitment to the team).

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Contributors and Attributions

22.7: Reading- Communication Barriers

Barriers to Effective Communication

Communicating can be more of a challenge than you think, when you realize the many things that can stand in the way of effective communication. These include filtering, selective perception, information overload, emotional disconnects, lack of source familiarity or credibility, workplace gossip, semantics, gender differences, differences in meaning between sender and receiver, and biased language. Let's examine each of these barriers.

Filtering

Filtering is the distortion or withholding of information to manage a person's reactions. Some examples of filtering include a manager who keeps her division's poor sales figures from her boss, the vice president, fearing that the bad news will make him angry. The old saying, "Don't shoot the messenger!" illustrates the tendency of receivers (in this case, the vice president) to vent their negative response to unwanted messages on the sender. A gatekeeper (the vice president's assistant, perhaps) who doesn't pass along a complete message is also filtering. The vice president may delete the e-mail announcing the quarter's sales figures before reading it, blocking the message before it arrives.

As you can see, filtering prevents members of an organization from getting a complete picture of the way things are. To maximize your chances of sending and receiving effective communications, it's helpful to deliver a message in multiple ways and to seek information from multiple sources. In this way, the effect of any one person's filtering the message will be diminished.

Since people tend to filter bad news more during upward communication, it is also helpful to remember that those below you in an organization may be wary of sharing bad news. One way to defuse the tendency to filter is to reward employees who clearly convey information upward, regardless of whether the news is good and bad.

The following lists some of the criteria that individuals may use when deciding whether to filter a message or pass it on as is:

- Past experience: Was the sender rewarded for passing along news of this kind in the past, or was she criticized?
- Knowledge, perception of the speaker: Has the receiver's direct superior made it clear that "no news is good news?"
- Emotional state, involvement with the topic, level of attention: Does the sender's fear of failure or criticism prevent him from conveying the message? Is the topic within his realm of expertise, increasing his confidence in his ability to decode it, or is he out of his comfort zone when it comes to evaluating the message's significance? Are personal concerns impacting his ability to judge the message's value?

Once again, filtering can lead to miscommunications in business. Each sender translates the message into his or her own words, creating his or her own version of what was said.

Selective Perception

Selective perception refers to filtering what we see and hear to suit our own needs. This process is often unconscious. Small things can command our attention when we're visiting a new place—a new city or a new company. Over time, however, we begin to make assumptions about the way things are on the basis of our past experience. Often, much of this process is unconscious. "We simply are bombarded with too much stimuli every day to pay equal attention to everything so we pick and choose according to our own needs." Selective perception is a time-saver, a necessary tool in a complex culture. But it can also lead to mistakes.

Think back to the earlier example conversation between Bill, who was asked to order more toner cartridges, and his boss. Since Bill found his boss's to-do list to be unreasonably demanding, he assumed the request could wait. (How else could he do everything else on the list?) The boss, assuming that Bill had heard the urgency in her request, assumed that Bill would place the order before returning to the other tasks on her list.

Both members of this organization were using selective perception to evaluate the communication. Bill's perception was that the task of ordering could wait. The boss's perception was that her time frame was clear, though unstated. When two selective perceptions collide, a misunderstanding occurs.

Information Overload

Information overload can be defined as "occurring when the information processing demands on an individual's time to perform interactions and internal calculations exceed the supply or capacity of time available for such processing." Messages reach us in countless ways every day. Some are societal—advertisements that we may hear or see in the course of our day. Others are professional—e-mails, and memos, voice mails, and conversations from our colleagues. Others are personal—messages and conversations from our loved ones and friends.

Add these together and it's easy to see how we may be receiving more information than we can take in. This state of imbalance is known as information overload. Experts note that information overload is "A symptom of the high-tech age, which is too much information for one human being to absorb in an expanding world of people and technology. It comes from all sources including TV, newspapers, and magazines as well as wanted and unwanted regular mail, e-mail and faxes. It has been exacerbated enormously because of the formidable number of results obtained from Web search engines." Other research shows that working in such fragmented fashion has a significant negative effect on efficiency, creativity, and mental acuity.

Going back to our example of Bill. Let's say he's in his cubicle on the phone with a supplier. While he's talking, he hears the chime of e-mail alerting him to an important message from his boss. He's scanning through it quickly, while still on the phone, when a coworker pokes his head around the cubicle corner to remind Bill that he's late for a staff meeting. The supplier on the other end of the phone line has just given Bill a choice among the products and delivery dates he requested. Bill realizes he missed hearing the first two options, but he doesn't have time to ask the supplier to repeat them all or to try reconnecting to place the order at a later time. He chooses the third option—at least he heard that one, he reasons, and it seemed fair. How good was Bill's decision amid all the information he was processing at the same time?

Emotional disconnects

Emotional disconnects happen when the sender or the receiver is upset, whether about the subject at hand or about some unrelated incident that may have happened earlier. An effective communication requires a sender and a receiver who are open to speaking and listening to one another, despite possible differences in opinion or personality. One or both parties may have to put their emotions aside to achieve the goal of communicating clearly. A receiver who is emotionally upset tends to ignore or distort what the sender is saying. A sender who is emotionally upset may be unable to present ideas or feelings effectively.

Lack of Source Credibility

Lack of source familiarity or credibility can derail communications, especially when humor is involved. Have you ever told a joke that fell flat? You and the receiver lacked the common context that could have made it funny. (Or yes, it could have just been a lousy joke.) Sarcasm and irony are subtle, and potentially hurtful, commodities in business. It's best to keep these types of communications out of the workplace as their benefits are limited, and their potential dangers are great. Lack of familiarity with the sender can lead to misinterpreting humor, especially in less-rich information channels like e-mail. For example, an e-mail from Jill that ends with, "Men, like hens, should boil in vats of oil," could be interpreted as anti-male if the receiver didn't know that Jill has a penchant for rhyme and likes to entertain coworkers by making up amusing sayings.

Similarly, if the sender lacks credibility or is untrustworthy, the message will not get through. Receivers may be suspicious of the sender's motivations ("Why am I being told this?"). Likewise, if the sender has communicated erroneous information in the past, or has created false emergencies, his current message may be filtered.

Workplace gossip

Workplace gossip, also known as the grapevine, is a lifeline for many employees seeking information about their company.

Employees trust their peers as a source of messages, but the grapevine's informal structure can be a barrier to effective communication from the managerial point of view. Its grassroots structure gives it greater credibility in the minds of employees than information delivered through official channels, even when that information is false.

Some downsides of the office grapevine are that gossip offers politically minded insiders a powerful tool for disseminating communication (and self-promoting miscommunications) within an organization. In addition, the grapevine lacks a specific sender, which can create a sense of distrust among employees—who is at the root of the gossip network? When the news is volatile, suspicions may arise as to the person or persons behind the message. Managers who understand the grapevine's power can use it to send and receive messages of their own. They also decrease the grapevine's power by sending official messages quickly and accurately, should big news arise.

Semantics

Semantics is the study of meaning in communication. Words can mean different things to different people, or they might not mean anything to another person. For example, companies often have their own acronyms and buzzwords (called business jargon) that are clear to them but impenetrable to outsiders. For example, at IBM, GBS is focusing on BPTS, using expertise acquired from the

PwC purchase (which had to be sold to avoid conflicts of interest in light of SOX) to fend other BPO providers and inroads by the Bangalore tiger. Does this make sense to you? If not, here's the translation: IBM's Global Business Services (GBS) division is focusing on offering companies Business Process Transformation Services (BPTS), using the expertise it acquired from purchasing the management consulting and technology services arm of PricewaterhouseCoopers (PwC), which had to sell the division because of the Sarbanes-Oxley Act (SOX, enacted in response to the major accounting scandals like the Enron). The added management expertise puts it above business process outsourcing (BPO) vendors who focus more on automating processes rather than transforming and improving them. Chief among these BPO competitors is Wipro, often called the "Bangalore tiger" because of its geographic origin and aggressive growth.

Given the amount of messages we send and receive every day, it makes sense that humans try to find shortcuts—a way to communicate things in code. In business, this code is known as jargon. Jargon is the language of specialized terms used by a group or profession. It is common shorthand among experts and if used sensibly can be a quick and efficient way of communicating. Most jargon consists of unfamiliar terms, abstract words, nonexistent words, acronyms, and abbreviations, with an occasional euphemism thrown in for good measure. Every profession, trade, and organization has its own specialized terms. At first glance, jargon seems like a good thing—a quicker way to send an effective communication, the way text message abbreviations can send common messages in a shorter, yet understandable way. But that's not always how things happen. Jargon can be an obstacle to effective communication, causing listeners to tune out or fostering ill-feeling between partners in a conversation. When jargon rules the day, the message can get obscured.

A key question to ask before using jargon is, "Who is the receiver of my message?" If you are a specialist speaking to another specialist in your area, jargon may be the best way to send a message while forging a professional bond—similar to the way best friends can communicate in code. For example, an information technology (IT) systems analyst communicating with another IT employee may use jargon as a way of sharing information in a way that reinforces the pair's shared knowledge. But that same conversation should be held in standard English, free of jargon, when communicating with staff members outside the IT group.

LINK IT UP

Here is a website containing eighty buzz words in business and a discussion of why slang is a problem.

Gender Differences

Gender differences in communication have been documented by a number of experts, including linguistics professor Deborah Tannen in her best-selling book *You Just Don't Understand: Women and Men in Conversation*. Men and women work together every day. But their different styles of communication can sometimes work against them. Generally speaking, women like to ask questions before starting a project, while men tend to "jump right in." A male manager who's unaware of how many women communicate their readiness to work may misperceive a ready employee as not ready.

Another difference that has been noticed is that men often speak in sports metaphors, while many women use their home as a starting place for analogies. Women who believe men are "only talking about the game" may be missing out on a chance to participate in a division's strategy and opportunities for teamwork and "rallying the troops" for success.

"It is important to promote the best possible communication between men and women in the workplace," notes gender policy adviser Dee Norton, who provided the above example. "As we move between the male and female cultures, we sometimes have to change how we behave (speak the language of the other gender) to gain the best results from the situation. Clearly, successful organizations of the future are going to have leaders and team members who understand, respect and apply the rules of gender culture appropriately.

Being aware of these gender differences can be the first step in learning to work with them, as opposed to around them. For example, keep in mind that men tend to focus more on competition, data, and orders in their communications, while women tend to focus more on cooperation, intuition, and requests. Both styles can be effective in the right situations, but understanding the differences is a first step in avoiding misunderstandings based on them.

Differences in meaning between sender and receiver

Differences in meaning often exist between the sender and receiver. *"Mean what you say, and say what you mean."* It's an easy thing to say. But in business, what do those words mean? Different words mean different things to different people. Age, education, and cultural background are all factors that influence how a person interprets words. The less we consider our audience, the greater our chances of miscommunication will be. When communication occurs in the cross-cultural context, extra caution is needed given that different words will be interpreted differently across cultures and different cultures have different norms regarding nonverbal communication. Eliminating jargon is one way of ensuring that our words will convey real-world concepts to others. Speaking to our audience, as opposed to about ourselves, is another. Nonverbal messages can also have different meanings.

Table 22.7.1. Gestures Around the Globe

Figure 22.7.1 	*V" for victory*. Use this gesture with caution! While in North America it signs victory or peace, in England and Australia it means something closer to "take this!"
Figure 22.7.2 	*The "OK" gesture*. While in North America it means things are going well, in France it means a person is thought to be worthless, in Japan it refers to money, and in Brazil, Russia, and Germany it means something really not appropriate for the workplace.
Figure 22.7.3 	The *"thumbs up"* means one in Germany, five in Japan, but a good job in North America. This can lead to confusion.
Figure 22.7.1 	4. *"Hook 'em horns."* This University of Texas rallying call looks like the horns of a bull. However, in Italy it means you are being tricked, while in Brazil and Venezuela it means you are warding off evil.

Table 22.7.1. Gestures Around the Globe

Figure 22.7.1 	*Waving your hand*. In much of Europe waving your hand indicates a disagreement. However, in North America it is routinely used as a way to signal greetings or to get someone's attention.

Adapted from information in Axtell, R. E. (1998). *Gestures: The Do's and Taboos of Body Language around the World*. New York: John Wiley.

Managers who speak about "long-term goals and profits" to a staff that has received scant raises may find their core message ("You're doing a great job—and that benefits the folks in charge!") has infuriated the group they hoped to inspire. Instead, managers who recognize the "contributions" of their staff and confirm that this work is contributing to company goals in ways "that will benefit the source of our success—our employees as well as executives," will find their core message ("You're doing a great job—we really value your work") is received as opposed to being misinterpreted.

Biased Language

Biased language can offend or stereotype others on the basis of their personal or group affiliation. The figure below provides a list of words that have the potential to be offensive in the left-hand column. The right-hand column provides more neutral words that you can use instead.

Table 22.7.2. Avoiding Biased Language

Avoid	Consider Using
Black attorney	attorney
businessman	business person
chairman	chair or chairperson
cleaning lady	cleaner or maintenance worker
male nurse	nurse
manpower	staff or personnel
secretary	assistant or associate

Effective communication is clear, factual, and goal-oriented. It is also respectful. Referring to a person by one adjective (a *brain*, a *diabetic*, an *invalid*) reduces that person to that one characteristic. Language that belittles or stereotypes a person poisons the communication process. Language that insults an individual or group based on age, ethnicity, sexual preference, or political beliefs violates public and private standards of decency, ranging from civil rights to corporate regulations.

The effort to create a neutral set of terms to refer to heritage and preferences has resulted in a debate over the nature of "political correctness." Proponents of political correctness see it as a way to defuse the volatile nature of words that stereotyped groups and individuals in the past. Critics of political correctness see its vocabulary as stilted and needlessly cautious.

Many companies offer new employees written guides on standards of speech and conduct. These guides, augmented by common sense and courtesy, are solid starting points for effective, respectful workplace communication. Tips for appropriate workplace speech include but are not limited to the following:

- Alternating the use of "he" and "she" when referring to people in general.
- Relying on human resources–generated guidelines.
- Remembering that terms that feel respectful or comfortable to us may not be comfortable or respectful to others.

Poor Listening and Active Listening

Former Chrysler CEO Lee Iacocca lamented, “I only wish I could find an institute that teaches people how to listen. After all, a good manager needs to listen at least as much as he needs to talk.” A sender may strive to deliver a message clearly. But the receiver’s ability to listen effectively is equally vital to effective communication. The average worker spends 55% of her workdays listening. Managers listen up to 70% each day. But listening doesn’t lead to understanding in every case. Listening takes practice, skill, and concentration.

According to University of San Diego professor Phillip Hunsaker, “The consequences of poor listening are lower employee productivity, missed sales, unhappy customers, and billions of dollars of increased cost and lost profits. Poor listening is a factor in low employee morale and increased turnover because employees do not feel their managers listen to their needs, suggestions, or complaints.” Clearly, if you hope to have a successful career in management, it behooves you to learn to be a good listener.

Alan Gulick, a Starbucks spokesperson, puts better listening to work in pursuit of better profits. If every Starbucks employee misheard one $10 order each day, he calculates, their errors would cost the company a billion dollars annually. To teach its employees to listen, Starbucks created a code that helps employees taking orders hear the size, flavor, and use of milk or decaf coffee. The person making the drink echoes the order aloud.

How can you improve your listening skills? The Roman philosopher Cicero said, “Silence is one of the great arts of conversation.” How often have we been in conversation with someone else where we are not really listening but itching to convey our portion? This behavior is known as “rehearsing.” It suggests the receiver has no intention of considering the sender’s message and intends to respond to an earlier point instead. Clearly, rehearsing is an impediment to the communication process. Effective communication relies on another kind of listening: active listening.

Active listening can be defined as giving full attention to what other people are saying, taking time to understand the points being made, asking questions as appropriate, and not interrupting at inappropriate times.[1] Active listening creates a real-time relationship between the sender and the receiver by acknowledging the content and receipt of a message. As we’ve seen in the Starbucks example, repeating and confirming a message’s content offers a way to confirm that the correct content is flowing between colleagues. The process creates a bond between coworkers while increasing the flow and accuracy of messaging.

Carl Rogers, founder of the “person-centered” approach to psychology, formulated the following five rules for active listening:

1. Listen for message content
2. Listen for feelings
3. Respond to feelings
4. Note all cues
5. Paraphrase and restate

The good news is that listening is a skill that can be learned. The first step is to decide that we want to listen. Casting aside distractions, such as by reducing background or internal noise, is critical. The receiver takes in the sender’s message silently, without speaking. Second, throughout the conversation, show the speaker that you’re listening. You can do this nonverbally by nodding your head and keeping your attention focused on the speaker. You can also do it verbally, by saying things like, “Yes,” “That’s interesting,” or other such verbal cues. As you’re listening, pay attention to the sender’s body language for additional cues about how they’re feeling. Interestingly, silence plays a major role in active listening. During active listening, we are trying to understand what has been said, and in silence, we can consider the implications. We can’t consider information and reply to it at the same time. That’s where the power of silence comes into play. Finally, if anything is not clear to you, ask questions. Confirm that you’ve heard the message accurately, by repeating back a crucial piece like, “Great, I’ll see you at 2 p.m. in my office.” At the end of the conversation, a “thank-you” from both parties is an optional but highly effective way of acknowledging each other’s teamwork.

In summary, active listening creates a more dynamic relationship between a receiver and a sender. It strengthens personal investment in the information being shared. It also forges healthy working relationships among colleagues by making speakers and listeners equally valued members of the communication process.

KEY TAKEAWAYS

Many barriers to effective communication exist. Examples include filtering, selective perception, information overload, emotional disconnects, lack of source familiarity or credibility, workplace gossip, semantics, gender differences, differences in meaning between sender and receiver, and biased language. The receiver can enhance the probability of effective communication by engaging in active listening, which involves (1) giving one's full attention to the sender and (2) checking for understanding by repeating the essence of the message back to the sender.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/215

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1. O*NET Resource Center, the nation's primary source of occupational information. ↵

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CHAPTER OVERVIEW

23: Module 10- Motivating Employees

23.1: Why It Matters- Motivating Employees

Why explain common motivational theories and apply them to business?

What motivates you to do what you do? How do you motivate others to help you or to accomplish things on their own? You have already learned a lot about business and the role people play, both as managers and employees, in helping the organization reach its goals. As a manager you are expected to lead and manage people. As an employee you are given job specific duties and responsibilities you are expected to perform. Neither leading nor following will happen until people are motivated.

The following video on the motivational strategies used by Zappos is a good place to begin our discussion of motivation in business. What motivates the employees at Zappos? Is it high salaries? Long vacations? The chance to shave your head at the company picnic once a year? As you watch the video, pay attention to what really motivates Zappos workers.

You can view the transcript for “Zappos CEO” (opens in new window).

Since the 1920s researchers have studied human behavior and developed a variety of theories to explain the driving force behind motivation. These theories range from the need to provide a safe and secure environment for oneself and family to the compelling desire *not* to experience negative consequences from action or inaction. Understanding the basis for motivation and learning how motivational approaches work in the business environment can be helpful to your professional and organizational success.

Before you begin this module ask yourself the following questions:

- What motivates me?
- How have others tried to motivate me?
- Which motivational approaches have been the most and least successful?
- When have I been successful in motivating others?
- How can I use this information to be successful in my personal and professional life?

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23.2: Introduction to the Hawthorne Effect

What you'll learn to do: describe the Hawthorne effect, and explain its significance in management

Understanding and optimizing motivation is a study that dates back to the ancient Greek philosophers and scientists. Over the centuries, the focus was primarily on improving individual performance. In 1924, Australian sociologist Elton Mayo, who later became an industrial research professor at Harvard, began a series of studies that demonstrated that employee motivation is heavily influenced by social factors. Mayo's findings, referred to as the "Hawthorne Effect," marked a radical change in motivational theory and management practice. Many of today's ideas about the connection between human motivation and employee performance can be traced back to the discoveries of the Hawthorne studies.

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23.3: The Hawthorne Studies

Learning Objectives

- Describe the Hawthorne effect
- Explain the role of the Hawthorne effect in management

During the 1920s, a series of studies that marked a change in the direction of motivational and managerial theory was conducted by Elton Mayo on workers at the Hawthorne plant of the Western Electric Company in Illinois. Previous studies, in particular Frederick Taylor's work, took a "man as machine" view and focused on ways of improving individual performance. Hawthorne, however, set the individual in a social context, arguing that employees' performance is influenced by work surroundings and coworkers as much as by employee ability and skill. The Hawthorne studies are credited with focusing managerial strategy on the socio-psychological aspects of human behavior in organizations.

The following video from the AT&T archives contains interviews with individuals who participated in these studies. It provides insight into the way the studies were conducted and how they changed employers' views on worker motivation.

You can view the transcript for "AT&T Archives: The Year They Discovered People" (opens in new window).

The studies originally looked into the effects of physical conditions on productivity and whether workers were more responsive and worked more efficiently under certain environmental conditions, such as improved lighting. The results were surprising: Mayo found that workers were more responsive to social factors—such as their manager and coworkers—than the factors (lighting, etc.) the researchers set out to investigate. In fact, worker productivity improved when the lights were dimmed again and when everything had been returned to the way it was before the experiment began, productivity at the factory was at its highest level and absenteeism had plummeted.

What happened was Mayo discovered that workers were highly responsive to additional attention from their managers and the feeling that their managers actually cared about and were interested in their work. The studies also found that although financial incentives are important drivers of worker productivity, social factors are equally important.

Practice Question

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There were a number of other experiments conducted in the Hawthorne studies, including one in which two women were chosen as test subjects and were then asked to choose four other workers to join the test group. Together, the women worked assembling telephone relays in a separate room over the course of five years (1927–1932). Their output was measured during this time—at first, in secret. It started two weeks before moving the women to an experiment room and continued throughout the study. In the experiment room, they were assigned to a supervisor who discussed changes with them and, at times, used the women's suggestions. The researchers then spent five years measuring how different variables affected both the group's and the individuals' productivity. Some of the variables included giving two five-minute breaks (after a discussion with the group on the best length of time), and then changing to two ten-minute breaks (not the preference of the group).

Changing a variable usually increased productivity, even if the variable was just a change back to the original condition. Researchers concluded that the employees worked harder because they thought they were being monitored individually. Researchers hypothesized that choosing one's own coworkers, working as a group, being treated as special (as evidenced by working in a separate room), and having a sympathetic supervisor were the real reasons for the productivity increase.

The Hawthorne studies showed that people's work performance is dependent on social issues and job satisfaction. The studies concluded that tangible motivators such as monetary incentives and good working conditions are generally less important in improving employee productivity than intangible motivators such as meeting individuals' desire to belong to a group and be included in decision making and work.

? Practice Question

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23.4: Introduction to Need-Based Theories

What you'll learn to do: explain need-based theories of worker motivation

One of the approaches to understanding motivation is by studying human needs. Specifically, studying how the satisfaction of fundamental human needs drives behavior. In this section, we will introduce the four dominant theories—psychologist Abraham Maslow's Hierarchy of Needs, psychologist Clayton Alderfer's ERG theory, a modification of Maslow's theory, psychologist Frederick Herzberg's Motivator-Hygiene or two-factor theory and psychologist David McClelland's Acquired Needs theory—and their relevance to management.

Contributors and Attributions

23.5: Maslow's Hierarchy of Needs

Learning Objectives

- List the various levels of needs in Maslow's hierarchy
- Explain the impact that Maslow's levels of needs have on worker motivation

Human motivation can be defined as the fulfillment of various needs. These needs can encompass a range of human desires, from basic, tangible needs of survival to complex, emotional needs surrounding an individual's psychological well-being.

Abraham Maslow was a social psychologist who was interested in a broad spectrum of human psychological needs rather than on individual psychological problems. He is best known for his hierarchy-of-needs theory. Depicted in a pyramid (shown in Figure 1), the theory organizes the five different levels of human psychological and physical needs in order of importance.

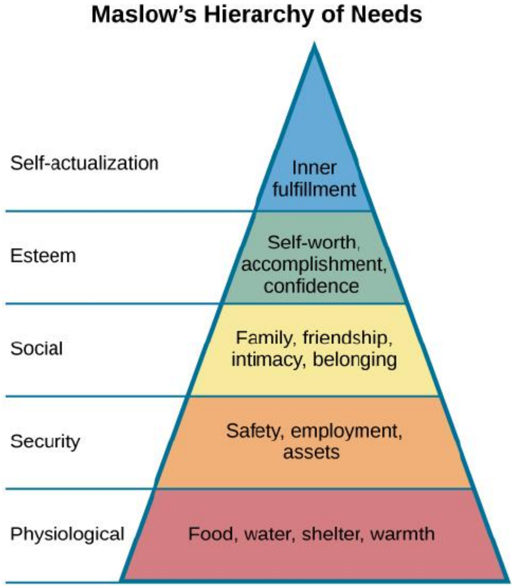

Figure 23.5.1: Maslow's hierarchy of needs is illustrated here. In some versions of the pyramid, cognitive and aesthetic needs are also included between esteem and self-actualization. Others include another tier at the top of the pyramid for self-transcendence.

The needs in Maslow's hierarchy include physiological needs (food and clothing), safety needs (job security), social needs (friendship), self-esteem, and self-actualization. This hierarchy addressing five needs can be used by managers to better understand employees' motivation and address them in ways that lead to high productivity and job satisfaction.

At the bottom of the pyramid are the **physiological** (or basic) human needs that are required for survival: food, shelter, water, sleep, etc. If these requirements are not met, the body cannot continue to function. Faced with a lack of food, love, and safety, most people would probably consider food to be their most urgent need.

Once physical needs are satisfied, **security** (sometimes referred to as individual safety) takes precedence. Security and safety needs include personal security, financial security, and health and well-being. These first two levels are important to the physical survival of the person. Once individuals have basic nutrition, shelter, and safety, they seek to fulfill higher-level needs.

The third level of need is **social**, which include love and belonging; when individuals have taken care of themselves physically, they can address their need to share and connect with others. Deficiencies at this level, on account of neglect, shunning, ostracism, etc., can impact an individual's ability to form and maintain emotionally significant relationships. Humans need to feel a sense of belonging and acceptance, whether it comes from a large social group or a small network of family and friends. Other sources of social connection may be professional organizations, clubs, religious groups, social media sites, and so forth. Humans need to love and be loved (sexually and non-sexually) by others. Without these attachments, people can be vulnerable to psychological difficulties such as loneliness, social anxiety, and depression. These conditions, when severe, can impair a person's ability to address basic physiological needs such as eating and sleeping.

The fourth level is **esteem**, which represents the normal human desire to be valued and validated by others, through, for example, the recognition of success or status. This level also includes self-esteem, which refers to the regard and acceptance one has for oneself. Imbalances at this level can result in low self-esteem or an inferiority complex. People suffering from low self-esteem may find that external validation by others—through fame, glory, accolades, etc.—only partially or temporarily fulfills their needs at this level.

The fifth level of the pyramid is **self-actualization**. At this stage, people feel that they have reached their full potential and are doing everything they're capable of. Self-actualization is rarely a permanent feeling or state. Rather, it refers to the ongoing need for personal growth and discovery that people have throughout their lives. Self-actualization may occur after reaching an important goal or overcoming a particular challenge, and it may be marked by a new sense of self-confidence or contentment.

Practice Question

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Hierarchy of Needs and Organizational Theory

Maslow's hierarchy of needs is relevant to organizational theory because both are concerned with human motivation. Understanding what people need—and how people's needs differ—is an important part of effective management. For example, some people work primarily for money, but they also like to go to work because they enjoy feeling respected by others and appreciated for their good work.

Maslow's hierarchy of needs suggests that if a lower need is not met, then the higher ones will be ignored. For example, if employees lack job security and are worried that they will be fired, they will be far more concerned about their financial well-being and meeting lower needs such as paying rent, bills, etc. However, if employees receive adequate financial compensation and have job security, meaningful group relationships and praise for good work may be more important motivators.

Can you think of recent examples of how Maslow's hierarchy of needs might have affected your behavior at work in some way?

Practice Question

https://assessments.lumenlearning.co...essments/14431

When needs aren't met, employees can become very frustrated. For example, if individuals work hard for a promotion and don't get the recognition it represents, they may lose motivation and put in less effort. Also, when a need *is* met, it will no longer serve a motivating function—the next level up in the needs hierarchy will become more important. From a management point of view, keeping one's employees motivated can seem like something of a moving target. People seldom fit neatly into pyramids or diagrams, and their needs are complicated and often change over time.

Maria at Work

Maria is an award-winning long-time employee. In the ten years that she worked for her company, she has always been punctual, does high-quality work, and is well liked by her coworkers. Maria has always been engaged with her coworkers and helped mentor new employees. Over the last six months, Jorge noticed that Maria has made a lot mistakes with on-boarding new employees with a mentoring program she helped design. He concludes that Maria is bored with her job and wants to leave, so he decides to use her semiannual performance appraisal, to bring up these matters.

To his surprise, Jorge learns that Maria's husband lost his job six months ago and, unable to keep up with mortgage payments, the two have been rotating living in their car and at a local hotel. In Jorge's office, Maria shares that she really needs this job, and promises she will improve, but she could use some help mentoring new employees. She asks him if she can train somebody else to do that job for the next six months while she and her husband figure out a new living situation. Jorge listens to her with compassion and helps redefine her priorities with the company.

Jorge notes Maria has moved down on Maslow's needs pyramid and because he wants to be an effective manager, he promises to adapt his motivational approaches he uses with his team. In short, he know a manager's best strategy is to recognize this complexity and try to remain attuned to what employees say they need.

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23.6: Alderfer's ERG Theory

Learning Objectives

- Summarize the changes to Maslow's hierarchy of needs in Alderfer's ERG theory

Clayton Paul Alderfer is an American psychologist who developed Maslow's hierarchy of needs into a theory of his own. **Alderfer's ERG theory** suggests that there are three groups of core needs: **existence** (**E**), **relatedness** (**R**), and **growth** (**G**)—hence the acronym *ERG*. These groups align with Maslow's levels of physiological needs, social needs, and self-actualization needs, respectively.

Existence needs concern our basic material requirements for living. These include what Maslow categorized as physiological needs (such as air, food, water, and shelter) and safety-related needs (such as health, secure employment, and property).

Relatedness needs have to do with the importance of maintaining interpersonal relationships. These needs are based in social interactions with others and align with Maslow's levels of love/belonging-related needs (such as friendship, family, and sexual intimacy) and esteem-related needs (gaining the respect of others).

Finally, **growth** needs describe our intrinsic desire for personal development. These needs align with the other portion of Maslow's esteem-related needs (self-esteem, self-confidence, and achievement) and self-actualization needs (such as morality, creativity, problem-solving, and discovery).

Alderfer proposed that when a certain category of needs isn't being met, people will redouble their efforts to fulfill needs in a lower category. For example, if someone's self-esteem is suffering, he or she will invest more effort in the relatedness category of needs.

Practice Question

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23.7: Intrinsic and Extrinsic Motivators

Learning Objectives

- Explain the difference between intrinsic and extrinsic motivators in Herzberg's two-factor theory

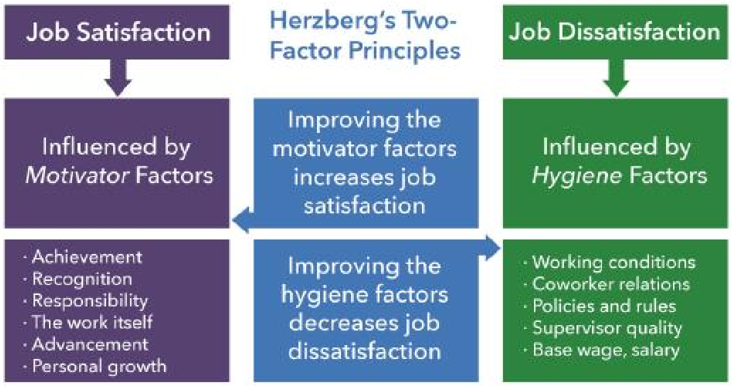
American psychologist **Frederick Herzberg** is regarded as one of the great original thinkers in management and motivational theory. Herzberg set out to determine the effect of attitude on motivation, by simply asking people to describe the times when they felt really good, and really bad, about their jobs. What he found was that people who felt good about their jobs gave very different responses from the people who felt bad.

The results from this inquiry form the basis of Herzberg's Motivation-Hygiene Theory (sometimes known as Herzberg's "**Two Factor Theory"**). Published in his famous article, "One More Time: How do You Motivate Employees," the conclusions he drew were extraordinarily influential, and still form the bedrock of good motivational practice nearly half a century later. He's especially recognized for his two-factor theory, which hypothesized that are two different sets of factors governing job satisfaction and job dissatisfaction: "hygiene factors," or extrinsic motivators and "motivation factors," or intrinsic motivators.

Hygiene factors, or extrinsic motivators, tend to represent more tangible, basic needs—i.e., the kinds of needs included in the existence category of needs in the ERG theory or in the lower levels of Maslow's hierarchy of needs. Extrinsic motivators include status, job security, salary, and fringe benefits. It's important for managers to realize that not providing the appropriate and expected extrinsic motivators will sow dissatisfaction and decrease motivation among employees.

Motivation factors, or intrinsic motivators, tend to represent less tangible, more emotional needs—i.e., the kinds of needs identified in the "relatedness" and "growth" categories of needs in the ERG theory and in the higher levels of Maslow's hierarchy of needs. Intrinsic motivators include challenging work, recognition, relationships, and growth potential. Managers need to recognize that while these needs may fall outside the more traditional scope of what a workplace ought to provide, they can be critical to strong individual and team performance.

The factor that differentiates two-factor theory from the others we've discussed is the role of employee *expectations*. According to Herzberg, intrinsic motivators and extrinsic motivators have an inverse relationship. That is, intrinsic motivators tend to increase motivation when they are present, while extrinsic motivators tend to reduce motivation when they are absent. This is due to employees' expectations. Extrinsic motivators (e.g., salary, benefits) are expected, so they won't increase motivation when they are in place, but they will cause dissatisfaction when they are missing. Intrinsic motivators (e.g., challenging work, growth potential), on the other hand, can be a source of additional motivation when they are available.



If management wants to increase employees' job satisfaction, they should be concerned with the nature of the work itself—the opportunities it presents employees for gaining status, assuming responsibility, and achieving self-realization. If, on the other hand, management wishes to reduce dissatisfaction, then it must focus on the job environment—policies, procedures, supervision, and working conditions. To ensure a satisfied and productive workforce, managers must pay attention to both sets of job factors.

? Practice Question

https://assessments.lumenlearning.co...essments/14433

Watch the following videos to hear these principles explained by Frederick Herzberg himself (in a smoke-filled 1970s lecture theater no less!).

You can view the transcript for "Jumping for the Jelly Beans (1 of 2)" (opens in new window).

You can view the transcript for “Jumping for the Jelly Beans (2 of 2)” (opens in new window).

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23.8: McClelland’s Acquired Needs Theory

Learning Objectives

- Describe how employees might be motivated using McClelland’s acquired needs theory

Psychologist **David McClelland’s acquired-needs theory** splits the needs of employees into three categories rather than the two we discussed in Herzberg’s theory. These three categories are **achievement**, **affiliation**, and **power**.

Employees who are strongly *achievement-motivated* are driven by the desire for mastery. They prefer working on tasks of moderate difficulty in which outcomes are the result of their effort rather than luck. They value receiving feedback on their work.

Employees who are strongly *affiliation-motivated* are driven by the desire to create and maintain social relationships. They enjoy belonging to a group and want to feel loved and accepted. They may not make effective managers because they may worry too much about how others will feel about them.

Employees who are strongly *power-motivated* are driven by the desire to influence, teach, or encourage others. They enjoy work and place a high value on discipline. However, they may take a zero-sum approach to group work—for one person to win, or succeed, another must lose, or fail. If channeled appropriately, though, this can positively support group goals and help others in the group feel competent.

The acquired-needs theory doesn’t claim that people can be neatly categorized into one of three types. Rather, it asserts that all people are motivated by all of these needs in varying degrees and proportions. An individual’s balance of these needs forms a kind of profile that can be useful in creating a tailored motivational paradigm for her. It is important to note that needs do not necessarily correlate with competencies; it is possible for an employee to be strongly affiliation-motivated, for example, but still be successful in a situation in which her affiliation needs are not met.

McClelland proposes that those in top management positions generally have a high need for power and a low need for affiliation. He also believes that although individuals with a need for achievement can make good managers, they are not generally suited to being in top management positions.

Practice Question

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23.9: Introduction to Process-Based Theories

What you'll learn to do: explain process-based theories of motivation

In this section, we will discuss three theories of motivation that represent an alternative to the needs-based approaches discussed in the prior section. Equity theory, expectancy theory and reinforcement theory are all process-based concepts positing that human behavior is based on predictable processes of environmental or situational analysis. We will also highlight similarities between needs- and process-based theories and the management implications of the each of the process theories.

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23.10: Equity Theory

Learning Objectives

- Describe the role of inputs and outcomes in equity theory
- Explain the implications of equity theory for business managers

In contrast to the need-based theories we have covered so far, process-based theories view motivation as a rational process. Individuals analyze their environment, develop reactions and feelings, and respond in certain predictable ways.

Equity theory attempts to explain relational satisfaction in terms of perceived fairness: that is, people evaluate the extent to which there is a fair or unfair distribution of resources within their interpersonal relationships. Regarded as one of many theories of justice, equity theory was first developed in 1963 by **John Stacey Adams**. Adams, a workplace and behavioral psychologist, asserted that employees seek to maintain equity between what they put into a job and what they receive from it against the perceived inputs and outcomes of others.

Equity theory proposes that people value fair treatment, which motivates them to maintain a similar standard of fairness with their coworkers and the organization. Accordingly, equity structure in the workplace is based on the ratio of inputs to outcomes.

Inputs are the employee's contribution to the workplace. Inputs include time spent working and level of effort but can also include less tangible contributions such as loyalty, commitment, and enthusiasm.

Outputs are what the employee receives from the employer and can also be tangible or intangible. Tangible outcomes include salary and job security. Intangible outcomes might be recognition, praise, or a sense of achievement.

Practice Question

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Ross and Monica

Let's look at Ross and Monica, two employees who work for a large magazine-publishing company doing very similar jobs. If Ross received a raise in pay but saw that Monica was given a larger raise for the same amount of work, Ross would evaluate this change, perceive an inequality, and be distressed.

However, if Ross perceived that Monica were being given more responsibility and therefore relatively more work along with the salary increase, then he would see no loss in equality status and not object to the change.

An employee will feel that he is treated fairly if he perceives the ratio of his inputs to his outcomes to be equivalent to those around him. Equity theory includes the following primary propositions:

1. Individuals will try to maximize their outcomes.
2. Individuals can maximize collective rewards by evolving accepted systems for equitably apportioning resources among members. As a result, groups will evolve such systems of equity and will attempt to induce members to accept and adhere to these systems. In addition, groups will generally reward members who treat others equitably and punish members who treat others inequitably.

3. When individuals find themselves participating in inequitable relationships, they will become distressed. The more inequitable the relationship, the more distress they will feel. According to equity theory, the person who gets "too much" and the person who gets "too little" both feel distressed. The person who gets too much may feel guilt or shame. The person who gets too little may feel angry or humiliated.
4. Individuals who discover they are in inequitable relationships will attempt to eliminate their distress by restoring equity.

The focus of equity theory is on determining whether the distribution of resources is fair to both relational partners. Partners do not have to receive equal benefits (such as receiving the same amount of love, care, and financial security) or make equal contributions (such as investing the same amount of effort, time, and financial resources), as long as the ratio between these benefits and contributions is similar.

In other words, Ross perceives equity if Monica makes more money but also has more job responsibilities, because the ratio of inputs (job responsibilities) to outcomes (salary) is about the same. On the other hand, Ross would perceive inequity if the ratio were different—say if Monica made more money for the same job or if Monica made a salary equal to Ross's but had fewer job responsibilities.

When an employee is comparing his input/outcome ratio to his fellow workers', he will look for other employees with similar jobs or skill sets. For example, Ross would not compare his salary and responsibilities to those of the magazine company's CEO. However, he might look outside the organization for comparison—for instance, he might visit glassdoor.com to check salaries for positions like his at other publishing houses.

Much like other prevalent theories of motivation, such as Maslow's hierarchy of needs, equity theory acknowledges that subtle and variable factors affect people's assessment and perception of their standing relative to others. According to Adams, underpayment inequity induces anger, while overpayment induces guilt. Compensation, whether hourly or salaried, is a central concern for employees and is therefore the cause of equity or inequity in most, but not all, cases.

In any position, employees want to feel that their contributions and work performance are being rewarded with fair pay. An employee who feels underpaid may experience feelings of hostility toward the organization and perhaps coworkers. This hostility may cause the employee to underperform and breed job dissatisfaction among others.

Subtle or intangible compensation also plays an important role in feelings about equity. Receiving recognition and being thanked for strong job performance can help employees feel valued and satisfied with their jobs, resulting in better outcomes for both the individual and the organization.

Equity theory has several implications for business managers, as follow:

- Employees measure the totals of their inputs and outcomes. This means a working parent may accept lower monetary compensation in return for more flexible working hours.
- Different employees ascribe different personal values to inputs and outcomes. Thus, two employees of equal experience and qualification performing the same work for the same pay may have quite different perceptions of the fairness of the deal.
- Employees are able to adjust for purchasing power and local market conditions. Thus a teacher from Vancouver, Washington, may accept lower compensation than his colleague in Seattle if his cost of living is different, while a teacher in a remote African village may accept a totally different pay structure.
- Although it may be acceptable for more senior staff to receive higher compensation, there are limits to the balance of the scales of equity, and employees can find excessive executive pay demotivating.
- Staff perceptions of inputs and outcomes of themselves and others may be incorrect, and perceptions need to be managed effectively.

? Practice Question

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23.11: Expectancy Theory

Learning Objectives

- Describe the ways in which managers can use expectancy theory to motivate employees

Expectancy theory, initially put forward by **Victor Vroom** at the Yale School of Management, suggests that behavior is motivated by anticipated results or consequences. Vroom proposed that a person decides to behave in a certain way based on the expected result of the chosen behavior. For example, people will be willing to work harder if they think the extra effort will be rewarded.

In essence, individuals make choices based on estimates of how well the *expected* results of a given behavior are going to match up with or eventually lead to the *desired* results. This process begins in childhood and continues throughout a person's life. Expectancy theory has three components: expectancy, instrumentality, and valence.

- **Expectancy** is the individual's belief that effort will lead to the intended performance goals. Expectancy describes the person's belief that "I can do this." Usually, this belief is based on an individual's past experience, self-confidence, and the perceived difficulty of the performance standard or goal. Factors associated with the individual's expectancy perception are competence, goal difficulty, and control.
- **Instrumentality** is the belief that a person will receive a desired outcome if the performance expectation is met. Instrumentality reflects the person's belief that, "If I accomplish this, I will get that." The desired outcome may come in the form of a pay increase, promotion, recognition, or sense of accomplishment. Having clear policies in place—preferably spelled out in a contract—guarantees that the reward will be delivered if the agreed-upon performance is met. Instrumentality is low when the outcome is vague or uncertain, or if the outcome is the same for all possible levels of performance.
- **Valence** is the unique value an individual places on a particular outcome. Valence captures the fact that "I find this particular outcome desirable because I'm me." Factors associated with the individual's valence are needs, goals, preferences, values, sources of motivation, and the strength of an individual's preference for a particular outcome. An outcome that one employee finds motivating and desirable—such as a bonus or pay raise—may not be motivating and desirable to another (who may, for example, prefer greater recognition or more flexible working hours).

Expectancy theory, when properly followed, can help managers understand how individuals are motivated to choose among various behavioral alternatives. To enhance the connection between performance and outcomes, managers should use systems that tie rewards very closely to performance. They can also use training to help employees improve their abilities and believe that added effort will, in fact, lead to better performance.

Practice Question

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It's important to understand that expectancy theory can run aground if managers interpret it too simplistically. Vroom's theory entails more than just the assumption that people will work harder if they think the effort will be rewarded. The reward needs to be meaningful and take valence into account. Valence has a significant cultural as well as personal dimension, as illustrated by the following case.

ASMO in Japan

When Japanese motor company ASMO opened a plant in the U.S., it brought with it a large Japanese workforce but hired American managers to oversee operations. The managers, thinking to motivate their workers with a reward system, initiated a costly employee-of-the-month program that included free parking and other perks.

However, the program was a huge flop, and participation was disappointingly low. Why?

The program required employees to nominate their coworkers to be considered for the award. Japanese culture values modesty, teamwork, and conformity, and to be put forward or singled out for being special is considered inappropriate and even shameful. To be named Employee of the Month would be a very great embarrassment indeed—not at all the reward that management assumed. Especially as companies become more culturally diverse, the lesson is that managers need to get to know their employees and their needs—their unique valences—if they want to understand what makes them feel motivated, happy, and valued.

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23.12: Reinforcement Theory

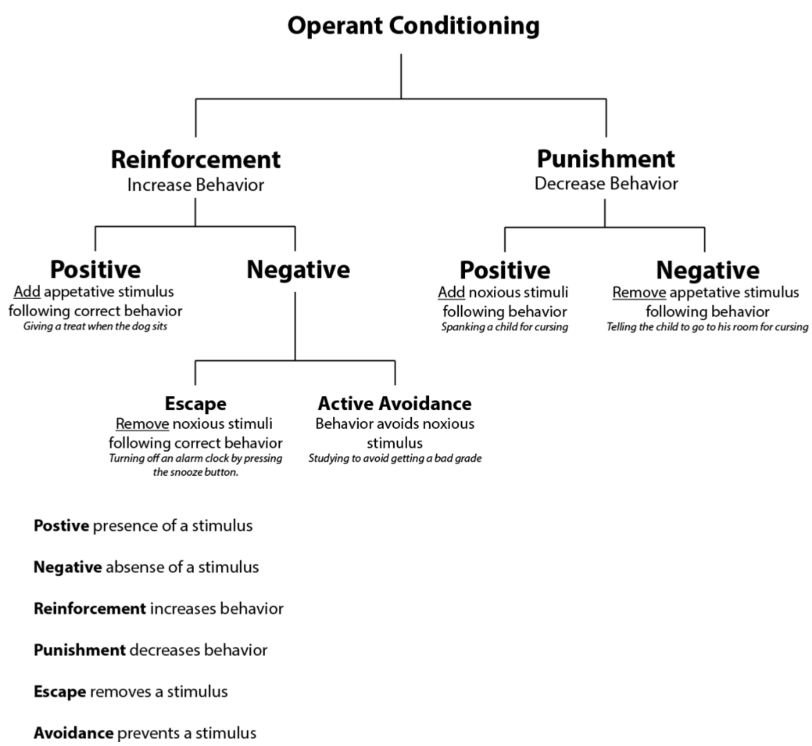
Learning Objectives

- Explain how reinforcement theory can be used as a management tool

The basic premise of the theory of reinforcement is both simple and intuitive: An individual's behavior is a function of the consequences of that behavior. You can think of it as simple cause and effect. If I work hard today, I'll make more money. If I make more money, I'm more likely to want to work hard. Such a scenario creates behavioral reinforcement, where the desired behavior is enabled and promoted by the desired outcome of a behavior.

Reinforcement theory is based on work done by **B. F. Skinner** in the field of operant conditioning. The theory relies on four primary inputs, or aspects of operant conditioning, from the external environment. These four inputs are **positive reinforcement**, **negative reinforcement**, **positive punishment**, and **negative punishment**.

This following chart shows the various pathways of operant conditioning, which can be established via reinforcement and punishment (both positive and negative for each).



Reinforcement

Positive reinforcement attempts to increase the frequency of a behavior by rewarding that behavior. For example, if an employee identifies a new market opportunity that creates profit, an organization may give her a bonus. This will positively reinforce the desired behavior.

Negative reinforcement, on the other hand, attempts to increase the frequency of a behavior by removing something the individual doesn't like. For example, an employee demonstrates a strong work ethic and wraps up a few projects faster than expected. This employee happens to have a long commute. The manager tells the employee to go ahead and work from home for a few days, considering how much progress she has made. This is an example of removing a negative stimulus as way of reinforcing a behavior.

Reinforcement can be affected by various factors, including the following:

- **Satiation**: the degree of need. If an employee is quite wealthy, for example, it may not be particularly reinforcing (or motivating) to offer a bonus.
- **Immediacy**: the time elapsed between the desired behavior and the reinforcement. The shorter the time between the two, the more likely it is that the employee will correlate the reinforcement with the behavior. If an employee does something great but isn't rewarded until two months after, he or she may not connect the desired behavior with the outcome. The reinforcement loses meaning and power.
- **Size**: the magnitude of a reward or punishment can have a big effect on the degree of response. For example, a bigger bonus often has a bigger impact (to an extent; see the satiation factor, above).

In a management context, reinforcers include salary increases, bonuses, promotions, variable incomes, flexible work hours, and paid sabbaticals. Managers are responsible for identifying the behaviors that should be promoted, the ones that should be discouraged, and carefully considering how those behaviors relate to organizational objectives. Implementing rewards and punishments that are aligned with the organization's goals helps to create a more consistent, efficient work culture.

One particularly common positive-reinforcement technique is the incentive program, a formal scheme used to promote or encourage specific actions, behaviors, or results from employees during a defined period of time. Incentive programs can reduce turnover, boost morale and loyalty, improve wellness, increase retention, and drive daily performance among employees. Motivating staff can, in turn, help businesses increase productivity and meet goals.

To maximize the impact of such a reinforcement, every feature of the incentive program must be tailored to the participants' interests. A successful incentive program contains clearly defined rules, suitable rewards, efficient communication strategies, and measurable success metrics. By adapting each element of the program to fit the target audience, companies are better able to engage participating employees and enhance the overall program efficacy.

Punishment

Positive punishment is conditioning at its most straightforward: identifying a negative behavior and providing an adverse stimulus to discourage future occurrences. A simple example would be suspending an employee for inappropriate behavior.

The purpose of punishment is to prevent future occurrences of a particular socially unacceptable or undesirable behavior. According to deterrence theory, the awareness of a punishment can prevent people from engaging in the behavior. This can be accomplished either by punishing someone immediately after the undesirable behavior, so they are reluctant to do it again, or by educating people about the punishment preemptively, so they are inclined not to engage in the behavior at all. In a management context, punishment tools can include demotions, salary cuts, and terminations.

Reinforcement and Punishment in IT

Let's look at an IT sales team for a couple examples. The team's overarching goal is to sell their new software to businesses. The manager may want to emphasize sales to partners of a certain size (i.e., big contracts). To this end, the manager may reward team members who gain clients of 5,000 or more employees with a commission of 5 percent of the overall sales volume for each such partner. This reward reinforces the behavior of closing big contracts, strongly motivating team members to work toward that goal, and likely increases the total number of big contracts closed.

Negative punishment entails the removal or withholding of something in order to condition a response. For example, Nicole, an employee in the IT department prefers to work unconventional hours, from 10:30 a.m. to 7 p.m. However, her performance has been suffering lately. A negative punishment would be to revoke her right to keep the preferred schedule until performance improves.

In business organizations, punishment and deterrence theory play a vital role in shaping the work culture to be in line with operational expectations and to avoid conflicts and negative outcomes both internally and externally. If employees know exactly what they are *not* supposed to do, and they understand the possible repercussions of violating those expectations, they will generally try to avoid crossing the line. Prevention is a much cheaper and easier approach than waiting for something bad to happen, so preemptive education regarding rules—and the penalties for violations—is common practice, especially in the area of business ethics.

Practice Question

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23.13: Introduction to Theory X, Theory Y, and Theory Z

What you'll learn to do: differentiate between Theory X, Theory Y, and Theory Z managers

In this section, we approach motivation from the opposite—management versus employee—side of the equation. We will discuss three different theories (all developed by management professors): Douglas McGregor's contrasting Theory X and Theory Y and William Ouchi's cross-cultural Theory Z. As in prior sections, we'll discuss the underlying assumptions of each theory and the associated management approach or style and organizational impacts and implications.

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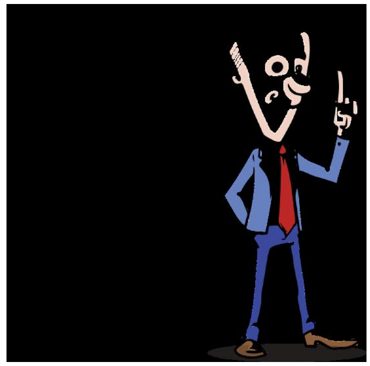
23.14: McGregor's Theory X and Theory Y

Learning Objectives

- Differentiate between Theory X, Theory Y, Theory Z managers
- Explain the implications of Theory X, Theory Y, and Theory Z for employee management



The idea that a manager's attitude has an impact on employee motivation was originally proposed by **Douglas McGregor**, a management professor at the Massachusetts Institute of Technology during the 1950s and 1960s. In his 1960 book, *The Human Side of Enterprise*, McGregor proposed two theories by which managers perceive and address employee motivation. He referred to these opposing motivational methods as Theory X and Theory Y management. Each assumes that the manager's role is to organize resources, including people, to best benefit the company. However, beyond this commonality, the attitudes and assumptions they embody are quite different.

Theory X

According to McGregor, Theory X management assumes the following:

- Work is inherently distasteful to most people, and they will attempt to avoid work whenever possible.
- Most people are not ambitious, have little desire for responsibility, and prefer to be directed.
- Most people have little aptitude for creativity in solving organizational problems.
- Motivation occurs only at the physiological and security levels of Maslow's hierarchy of needs.
- Most people are self-centered. As a result, they must be closely controlled and often coerced to achieve organizational objectives.
- Most people resist change.
- Most people are gullible and unintelligent.

Essentially, Theory X assumes that the primary source of employee motivation is monetary, with security as a strong second. Under Theory X, one can take a hard or soft approach to getting results.

The hard approach to motivation relies on coercion, implicit threats, micromanagement, and tight controls— essentially an environment of command and control. The soft approach, however, is to be permissive and seek harmony in the hopes that, in return, employees will cooperate when asked. However, neither of these extremes is optimal. The hard approach results in hostility, purposely low output, and extreme union demands. The soft approach results in a growing desire for greater reward in exchange for diminished work output.

It might seem that the optimal approach to human resource management would lie somewhere between these extremes. However, McGregor asserts that neither approach is appropriate, since the basic assumptions of Theory X are incorrect.

Drawing on Maslow's hierarchy of needs, McGregor argues that a need, once satisfied, no longer motivates. The company uses monetary rewards and benefits to satisfy employees' lower-level needs. Once those needs have been satisfied, the motivation disappears. Theory X management hinders the satisfaction of higher-level needs because it doesn't acknowledge that those needs are relevant in the workplace. As a result, the only way that employees can attempt to meet higher-level needs at work is to seek more compensation, so, predictably, they focus on monetary rewards. While money may not be the most effective way to self-fulfillment, it may be the only way available. People will use work to satisfy their lower needs and seek to satisfy their higher needs during their leisure time. However, employees can be most productive when their work goals align with their higher-level needs.

McGregor makes the point that a command-and-control environment is not effective because it relies on lower needs for motivation, but in modern society those needs are mostly satisfied and thus are no longer motivating. In this situation, one would expect employees to dislike their work, avoid responsibility, have no interest in organizational goals, resist change, etc.—creating, in effect, a self-fulfilling prophecy. To McGregor, a steady supply of motivation seemed more likely to occur under Theory Y management.

Theory Y

The higher-level needs of esteem and self-actualization are ongoing needs that, for most people, are never completely satisfied. As such, it is these higher-level needs through which employees can best be motivated.

In strong contrast to Theory X, Theory Y management makes the following assumptions:

- Work can be as natural as play if the conditions are favorable.
- People will be self-directed and creative to meet their work and organizational objectives if they are committed to them.
- People will be committed to their quality and productivity objectives if rewards are in place that address higher needs such as self-fulfillment.
- The capacity for creativity spreads throughout organizations.
- Most people can handle responsibility because creativity and ingenuity are common in the population.
- Under these conditions, people will seek responsibility.

Under these assumptions, there is an opportunity to align personal goals with organizational goals by using the employee's own need for fulfillment as the motivator. McGregor stressed that Theory Y management does not imply a soft approach.

McGregor recognized that some people may not have reached the level of maturity assumed by Theory Y and may initially need tighter controls that can be relaxed as the employee develops.

If Theory Y holds true, an organization can apply the following principles of scientific management to improve employee motivation:

- **Decentralization and delegation**: If firms decentralize control and reduce the number of levels of management, managers will have more subordinates and consequently need to delegate some responsibility and decision making to them.
- **Job enlargement**: Broadening the scope of an employee's job adds variety and opportunities to satisfy ego needs.
- **Participative management**: Consulting employees in the decision-making process taps their creative capacity and provides them with some control over their work environment.
- **Performance appraisals**: Having the employee set objectives and participate in the process of self-evaluation increases engagement and dedication.

If properly implemented, such an environment can increase and continually fuel motivation as employees work to satisfy their higher-level personal needs through their jobs.

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23.15: Ouchi's Theory Z

Learning Objectives

- Differentiate between Theory X, Theory Y, Theory Z managers
- Explain the implications of Theory X, Theory Y, and Theory Z for employee management

During the 1980s, American business and industry experienced a tsunami of demand for Japanese products and imports, particularly in the automotive industry. Why were U.S. consumers clambering for cars, televisions, stereos, and electronics from Japan? Two reasons: (1) high-quality products and (2) low prices. The Japanese had discovered something that was giving them the competitive edge. The secret to their success was not what they were producing but how they were managing their people—Japanese employees were engaged, empowered, and highly productive.

Management professor **William Ouchi** argued that Western organizations could learn from their Japanese counterparts. Although born and educated in America, Ouchi was of Japanese descent and spent a lot of time in Japan studying the country's approach to workplace teamwork and participative management. The result was Theory Z—a development beyond Theory X and Theory Y that blended the best of Eastern and Western management practices. Ouchi's theory first appeared in his 1981 book, *Theory Z: How American Management Can Meet the Japanese Challenge.* The benefits of Theory Z, Ouchi claimed, would be reduced employee turnover, increased commitment, improved morale and job satisfaction, and drastic increases in productivity.

Theory Z stresses the need to help workers become generalists, rather than specialists. It views job rotations and continual training as a means of increasing employees' knowledge of the company and its processes while building a variety of skills and abilities. Since workers are given much more time to receive training, rotate through jobs, and master the intricacies of the company's operations, promotions tend to be slower. The rationale for the drawn-out time frame is that it helps develop a more dedicated, loyal, and permanent workforce, which benefits the company; the employees, meanwhile, have the opportunity to fully develop their careers at one company. When employees rise to a higher level of management, it is expected that they will use Theory Z to "bring up," train, and develop other employees in a similar fashion.

Ouchi's Theory Z makes certain assumptions about workers. One assumption is that they seek to build cooperative and intimate working relationships with their coworkers. In other words, employees have a strong desire for affiliation. Another assumption is that workers expect reciprocity and support from the company. According to Theory Z, people want to maintain a work-life balance, and they value a working environment in which things like family, culture, and traditions are considered to be just as important as the work itself. Under Theory Z management, not only do workers have a sense of cohesion with their fellow workers, they also develop a sense of order, discipline, and a moral obligation to work hard. Finally, Theory Z assumes that given the right management support, workers can be trusted to do their jobs to their utmost ability and look after for their own and others' well-being.

Theory Z also makes assumptions about company culture. If a company wants to realize the benefits described above, it need to have the following:

- **A strong company philosophy and culture**: The company philosophy and culture need to be understood and embodied by all employees, and employees need to believe in the work they're doing.
- **Long-term staff development and employment**: The organization and management team need to have measures and programs in place to develop employees. Employment is usually long-term, and promotion is steady and measured. This leads to loyalty from team members.
- **Consensus in decisions:** Employees are encouraged and expected to take part in organizational decisions.

- **Generalist employees:** Because employees have a greater responsibility in making decisions and understand all aspects of the organization, they ought to be generalists. However, employees are still expected to have specialized career responsibilities.
- **Concern for the happiness and well-being of workers**: The organization shows sincere concern for the health and happiness of its employees and their families. It takes measures and creates programs to help foster this happiness and well-being.
- **Informal control with formalized measures**: Employees are empowered to perform tasks the way they see fit, and management is quite hands-off. However, there should be formalized measures in place to assess work quality and performance.
- **Individual responsibility**: The organization recognizes the individual contributions but always within the context of the team as a whole.

Theory Z is not the last word on management, however, as it does have its limitations. It can be difficult for organizations and employees to make life-time employment commitments. Also, participative decision-making may not always be feasible or successful due to the nature of the work or the willingness of the workers. Slow promotions, group decision-making, and life-time employment may not be a good fit with companies operating in cultural, social, and economic environments where those work practices are not the norm.

Practice Questions

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23.16: Introduction to Strategies for Motivating Employees

What you'll learn to do: explain how managers can use job characteristics and goal-setting theory to motivate employees

In this section you'll study two methods used by managers to put motivational theory into practice: job models and goals. These two practices can be observed in almost every organization, profit and nonprofit alike. You'll also see some examples of the way companies are actually implementing those practices today.

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23.17: Job Design and Job Characteristics Theory

> **Learning Objectives**
>
> - Explain how job characteristics theory can be used to enhance employee motivation

Job design is an important prerequisite to workplace motivation, as a well-designed job can encourage positive behaviors and create a strong infrastructure for employee success. Job design involves specifying the contents, responsibilities, objectives, and relationships required to satisfy the expectations of the role. Below are some established approaches managers can take to doing it thoughtfully and well.

Proposed by Greg R. Oldham and J. Richard Hackman in 1976, job characteristics theory identifies five core characteristics that managers should keep in mind when they are designing jobs. The theory is that these dimensions relate to, and help satisfy, important psychological states of the employee filling the role, with the results of greater job satisfaction and motivation and less absenteeism and turnover.

Core Job Characteristics

Below are the core job characteristics:

- **Skill variety**: Doing the same thing day in, day out gets tedious. The solution to design jobs with enough variety to stimulate ongoing interest, growth, and satisfaction.
- **Task identity**: Being part of a team is motivating, but so, too, is having some ownership of a set of tasks or part of the process. Having a clear understanding of what one is responsible for, with some degree of control over it, is an important motivator.
- **Task significance**: Feeling relevant to organizational success provides important motivation for getting a task or job done. Knowing that one's contributions are important contribute's to sense of satisfaction and accomplishment.
- **Autonomy**: No one likes to be micromanaged, and having some freedom to be the expert is critical to job satisfaction. Companies usually hire people for their specialized knowledge. Giving specialists autonomy to make the right decisions is a win-win.
- **Feedback**: Finally, everyone needs objective feedback on how they are doing and how they can do better. Providing well-constructed feedback with tangible outcomes is a key component of job design.

In the following Ted Talk, career analyst Dan Pink examines the puzzle of motivation, starting with a fact that social scientists know but most managers don't: Traditional external rewards aren't always as effective as we think, and those that speak to a person's internal motivation are often more potent and lasting:

You can view the transcript for “The Puzzle of Motivation | Dan Pink” (opens in new window) or the text alternative for “The Puzzle of Motivation | Dan Pink” (opens in new window).

Psychological States

Below are the psychological states that help employees feel motivated and satisfied with their work:

- **Experienced meaningfulness**: This is a positive psychological state that will be achieved if the first three job dimensions—skill variety, task identity, and task significance—are in place. All three dimensions help employees feel that what they do is meaningful.
- **Experienced responsibility**: Dimension four, autonomy, contributes to a sense of accountability, which, for most, people is intrinsically motivating.
- **Knowledge of results**: Dimension five, feedback, provides a sense of progress, growth, and personal assessment. Understanding one’s accomplishments is a healthy state of mind for motivation and satisfaction.

Work Outcomes

The combination of core job characteristics with psychological states influences work outcomes such as the following:

- **Job satisfaction**: When employees feel that their jobs are meaningful, that positive psychological state contributes to a sense of satisfaction.
- **Motivation**: Employees who experience responsibility in their job, a sense of ownership over their work, and knowledge of the results tend to be more highly motivated.
- **Absenteeism**: When employees are motivated and satisfied, absenteeism and job turnover decrease.

Overall, the manager’s goal is to design the job in such a way that the core characteristics complement the psychological states of the worker and lead to positive outcomes.

Job Design Techniques

As a motivational force in the organization, managers must consider how they can design jobs that lead to empowered, motivated, and satisfied employees. Below are a few established methods to accomplish this objective:

- **Job rotation**: As noted in the above model, it’s not particularly motivating to do the exact same thing every day. As a result, rotating jobs and expanding employees’ skill sets accomplish two objectives: increased employee satisfaction and broader employee skills.
- **Job enlargement (horizontal)**: Giving employees the autonomy to step back and assess the quality of their work, improve the efficiency of their processes, and address mistakes contributes to satisfaction in the workplace.
- **Intrinsic and extrinsic rewards**: Giving employees autonomy helps generate intrinsic rewards (self-satisfaction) and motivation. Extrinsic rewards (such as time off, a bonus, or commission) are also motivating.
- **Job enrichment (vertical)**: It’s important for managers to delegate some of their planning to seasoned employees as they grow into their roles. By turning over control of work-task planning to employees themselves, they feel a strong sense of engagement, progress in their career, and ownership of their work outcomes.

Practice Question

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23.18: Goal-Setting Theory

> **Learning Objectives**
>
> - Describe ways in which goal setting can improve employee performance

Goal Setting

Figure 23.18.1: Athletes set goals during the training process. Through choice, effort, persistence, and cognition, they can prepare to compete.

Research shows that people perform better when they are committed to achieving particular goals. Factors that help ensure commitment to goals include the following:

- The importance of the expected outcomes
- Self-efficacy, or belief that the goal can be achieved
- Promises or engagements to others, which can strengthen commitment level

In a business setting, managers cannot constantly drive employees' motivation or monitor their work from moment to moment. Instead, they rely on goal setting as an effective means of helping employees regulate their own performance and stay on track. Goal setting affects outcomes in the following important ways:

- **Choice**: Goals narrow attention and direct efforts to goal-relevant activities, and away from goal-irrelevant actions.
- **Effort**: Goals can lead to more effort; for example, if one typically produces four widgets per hour and has the goal of producing six, one may work more intensely to reach the goal than one would otherwise.
- **Persistence**: People are more likely to work through setbacks if they are pursuing a goal.
- **Cognition**: Goals can lead individuals to develop and change their behavior.

Edwin Locke and his colleagues examined the behavioral effects of goal setting, and they found that 90 percent of laboratory and field studies involving specific and challenging goals led to higher performance, whereas those with easy or no goals showed minimal improvement. While some managers believe it is sufficient to urge employees to "do their best," these researchers learned that people who are instructed to do their best generally do not. The reason is that if you want to elicit a specific behavior, you need to give a clear picture of what is expected. "Do your best" is too vague. A goal is important because it establishes a specified direction and measure of performance.

You'll recall from the discussion of SMART objectives in the Management module that setting effective goals and identifying the best means of meeting them are important aspects of the controlling function of managers. It turns out that setting SMART goals is also a powerful way to motivate employees, especially when employees are able to participate in the goal-setting process. **S**pecific, **M**easurable, **A**chievable, **R**ealistic, and **T**ime-constrained goals give both managers and employees clear direction and a way to measure performance.

Goals and Feedback

Figure 23.18.2: Aim for the goal: goal-setting is closely tied to performance. Those who set realistic but challenging goals are likely to perform better than those who do not.

Managers need to track performance so employees can see how effective they have been in attaining their goals. Without proper feedback channels, employees find it impossible to adapt or adjust their behavior. Goal setting and feedback go hand-in-hand. Without feedback, goal setting is unlikely to work.

Providing feedback on short-term objectives helps to sustain an employee's motivation and commitment. When giving feedback, managers should do the following:

- Create a positive context
- Use constructive and positive language
- Focus on behaviors and strategies
- Tailor feedback to the needs of the individual worker
- Make feedback a two-way communication process

Goal setting may have little effect if the employee can't evaluate his own performance in relation to the goal. By giving accurate, constructive feedback, managers can help employees evaluate whether they need to work harder or change their approach.

Goal-setting theory is very useful in business, but it does have limitations. Using production targets to drive motivation may encourage workers to meet those targets by any means necessary—resulting in poor quality or, worse, unethical behavior. You'll recall that this was the case in the recent Wells Fargo scandal, where employees created millions of fake bank accounts in order to hit sales targets. Another problem with goal setting is that a manager's goals may not be aligned with the goals of the organization as whole, and conflict may ensue, or the employees may feel uncertain about which goals ought to be prioritized (first the manager's, then the organization's? Or vice versa?). Either way, performance can suffer. In addition, for complex or creative tasks, it is possible for goal setting to actually hamper achievement, because the individual can become too preoccupied with meeting goals and distracted from completing tasks. This is especially true is if reviews and pay increases are strongly tied to goal achievement.

? Practice Question

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23.19: Motivation in Today’s Workplace

Learning Objectives

- Explain how job characteristics theory can be used to enhance employee motivation
- Describe ways in which goal setting can improve employee performance

The following videos contain examples of motivational theory being used in today’s companies. As you watch, see if you can recognize any of the theories you’ve studied. Are they need based or process based? What are the results of the different motivational strategies these companies use?

You can view the transcript for “Starbucks Gives Employees Free College Education” (opens in new window).

You can view the transcript for “Flex Year” (opens in new window).

You can view the transcript for “Container Store Employee Benefits” (opens in new window).

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23.20: Putting It Together- Motivating Employees

Synthesis

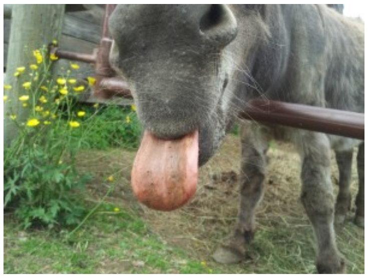

Figure 23.20.1: “You can’t make me.”

Have you ever heard the expression “stubborn as a mule” and heard it used to describe someone who won’t change their mind or way of doing things? What would it take to get such a mulish person to change, to work in a different way—say, more efficiently or effectively? Well, now that you have some motivational theories under your belt, you probably have some ideas. Being able to motivate people is obviously an invaluable skill—in business and in life—and it’s not surprising that the most effective leaders and managers are those who can inspire others to work hard and get things done.

At the beginning of this module you were asked what motivates you, how you motivate others, and which strategies have worked (or not worked) for you. Now that you have completed the module, reflect on your answers to those questions. Can you identify some of these motivational theories at work in your own motivations? Do you have a better understanding of where your own motivation comes from?

One last thought as we conclude the module. When you came up with your list of motivating factors, it was *your* list. What motivates you might not motivate the person working beside you. So, as you interact with people throughout your personal and professional life, keep in mind that motivation is highly variable. It doesn’t mean that the theories are wrong or completely irrelevant—it’s just that everyone, like you, is motivated by a different set of needs, wants, and aspirations, and you’ll need to understand those differences before creatively engaging with them. If you can, you’ll be well on your way to being an effective leader and achieving great things.

Summary

In this module you learned about motivation and how organizations can use motivation theory to achieve organizational goals and objectives. The following is a summary of the key points.

The Hawthorne Effect

Conducted at the Western Electric Hawthorne Works plant in Cicero, Illinois, Elton Mayo and his colleagues attempted to apply Taylor’s process of scientific management by conducting experiments in the workplace. What resulted is a phenomenon known as the “Hawthorne effect,” which occurs when subjects being studied change their behavior simply because they are being observed and treated differently.

Need-Based Theories

The first theories used to explain human motivation were need based. These theories proposed that people are mainly motivated by trying to meet certain needs and that if you can understand their needs, you can better motivate them. Among the need-based theories are Maslow’s hierarchy of needs, ERG theory, Herzberg’s two-factor theory, and McClelland’s acquired-needs theory.

Process-Based Theories

Process-based theories of motivation view motivation as a more rational, deliberate process. The three best-known process-based theories are equity, expectancy, and reinforcement theories.

Theory X, Theory Y, and Theory Z

Douglas McGregor theorized that worker motivation is closely linked to the way managers view and treat their workers and that all managers fall into one of two types—Theory X and Theory Y. Later, William Ouchi combined Eastern and Western management practices to develop Theory Z

Strategies for Motivating Employees

Two methods of applying motivation theory in the workplace are job models and goal setting. Beyond these two applications, companies have become very aware of the way motivated employees impact organizational effectiveness and efficiency.

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23.21: Discussion- Why Isn’t Jamie More Motivated?

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document “Salty Pawz Background.”

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda just doesn’t understand her friend Jamie sometimes. They have been working together since the first dog biscuit came out of the oven, but now that the business is expanding, she can’t seem to get Jamie motivated to accomplish the things she delegates to her. She pays Jamie a salary now, so it’s not like the old days when she was working in exchange for dog treats. She has even given Jamie more responsibility; Jamie now supervises two other employees, a challenge Wanda assumed that Jamie wanted.

One afternoon she stops Jamie in the hallway and asks her if everything is going okay. Jamie responds that things are fine. Later that same week Wanda and Jamie are meeting about an upcoming promotion they are holding at the local animal shelter. Jamie takes a few notes but doesn’t share Wanda’s enthusiasm for the event. Wanda comes right out and asks Jamie if she has lost interest in the business. Jamie shrugs and says no, she is good with everything.

For Discussion

1. Explain some reasons why Jamie may lack motivation and enthusiasm for the business at this point. Make sure the reasons you present are supported by sound motivational theory as established by leaders in the field.
2. What types of forces motivate you to accomplish tasks in your personal, work, or school life? How is your motivation affected by the types of motivators you have studied in this module, and could you and Jamie be experiencing some of the same things?

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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23.22: Discussion- Motivate Me!

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Some motivational speakers are paid hundreds of thousands of dollars to speak to stadium-sized crowds. People buy books, listen to podcasts, and attend seminars—all in the hope of finding the motivation to accomplish their goals or make their dreams come true. Without question, people want to be motivated! However, there is probably a difference between a celebrity speaker stirring up a crowd and someone who can genuinely motivate others to reach their goals. Motivational speaker Tony Robbins recently got into some trouble when sixty people were injured while trying to walk barefoot across a bed of hot coals after attending one of his presentations (read about it here – Tony Robbins Hot Coal Walkers Burned). Was that motivation? You decide.

True motivation sets a person on a path that he or she can continue to travel even after the individual who lit the spark is gone. These are the motivating people we want to identify and talk about here.

For the purpose of discussion, choose an individual known for providing motivation to others. This person can be alive or deceased, from business, politics, or society at large. You'll need to select someone you can research and provide proof of that research to your classmates and instructor.

For Discussion

1. Tell your classmates whom you selected and why.
2. Provide an example (supported by research) of a time when this individual served as a motivator for others.
3. Based on the material you studied in this module, the experience of being motivated yourself, and your experience motivating others, what is it about this person that you believe made or makes them a motivator. Do they motivate YOU? Why?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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23.23: Assignment- Motivating with Dog Treats?

Scenario

Wanda wants all of her employees to be motivated to do a good job and continue the success of Salty Pawz, but there is only so much money she can shell out and still keep the business profitable. She begins to wonder if there aren't ways she can motivate her employees without writing yet another check.

Recently Wanda was asked to donate dog treats to the local Humane Society for a free rabies vaccination clinic being held at the local high school. She donated one hundred bags of Chicken Cuties and even stopped by the event to see how it was going. When she arrived, she was surprised to see her friend Jamie there, happily greeting and signing in owners and their dogs. On the way home, Wanda began to think that perhaps there are ways that she can motivate her employees without paying them, but she doesn't know much about motivation theory. She turns to you once again for information and guidance.

Your Task

1. Select one of the motivation theories you studied in this module that you believe can be used effectively with the employees at Salty Pawz. Briefly explain the theory to Wanda and how it applies to her staff.
2. Using that theory, provide Wanda with 2–3 specific ways she can motivate her employees without money. Your suggestions should be specific and detailed enough that Wanda could implement them immediately.

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Identify a motivational theory and explain how the theory can be applied to the employees at Salty Pawz.	0 points	22 points	32 points	40 points	40%
Identify 2–3 specific ways that employees can be motivated without money. Suggestions specific and detailed enough to be applied immediately.	0 points	22 points	32 points	40 points	40%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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23.24: Assignment- What's Empowerment Got to Do with It?

Preparation

Contemporary companies are spotlighted as "best places to work" and their employee motivation practices are openly discussed. For example, Google, Southwest Airlines, and Zappos all claim that "empowering their employees" is the reason that their workforce is so dedicated and highly motivated.

Read the article **"**Motivating Employees Has Everything To Do With Giving Them Feelings Of Ownership" from *Forbes Magazine.*

Your Task

After reading the article, you are ready to begin the assignment:

1. Research employee motivation and contemporary companies by choosing a company known to be a "great place to work" as the focus of your written assignment. If you are not certain which companies meet this criteria, you can start at one of these websites: GlassDoor or Best Places to Work. *Forbes Magazine* and Indeed.com also gather data on employee satisfaction.
2. Once you have selected the company, summarize the key components or characteristics of your selected company's employee motivation strategy or practice.
3. Compare the strategy or practice used by the company to one of the theories presented in the module readings (i.e. Maslow's hierarchy of needs, ERG, Herzberg's Two-Factor, Theory X and Theory Y Theory, Theory Z, Equity Theory, etc.). Be specific when you make this comparison, and be aware of the fact that you may see elements of more than one theory being put into practice.
4. After you have studied how your chosen company keeps its employees motivated and creates a great place to work, summarize which theory would most motivate *you* and why.

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CHAPTER OVERVIEW

24: Module 10 Readings - Motivating Employees

24.1: Reading- Introduction to Motivational Theory

Introduction to Motivational Theory

Motivation is defined as "the intention of achieving a goal, leading to goal-directed behavior" (*Columbia Encyclopedia*, 2004, New York: Columbia University Press). When we say that someone is motivated, we mean that the person is trying hard to accomplish a certain task. Motivation is clearly important in order for someone to perform well. However, motivation alone is not sufficient. **Ability**—having the skills and knowledge required to perform the job—is also important, and is sometimes key to being effective. Finally, environmental factors—having the resources, information, and support one needs to perform well—are also critical to reaching one's goals.

What makes employees willing to "go the extra mile" to provide excellent service, market a company's products effectively, or achieve the goals set for them? Answering such questions can help us understand and manage the work of peers, subordinates, and even supervisors. As with many questions involving human behavior, though, the answers are anything but uniform or simple. Instead, you'll find a number of theories that explore the concept of motivation and attempt to explain its source.

The following video on the motivational strategies used by Zappos is a good place to begin our discussion of motivation in business:

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24.2: Reading- Fredrick Taylor's Scientific Management

Fredrick Taylor's Scientific Management

In 1913, Frederick Taylor published *Principles of Scientific Management*,[1] ushering in a completely new way of understanding the modern organization. Frederick Taylor was trained as an engineer and played a prominent role in the idea of scientific management. *Scientific management* is a management-oriented and production-centered perspective of organizational communication.[2] Taylor believed that the reason most organizations failed was because they lacked successful systematic management. He wrote that "the best management is true science resting upon clearly defined laws, rules, and principles, as a foundation."[3] He further noted that "under scientific management, arbitrary power, arbitrary dictation ceases, and every single subject, large and small, becomes a question for scientific investigation, for reduction to law."[4] Taylor believed that any job could be performed better if it were investigated scientifically. Taylor developed time and motion studies that helped improve organizational efficiency.

Working as a foreman for the Bethlehem Steel Works in the 1900s, Taylor observed how workers could do more with less time. He analyzed coal shoveling at the factory and noticed that several workers brought different sizes of shovels from home. Workers who brought small shovels could do more but it took them longer, and workers who brought big shovels could do less but it was faster. He observed that the best size shovel was one weighing about twenty pounds. As a result, he directed the organization to provide all the workers with the same size shovel. He also provided pay incentives for workers who could shovel more coal. By making these changes, the organization dramatically increased its production.

Taylor believed that several steps must be taken in order to create a more productive organization. First, one must examine the job or task. Second, one needs to determine the best way to complete the job or task. Third, one must choose the most appropriate person for the task while at the same time providing proper compensation. Last, one must be able to train the person to do the task efficiently. Taylor believed that by using these scientific steps organizations gain efficiencies.

Taylor's idea of scientific management originated during a time when most worker training was based on apprenticeship models. In an apprenticeship, a person would be taught by a more skilled and experienced person, who would demonstrate the task so the inexperienced person could model the behavior. Taylor believed that this was a very ineffective way of training because he felt that workers would differ in terms of the tasks they performed, and the quality or efficiency of task completion would depend on the kind of training they received. Taylor argued that there should be only one way to explain the job and one way to execute the task. He didn't think the training of apprentices should be left to individual "experts."

Overall, Taylor felt that employees are lazy and need constant supervision. He posited that "the tendency of the average [employee] is toward working at a slow easy gait." He called this tendency "natural soldiering" ("soldiering" is another word for "taking it easy"). One's natural tendency to take it easy on the job can also be affected by "systematic soldiering," which occurs when when employees decrease their work production based on input or communications from others or if they feel that working harder will not result in greater compensation. When employees are paid by the hour, there is an additional incentive to slow down—it's better to "soldier" and show that tasks take longer than might really be necessary. On account of what he took to be workers' inherent laziness, Taylor understood the impact of workers on production rates and the need for more efficient work practices.

Taylor is known for developing *time and motion studies* of work. These were methods for calculating production efficiency by recording outcomes and the time it takes to produce those outcomes. Taylor believed that if each task were scientifically designed and the workers could be trained, then production could be measured by timing the labor the workers performed. The idea was to create quantified benchmarks for work in order to improve efficiency and production outcomes. Taylor's time and motion studies were furthered by Frank Gilbreth, who used film to capture workers in action to gain a better understanding of physical movements.[5] In the following video, you can see the work of Frank Gilbreth, along with his wife Lilian, as they attempted to use time and motion techniques to make bricklaying more effective, productive, and profitable.

In the first half of the video, the initial configuration of the scaffolding required the bricklayers to do a lot of bending. The bending motion not only took more time but also increased the workers' fatigue as the day wore on, making them less effective and productive. In the second half of the video, after the time and motion study, you saw the solution: a new scaffolding arrangement that no longer required bending over to pick up the bricks. It was time and motion studies like these that enabled researchers (and employers) to investigate the mechanics of *doing work*—which, in many cases, led to genuine improvements in worker conditions and work techniques.

Taylor's mechanistic vision applied to organizations as a whole: ideally, work tasks would be clearcut and simple, and the sum total of employees efficiently performing their tasks would be a company that runs like a well-functioning machine.

Taylor's ideas do not leave much room for flexibility, creativity, or originality on the worker's part. In his view, there is a strong and necessary division between managers, who do the thinking, and workers, who do the laboring. Nor do Taylor's scientific principles address the messier, more human side of organizational management—things like interpersonal relationships, work motivation, and turbulence in organizations. Taylor didn't think it was important to build rapport with workers. Managers ought to communicate in a straightforward manner; employees don't need to give input—they just need to know how to do their jobs.

Though Taylor's ideas were wildly popular in their day, they had detractors even then. As early as 1912, the U.S. Commission on Industrial Relations expressed skepticism about scientific management (what many were calling "Taylorism"):

To sum up, scientific management in practice generally tends to weaken the competitive power of the individual worker and thwarts the formation of shop groups and weakens group solidarity; moreover, generally scientific management is lacking in the arrangements and machinery necessary for the actual voicing of the workers ideas and complaints and for the democratic consideration and adjustment of grievances.[6]

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. Taylor, F. (1913). Principles of scientific management. New York, NY: Harper. ↵
2. Einsenberg, E. M., & Goodall, H. L., Jr. (1993). Organizational communication: Balancing creativity and constraint. New York, NY: St. Martin's Press. ↵
3. Taylor, F. (1913). Principles of scientific management. New York: Harper, pg. 19. ↵
4. Ibid., p 211 ↵

5. Nadworny, M. J. (1957). Frederick Taylor and Frank Gilbreth: Competition in scientific management. Business History Review, 31, 23–34. ↵
6. U.S. Commission on Industrial Relations (1912). A government evaluation of scientific management: Final report and testimony. Washington, D. C.: Government Printing Office, pg. 136. ↵

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24.3: Reading- The Hawthorne Studies

Results of the Hawthorne Studies

The Hawthorne studies were conducted on workers at the Hawthorne plant of the Western Electric Company by Elton Mayo and Fritz Roethlisberger in the 1920s. The Hawthorne studies were part of a refocus on managerial strategy incorporating the socio-psychological aspects of human behavior in organizations.

The following video from the AT&T archives contains interviews with individuals who participated in these studies. It provides additional insight into the way the studies were conducted and how they changed employers’ views on worker motivation.

The studies originally looked into whether workers were more responsive and worked more efficiently under certain environmental conditions, such as improved lighting. The results were surprising: Mayo and Roethlisberger found that workers were more responsive to social factors—such as the people they worked with on a team and the amount of interest their manager had in their work—than the factors (lighting, etc.) the researchers had gone in to inspect.

The Hawthorne studies discovered that workers were highly responsive to additional attention from their managers and the feeling that their managers actually cared about, and were interested in, their work. The studies also found that although financial motives are important, social issues are equally important factors in worker productivity.

There were a number of other experiments conducted in the Hawthorne studies, including one in which two women were chosen as test subjects and were then asked to choose four other workers to join the test group. Together, the women worked assembling telephone relays in a separate room over the course of five years (1927–1932). Their output was measured during this time—at first, in secret. It started two weeks before moving the women to an experiment room and continued throughout the study. In the experiment room, they had a supervisor who discussed changes with them and, at times, used the women’s suggestions. The researchers then spent five years measuring how different variables impacted both the group’s and the individuals’ productivity. Some of the variables included giving two five-minute breaks (after a discussion with the group on the best length of time), and then changing to two 10-minute breaks (not the preference of the group).

Intangible Motivators

Changing a variable usually increased productivity, even if the variable was just a change back to the original condition. Researchers concluded that the employees worked harder because they thought they were being monitored individually. Researchers hypothesized that choosing one’s own coworkers, working as a group, being treated as special (as evidenced by working in a separate room), and having a sympathetic supervisor were the real reasons for the productivity increase.

The Hawthorne studies showed that people’s work performance is dependent on social issues and job satisfaction, and that monetary incentives and good working conditions are generally less important in improving employee productivity than meeting individuals' need and desire to belong to a group and be included in decision making and work.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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24.4: Reading- Need-Based Motivation Theories

Maslow's Hierarchy of Needs

Abraham Maslow is among the most prominent psychologists of the twentieth century, and the hierarchy of needs, accompanied by the pyramid representing how human needs are ranked (see Figure 1, below), is an idea familiar to most business students and managers. Maslow's theory is based on a simple premise: Human beings have needs that are hierarchically ranked.[1] Some needs 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 will probably 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.[2] 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.

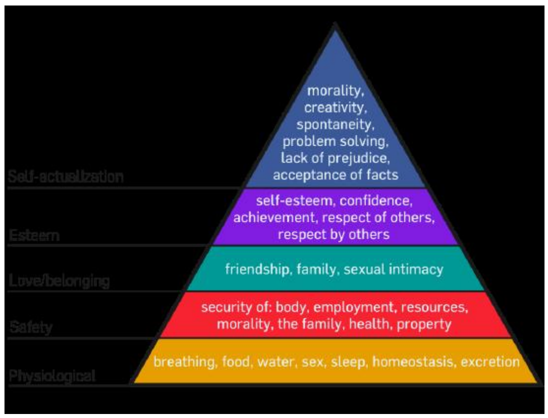

Figure 24.4.1: Maslow's Hierarchy of Needs

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

The ERG theory of Clayton Alderfer is a modification of Maslow's hierarchy of needs.[3] Instead of the five needs that are hierarchically organized, Alderfer proposed that basic human needs may be grouped under three categories: Existence, Relatedness, and Growth (see Figure 24.4.2, below). 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.

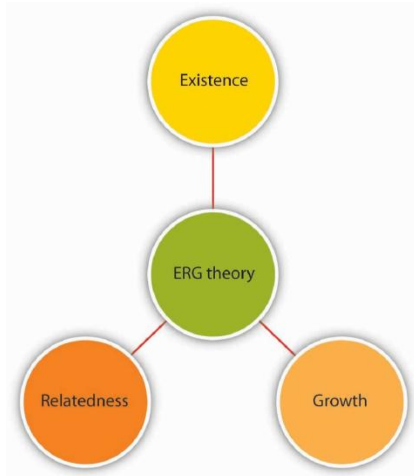

Figure 24.4.2: ERG Theory of Needs

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. [4] 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 24.4.3: Two-Factor Theory of Motivation

Herzberg's research, which is summarized in Figure 24.4.3, above, has received its share of criticism.[5] 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.

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 a 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.[6] Because of their success in lower-level jobs, those in high need for achievement are often promoted to higher-level positions.[7] 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.[8]

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.[9] 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.[10]

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.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Contributors and Attributions

24.5: Reading- Process-Based Theories

Equity Theory

Imagine that your friend Marie is paid $10 an hour working as an office assistant. She has held this job for six months. She is very good at what she does, she comes up with creative ways to make things easier in the workplace, and she is a good colleague who is willing to help others. She stays late when necessary and is flexible if asked to rearrange her priorities or her work hours. Now imagine that Marie finds out her manager is hiring another employee, Spencer, who is going to work with her, who will hold the same job title and will perform the same type of tasks. Spencer has more advanced computer skills, but it is unclear whether these will be used on the job. The starting pay for Spencer will be $14 an hour. How would Marie feel? Would she be as motivated as before, going above and beyond her duties?

If your reaction to this scenario was along the lines of "Marie would think it's unfair," your feelings may be explained using equity theory. According to this theory, individuals are motivated by a sense of fairness in their interactions. Moreover, our sense of fairness is a result of the social comparisons we make. Specifically, we compare our inputs and outputs with someone else's inputs and outputs. We perceive fairness if we believe that the input-to-output ratio we are bringing into the situation is similar to the input/output ratio of a comparison person, or a referent. Perceptions of inequity create tension within us and drive us to action that will reduce perceived inequity. This process is illustrated in the Equity Formula.[1]

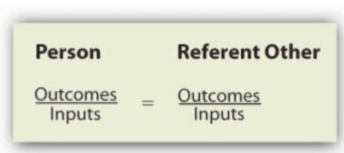

Figure 24.5.1: The Equity Formula

What Are Inputs and Outputs?

Inputs are the contributions the person feels he or she is making to the environment. In the previous example, the hard work Marie was providing, loyalty to the organization, the number of months she has worked there, level of education, training, and her skills may have been relevant inputs. Outputs are the rewards the person feels he or she is receiving from the situation. The $10 an hour Marie is receiving was a salient output. There may be other outputs, such as the benefits received or the treatment one gets from the boss. In the prior example, Marie may reason as follows: "I have been working here for six months. I am loyal and I perform well (inputs). I am paid $10 an hour for this (outputs). The new guy, Spencer, does not have any experience here (referent's inputs) but will be paid $14 (referent's outcomes). This situation is unfair."

We should emphasize that equity perceptions develop as a result of a subjective process. Different people may look at exactly the same situation and perceive different levels of equity. For example, another person may look at the same scenario and decide that the situation is fair because Spencer has computer skills and the company is paying extra for these skills.

Who Is the Referent?

The referent other may be a specific person or an entire category of people. For example, Marie might look at want ads for entry-level clerical workers and see whether the pay offered is in the $10-per-hour range; in this case, the referent other is the category of entry-level clerical workers, including office assistants, in Marie's local area. Referents should be comparable to us—otherwise the comparison is not meaningful. It would be illogical for Marie to compare herself to the CEO of the company, given the differences in the nature of inputs and outcomes. Instead, she would logically compare herself to those performing similar tasks within the same organization or a different organization.

Reactions to Unfairness

The theory outlines several potential reactions to perceived inequity, which are summarized in Table 1, "Potential Responses to Inequity." Oftentimes, the situation may be dealt with perceptually, by distorting our perceptions of our own or referent's inputs and outputs. For example, Marie may justify the situation by downplaying her own inputs ("I don't really work very hard on this job"), valuing the outputs more highly ("I am gaining valuable work experience, so the situation is not that bad"), distorting the other person's inputs ("Spencer really is more competent than I am and deserves to be paid more") or distorting the other person's outputs ("Spencer gets $14 but will have to work with a lousy manager, so the situation is not unfair").

Table 24.5.1 Potential Responses to Inequity[2]

Reactions to Inequity	Example
Distort perceptions	Changing one’s thinking to believe that the referent actually is more skilled than previously thought
Increase referent’s inputs	Encouraging the referent to work harder
Reduce own input	Deliberately putting forth less effort at work. Reducing the quality of one’s work
Increase own outcomes	Negotiating a raise for oneself or using unethical ways of increasing rewards such as stealing from the company
Change referent	Comparing oneself to someone who is worse off
Leave the situation	Quitting one’s job
Seek legal action	Suing the company or filing a complaint if the unfairness in question is under legal protection

Another way of addressing perceived inequity is to reduce one’s own inputs or increase one’s own outputs. If Marie works less hard, perceived inequity would be reduced. And, indeed, research shows that people who perceive inequity tend to reduce their work performance or reduce the quality of their inputs.[3] Increasing one’s outputs can be achieved through legitimate means such as negotiating a pay raise. At the same time, research shows that those feeling inequity sometimes resort to stealing to balance the scales.[4] Other options include changing the comparison person (for example, Marie may learn that others doing similar work in different organizations are paid only minimum wage) and leaving the situation by quitting one’s job.[5] We might even consider taking legal action as a potential outcome of perceived inequity. For example, if Marie finds out that the main reason behind the pay gap is gender, she may react to the situation by taking legal action because sex discrimination in pay is illegal in the United States.

Overpayment Inequity

What would you do if you felt you were overrewarded? In other words, how would you feel if you were the new employee, Spencer (and you knew that your coworker Marie was being paid $4 per hour less than you)? Originally, equity theory proposed that overrewarded individuals would experience guilt and would increase their effort to restore perceptions of equity. However, research does not provide support for this argument. Instead, it seems that individuals experience less distress as a result of being overrewarded.[6] It is not hard to imagine that individuals find perceptual ways to deal with a situation like this, such as believing that they have more skills and bring more to the situation compared with the referent person. Therefore, research does not support equity theory’s predictions with respect to people who are overpaid.[7]

Individual Differences in Reactions to Inequity

So far, we have assumed that once people feel that the situation is inequitable, they will be motivated to react. However, does inequity disturb everyone equally? Researchers identified a personality trait that explains different reactions to inequity and named this trait equity sensitivity.[8] Equity sensitive individuals experience distress when they feel they are overrewarded or underrewarded and expect to maintain equitable relationships. At the same time, there are some individuals who are benevolents who give without waiting to receive much in return and entitleds who expect to receive a lot without giving much in return. Thus, the theory is more useful in explaining the behavior of equity sensitive individuals, and organizations will need to pay particular attention to how these individuals view their relationships.

Fairness Beyond Equity: Procedural and Interactional Justice

Equity theory looks at perceived fairness as a motivator. However, the way equity theory defines fairness is limited to fairness regarding rewards. Starting in the 1970s, researchers of workplace fairness began taking a broader view of justice. Equity theory deals with outcome fairness, and therefore, it is considered to be a distributive justice theory. Distributive justice refers to the degree to which the outputs received from the organization are fair. Two other types of fairness have been identified: procedural justice and interactional justice.

Let’s assume that Marie found out she is getting a promotion that will include a pay raise, increased responsibilities, and prestige. If Marie feels she deserves to be promoted, she would perceive high distributive justice (“getting the promotion is fair”). However, Marie later found out that the department manager picked her name out of a hat! What would she feel? She might still like the outcome but feel that the decision-making process was unfair since it wasn't based on performance. This response would involve feelings of procedural injustice. Procedural justice refers to the degree to which fair decision-making procedures are used. Research shows that employees care about procedural justice for many organizational decisions, including layoffs, employee selection, surveillance of employees, performance appraisals, and pay decisions.[9] They tend to care about procedural justice particularly when they do not get the outcome they feel they deserve.[10] If Marie does not get the promotion and finds out that management chose the candidate by picking a name out of a hat, she may view this as adding insult to injury. When people do not get the rewards they want, they tend to hold management responsible if procedures are not fair.[11]

Research has identified many ways of achieving procedural justice. For example, giving employees advance notice before laying them off, firing them, or disciplining them is perceived as fairer.[12] Allowing employees voice into decision making is also important.[13] When designing a performance appraisal system or implementing a reorganization, asking employees for their input may be a good idea because it increases perceptions of fairness. Even when it is not possible to have employees participate, providing explanations is helpful in fostering procedural justice.[14] Finally, people expect consistency in treatment.[15] If one person is given extra time when taking a test while another is not, individuals would perceive decision making as unfair.

Now let's imagine Marie's boss telling her she is getting the promotion. The manager's exact words: "Yes, Marie, we are giving you the promotion. The job is so simple that we thought even you can handle it." Now what is Marie's reaction? The unpleasant feelings she may now experience are explained by interactional justice. Interactional justice refers to the degree to which people are treated with respect, kindness, and dignity in interpersonal interactions. We expect to be treated with dignity by our peers, supervisors, and customers. When the opposite happens, we feel angry. Even when faced with negative outcomes such as a pay cut, being treated with dignity and respect serves as a buffer and alleviates our stress.[16]

Employers would benefit from paying attention to all three types of justice perceptions. In addition to being the right thing to do, justice perceptions lead to outcomes companies care about. Injustice is directly harmful to employee psychological health and well-being and contributes to stress.[17] High levels of justice create higher levels of employee commitment to organizations, are related to higher job performance, higher levels of organizational citizenship (behaviors that are not part of one's job description but help the organization in other ways such as speaking positively about the company and helping others), and higher levels of customer satisfaction, whereas low levels of justice lead to retaliation and supporting union certification movements.[18]

Expectancy Theory

According to expectancy theory, individual motivation to put forth more or less effort is determined by a rational calculation.[19] According to this theory, individuals ask themselves three questions.

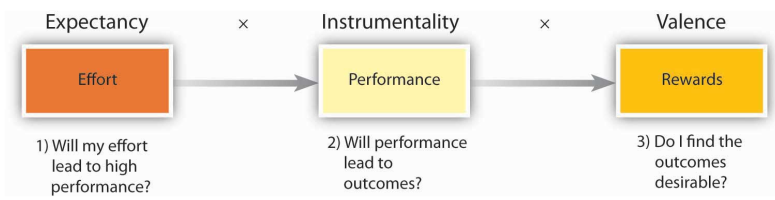

Figure 24.5.2: Summary of Expectancy Theory. Based on Porter, L. W., & Lawler, E. E. (1968). Managerial attitudes and performance. Homewood, IL: Irwin; Vroom, V. H. (1964). Work and motivation. New York: Wiley.

The first question is whether the person believes that high levels of effort will lead to desired outcomes. This perception is labeled as expectancy. For example, do you believe that the effort you put forth in a class is related to learning worthwhile material and receiving a good grade? If you do, you are more likely to put forth effort.

The second question is the degree to which the person believes that performance is related to secondary outcomes such as rewards. This perception is labeled as instrumentality. For example, do you believe that passing the class is related to rewards such as getting a better job, or gaining approval from your instructor, from your friends, or parents? If you do, you are more likely to put forth effort.

Finally, individuals are also concerned about the value of the rewards awaiting them as a result of performance. The anticipated satisfaction that will result from an outcome is labeled as valence. For example, do you value getting a better job or gaining approval from your instructor, friends, or parents? If these outcomes are desirable to you, you are more likely to put forth effort.

As a manager, how can you influence these perceptions to motivate employees? In fact, managers can influence all three perceptions.[20] To influence their expectancy perceptions, managers may train their employees, or hire people who are qualified for the jobs in question. Low expectancy may also be due to employees feeling that something other than effort predicts performance, such as political behaviors on the part of employees. In this case, clearing the way to performance and creating an environment in which employees do not feel blocked will be helpful. The first step in influencing instrumentality is to connect pay and other rewards to performance using bonuses, award systems, and merit pay. Publicizing any contests or award programs is helpful in bringing rewards to the awareness of employees. It is also important to highlight that performance and not something else is being rewarded. For example, if a company has an employee-of-the-month award that is rotated among employees, employees are unlikely to believe that performance is being rewarded. In the name of being egalitarian, such a reward system may actually hamper the motivation of highest performing employees by eroding instrumentality. Finally, to influence valence, managers will need to find out what their employees value. This can be done by talking to employees, or surveying them about what rewards they find valuable.

Reinforcement Theory

Reinforcement theory is based on the work of Ivan Pavlov in behavioral conditioning and the later work B. F. Skinner did on operant conditioning.[21] According to this theory, behavior is a function of its consequences. Imagine that even though no one asked you to, you stayed late and drafted a report. When the manager found out, she was ecstatic and took you out to lunch and thanked you genuinely. The consequences following your good deed were favorable, and therefore you are more likely to do similar good deeds in the future. In contrast, if your manager had said nothing about it and ignored the sacrifice you made, you would be less likely to demonstrate similar behaviors in the future, or your behavior would likely become extinct.

Despite the simplicity of reinforcement theory, how many times have you seen positive behavior ignored or, worse, negative behavior rewarded? In many organizations, this is a familiar scenario. People go above and beyond the call of duty, and yet their behaviors are ignored or criticized. People with disruptive habits may receive no punishments because the manager is afraid of the reaction the person will give when confronted. They may even receive rewards such as promotions so that the person is transferred to a different location and becomes someone else’s problem! Moreover, it is common for people to be rewarded for the wrong kind of behavior. Steven Kerr labeled this phenomenon “the folly of rewarding A while hoping for B.”[22] For example, a company may make public statements about the importance of quality. Yet, they choose to reward shipments on time regardless of the number of known defects contained in the shipments. As a result, employees are more likely to ignore quality and focus on hurrying the delivery process.

Reinforcement Interventions

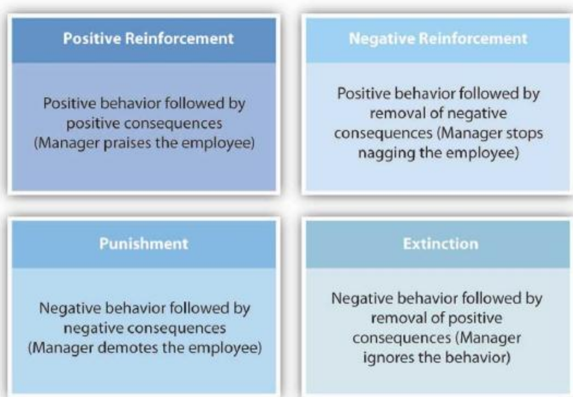

Figure 24.5.3: Reinforcement Methods

Reinforcement theory describes four interventions to modify employee behavior. Two of these are methods of increasing the frequency of desired behaviors while the remaining two are methods of reducing the frequency of undesired behaviors.

Positive reinforcement is a method of increasing the desired behavior.[23] Positive reinforcement involves making sure that behavior is met with positive consequences. Praising an employee for treating a customer respectfully is an example of positive reinforcement. If the praise immediately follows the positive behavior, the employee will see a link between behavior and positive consequences and will be motivated to repeat similar behaviors.

Negative reinforcement is also used to increase the desired behavior. Negative reinforcement involves removal of unpleasant outcomes once desired behavior is demonstrated. Nagging an employee to complete a report is an example of negative reinforcement. The negative stimulus in the environment will remain present until positive behavior is demonstrated. The problem with negative reinforcement may be that the negative stimulus may lead to unexpected behaviors and may fail to stimulate the desired behavior. For example, the person may start avoiding the manager to avoid being nagged.

Extinction occurs when a behavior ceases as a result of receiving no reinforcement. For example, suppose an employee has an annoying habit of forwarding e-mail jokes to everyone in the department, cluttering up people's in-boxes and distracting them from their work. Commenting about the jokes, whether in favorable or unfavorable terms, may be encouraging the person to keep forwarding them. Completely ignoring the jokes may reduce their frequency.

Punishment is another method of reducing the frequency of undesirable behaviors. Punishment involves presenting negative consequences following unwanted behaviors. Giving an employee a warning for consistently being late to work is an example of punishment.

Reinforce for Performance

This is a systematic application of reinforcement theory to modify employee behaviors. The model consists of five stages. The process starts with identifying the behavior that will be modified. Let's assume that we are interested in reducing absenteeism among employees. In step 2, we need to measure the baseline level of absenteeism. In step 3, the behavior's antecedents and consequences are determined. Why are employees absent? More importantly, what is happening when an employee is absent? If the behavior is being unintentionally rewarded, we may expect these to reinforce absenteeism behavior. For example, suppose that absences peak each month on the days when a departmental monthly report is due, meaning that coworkers and supervisors must do extra work to prepare the report. To reduce the frequency of absenteeism, it will be necessary to think of financial or social incentives to follow positive behavior and negative consequences to follow negative behavior. In step 4, an intervention is implemented. Removing the positive consequences of negative behavior may be an effective way of dealing with the situation, for example, starting the monthly report preparation a few days earlier, or letting employees know that if they are absent when the monthly report is being prepared, their contribution to the report will be submitted as incomplete until they finish it. Punishments may be used in persistent cases. Finally, in step 5 the behavior is measured periodically and maintained. Studies examining the effectiveness of OB Mod have been supportive of the model in general. A review of the literature found that OB Mod interventions resulted in an average of 17% improvement in performance.[24]

Properly designed sales commissions are widely used to motivate sales employees. The blend of straight salary and commissions should be carefully balanced to achieve optimum sales volume, profitability, and customer satisfaction.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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24.6: Reading- Douglas McGregor's Theory X and Theory Y

Douglas McGregor's Theory X and Theory Y

In his 1960 management book, *The Human Side of Enterprise*, Douglas McGregor made his mark on the history of organizational management and motivational psychology when he proposed the two theories by which managers perceive employee motivation. He referred to these opposing motivational methods as Theory X and Theory Y management. Each assumes that the manager's role is to organize resources, including people, to best benefit the company. However, beyond this commonality, they're quite dissimilar.

Theory X Management

According to McGregor, Theory X leadership assumes the following:

- Work is inherently distasteful to most people, and they will attempt to avoid work whenever possible.
- Most people are not ambitious, have little desire for responsibility, and prefer to be directed.
- Most people have little aptitude for creativity in solving organizational problems.
- Motivation occurs only at the physiological and security levels of Maslow's Needs Hierarchy.
- Most people are self-centered. As a result, they must be closely controlled and often coerced to achieve organizational objectives
- Most people resist change.
- Most people are gullible and unintelligent.

Essentially, Theory X assumes that the primary source of most employee motivation is monetary, with security as a strong second.

The Hard Approach and Soft Approach

Under Theory X, management approaches to motivation range from a hard approach to a soft approach.

The hard approach to motivation relies on coercion, implicit threats, micromanagement, and tight controls— essentially an environment of command and control. The soft approach, however, is to be permissive and seek harmony in the hopes that, in return, employees will cooperate when asked. However, neither of these extremes is optimal. The hard approach results in hostility, purposely low output, and extreme union demands. The soft approach results in increasing desire for greater reward in exchange for diminishing work output.

It would appear that the optimal approach to human resource management would lie somewhere between these extremes. However, McGregor asserts that neither approach is appropriate since the foundations of Theory X are incorrect.

The Problem with X Theory

Drawing on Maslow's Hierarchy of Needs, McGregor argues that a need, once satisfied, no longer motivates. The company relies on monetary rewards and benefits to satisfy employees' lower level needs. Once those needs have been satisfied, the motivation is gone. This management style, in fact, hinders the satisfaction of higher-level needs. Consequently, the only way that employees can attempt to satisfy higher level needs at work is to seek more compensation, so it is quite predictable that they will focus on monetary rewards. While money may not be the most effective way to self-fulfillment, it may be the only way available. People will use work to satisfy their lower needs and seek to satisfy their higher needs during their leisure time. Unfortunately, employees can be most productive when their work goals align with their higher level needs.

McGregor makes the point that a command-and-control environment is not effective because it relies on lower needs for motivation, but in modern society those needs are mostly satisfied and thus no longer motivate. In this situation, one would expect employees to dislike their work, avoid responsibility, have no interest in organizational goals, resist change, etc., thus creating a self-fulfilling prophecy. To McGregor, motivation seemed more likely with the Theory Y model.

Theory Y

The higher-level needs of esteem and self-actualization are continuing needs in that they are never completely satisfied. As such, it is these higher-level needs through which employees can best be motivated.

In strong contrast to Theory X, Theory Y leadership makes the following general assumptions:

- Work can be as natural as play if the conditions are favorable.

- People will be self-directed and creative to meet their work and organizational objectives if they are committed to them.
- People will be committed to their quality and productivity objectives if rewards are in place that address higher needs such as self-fulfillment.
- The capacity for creativity spreads throughout organizations.
- Most people can handle responsibility because creativity and ingenuity are common in the population.
- Under these conditions, people will seek responsibility.

Under these assumptions, there is an opportunity to align personal goals with organizational goals by using the employee's own need for fulfillment as the motivator. McGregor stressed that Theory Y management does not imply a soft approach.

McGregor recognized that some people may not have reached the level of maturity assumed by Theory Y and therefore may need tighter controls that can be relaxed as the employee develops.

XY Theory Management Application: Business Implications for Workforce Motivation

If Theory Y holds true, an organization can apply these principles of scientific management to improve employee motivation:

- **Decentralization and Delegation**—If firms decentralize control and reduce the number of levels of management, managers will have more subordinates and consequently will be forced to delegate some responsibility and decision making to them.
- **Job Enlargement**—Broadening the scope of an employee's job adds variety and opportunities to satisfy ego needs.
- **Participative Management—**Consulting employees in the decision making process taps their creative capacity and provides them with some control over their work environment.
- **Performance Appraisals—**Having the employee set objectives and participate in the process of evaluating how well they were met ensures that the employee understands the goals of the company and works to support them.

If properly implemented, such an environment would result in a high level of workforce motivation as employees work to satisfy their higher level personal needs through their jobs.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

https://assessments.lumenlearning.com/assessments/207

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24.7: Reading- Job Models and Goals

Job Rotation, Enlargement, and Enrichment

One of the early alternatives to job specialization was *job rotation*, which involves moving employees from job to job at regular intervals, thereby relieving the monotony and boredom typical in repetitive jobs. For example, Maids International, a company that provides cleaning services to households and businesses, uses job rotation such that maids cleaning the kitchen in one house would clean the bedroom in another house.[1] Using this technique, among others, the company was able to reduce its turnover level. In a study conducted in a supermarket, cashiers were rotated to work in different departments. As a result of the rotation, employee stress level was reduced as measured by their blood pressure. Moreover, they reported fewer pain symptoms in their neck and shoulders.[2]

Job rotation has a number of advantages for organizations. It's an effective way for employees to acquire new skills, as the rotation involves cross-training to new tasks; this means that organizations increase the overall skill level of their employees.[3] In addition, job rotation is a means of knowledge transfer between departments.[4] For the employees, rotation is a benefit because they acquire new skills, which keeps them marketable in the long run.

Anecdotal evidence suggests that companies successfully rotate high-level employees to train their managers and increase innovativeness in the company. For example, Nokia uses rotation at all levels, such as assigning lawyers to act as country managers or moving network engineers to handset design. These approaches are thought to bring a fresh perspective to old problems.[5] India's information technology giant Wipro, which employs about 80,000 employees, uses a 3-year plan to groom future leaders of the company by rotating them through different jobs.[6]

Job enlargement refers to expanding the tasks performed by employees to add more variety. Like job rotation, job enlargement can reduce boredom and monotony as well as use human resources more effectively. When jobs are enlarged, employees view themselves as being capable of performing a broader set of tasks.[7] Job enlargement is positively related to employee satisfaction and higher-quality customer services, and it increases the chances of catching mistakes.[8] At the same time, the effects of job enlargement may depend on the *type* of enlargement. For example, exclusively giving employees simpler tasks had negative consequences on employee satisfaction with the job of catching errors, whereas giving employees more tasks that require them to be knowledgeable in different areas seemed to have more positive effects.[9]

Job enrichment is a job redesign technique that allows workers more control over how they perform their own tasks, giving them more responsibility. As an alternative to job specialization, companies using job enrichment may experience positive outcomes such as reduced turnover, increased productivity, and reduced absences.[10] This may be because employees who have the authority and responsibility over their own work can be more efficient, eliminate unnecessary tasks, take shortcuts, and overall increase their own performance. At the same time, there is some evidence that job enrichment may sometimes cause employees to be dissatisfied.[11] The reason may be that employees who are given additional autonomy and responsibility may expect greater levels of pay or other types of compensation, and if this expectation is not met, they may feel frustrated. One more thing to remember is that job enrichment may not be suitable for all employees.[12] Not all employees desire to have control over how they work, and if they do not have this desire, they may feel dissatisfied in an enriched job.

Job Characteristics Model

The *job characteristics model* is one of the most influential attempts to design jobs to increase their motivational properties.[13] Proposed in the 1970s by Hackman and Oldham, the model describes five core job dimensions, leading to three critical psychological states, which lead to work-related outcomes. In this model, shown in Figure 1 below, there are five core job dimensions.

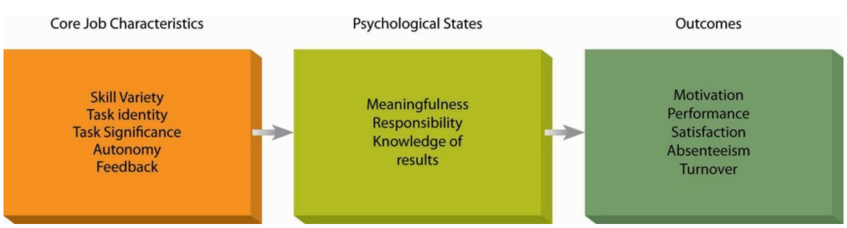

Figure 24.7.1: Job Characteristics Model. Adapted from Hackman, J. R., & Oldham, G. R. (1975). Development of the job diagnostic survey. Journal of Applied Psychology, 60, 159–170.

Skill variety refers to the extent to which the job requires the person to use multiple high-level skills. A car wash employee whose job consists of directing employees into the automated carwash demonstrates low levels of skill variety, whereas a car wash employee who acts as a cashier, maintains carwash equipment, and manages the inventory of chemicals demonstrates high skill variety.

Task identity refers to the degree to which the person completes a piece of work from start to finish. A Web designer who designs parts of a Web site will have low task identity because the work blends in with other Web designers' work, and in the end, it will be hard for the person to claim responsibility for the final output. The Webmaster who designs the entire Web site will have high task identity.

Task significance refers to whether the person's job substantially affects other people's work, health, or well-being. A janitor who cleans the floor at an office building may find the job low in significance, thinking it is not an important job. However, janitors cleaning the floors at a hospital may see their role as essential in helping patients recover in a healthy environment. When they see their tasks as significant, employees tend to feel that they are making an impact on their environment and their feelings of self worth are boosted.[14]

Autonomy is the degree to which the person has the freedom to decide how to perform tasks. As an example, a teacher who is required to follow a predetermined textbook, cover a given list of topics, and use a specified list of classroom activities has low autonomy, whereas a teacher who is free to choose the textbook, design the course content, and use any materials she sees fit has higher levels of autonomy. Autonomy increases motivation at work, but it also has other benefits. Autonomous workers are less likely to adopt a "this is not my job" attitude and instead be proactive and creative.[15] Giving employees autonomy is also a great way to train them on the job. For example, Gucci's CEO Robert Polet describes autonomy he received while working at Unilever as the key to his development of leadership talents.[16]

Feedback refers to the degree to which the person learns how effective he or she is at work. Feedback may come from other people such as supervisors, peers, subordinates, customers, or from the job. A salesperson who makes informational presentations to potential clients but is not informed whether they sign up has low feedback. If this salesperson receives a notification whenever someone who has heard his presentation becomes a client, feedback will be high.

The mere presence of feedback is not sufficient for employees to feel motivated to perform better, however. In fact, in about one-third of the cases, feedback was detrimental to performance.[17] In addition to whether feedback is present, the character of the feedback (positive or negative), whether the person is ready to receive the feedback, and the manner in which feedback was given will all determine whether employees feel motivated or demotivated as a result of feedback.

Goal Setting Theory

Goal setting theory[18] is one of the most influential and practical theories of motivation. It has been supported in over 1,000 studies with employees, ranging from blue-collar workers to research and development employees, and there is strong evidence that setting goals is related to performance improvements.[19] In fact, according to one estimate, goal setting improves performance between 10% and 25% or more.[20] On the basis of evidence such as this, thousands of companies around the world are using goal setting in some form, including companies such as Coca-Cola, PricewaterhouseCoopers, Nike, Intel, and Microsoft to name a few.

Setting SMART Goals

The mere presence of a goal does not motivate individuals. Think about New Year's resolutions that you may have made and failed to keep. Maybe you decided that you should lose some weight but then never put a concrete plan in action. Maybe you decided that you would read more but didn't. Why did you, like 97% of those who set New Year's resolutions, fail to meet your goal?

Accumulating research evidence indicates that effective goals are SMART. SMART goals are specific, measurable, achievable, realistic, and timely. Here is a sample SMART goal: Wal-Mart recently set a goal to eliminate 25% of the solid waste from its U.S. stores by the year 2009. This goal meets all the conditions of being SMART if we assume that it is an achievable goal.[21] Even though it seems like a simple concept, in reality many goals that are set within organizations may not be SMART. For example, Microsoft recently conducted an audit of its goal-setting and performance review system and found that only about 40% of the goals were specific and measurable.[22]

Why Do SMART Goals Motivate?

Figure 24.7.2: Why do SMART goals motivate?

There are at least four reasons why goals motivate.[23] First, goals give us direction; therefore, goals should be set carefully. Giving employees goals that are not aligned with company goals will be a problem because goals will direct employee's energy to a certain end. Second, goals energize people and tell them not to stop until they reach that point. Third, having a goal provides a challenge. When people have goals and when they reach them, they feel a sense of accomplishment. Finally, SMART goals urge people to think outside the box and rethink how they are working. If a goal is substantially difficult, merely working harder will not get you the results. Instead, you will need to rethink the way you usually work and devise a creative way of working. It has been argued that this is how designers and engineers in Japan came up with the bullet train. Having a goal that went way beyond the current speed of trains prevented engineers from making minor improvements and urged them to come up with a radically different concept.[24]

Are There Downsides to Goal Setting?

As with any management technique, there may be some downsides to goal setting.[25] First, setting goals for specific outcomes may hamper employee performance if employees lack skills and abilities to reach the goals. In these situations, setting goals for behaviors and for learning may be more effective than setting goals for outcomes. Second, goal setting may motivate employees to focus on a goal and ignore the need to respond to new challenges. For example, one study found that when teams had difficult goals and when employees within the team had high levels of performance orientation, teams had difficulty adapting to unforeseen circumstances.[26] Third, goals focus employee attention on the activities that are measured, which may lead to sacrificing other important elements of performance. When goals are set for production numbers, quality may suffer. As a result, it is important to set goals touching on all critical aspects of performance. Finally, aggressive pursuit of goals may lead to unethical behaviors. Particularly when employees are rewarded for goal accomplishment but there are no rewards whatsoever for coming very close to reaching the goal, employees may be tempted to cheat.

None of these theories are complete by themselves, but each theory provides us with a framework we can use to analyze, interpret, and manage employee behaviors in the workplace, which are important skills managers use when conducting their leading function. In fact, motivation is important throughout the entire P-O-L-C framework because most managerial functions involve accomplishing tasks and goals through others.

KEY TAKEAWAYS

By properly tying rewards to positive behaviors, eliminating rewards following negative behaviors and punishing negative behaviors, leaders can increase the frequency of desired behaviors. In job design, there are five components that increase the motivating potential of a job: Skill variety, task identity, task significance, autonomy, and feedback. These theories are particularly useful in designing reward systems within a company. Goal-setting theory is one of the most influential theories of motivation. To motivate employees, goals should be SMART (specific, measurable, achievable, realistic, and timely). Setting goals and objectives is a task managers undertake when involved in the planning portion of the P-O-L-C function.

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CHAPTER OVERVIEW

25: Module 11- Teamwork and Communication

25.1: Why It Matters- Teamwork and Communication

Why explain the importance of teamwork and effective communication in a business environment?

Why do businesses stress teamwork and communication? Why have you been subjected to the dreaded "group project" in some of your classes? We think of ourselves as individuals, each hired or chosen for our individual expertise, talents, and experience, and yet we are often asked to work with others on assignments and projects. Why? Because we are capable of so much more when we work together. In this module you will learn about teams, why businesses use them, why they succeed, and why they fail. As part of our examination of teamwork, we'll also look at the critical role communication plays in helping businesses achieve their goals and objectives, and also some of the challenges they face in using electronic communication.

In the following video, Steve Jobs explains the value of collaboration at Apple—a company that, he says, is great at teamwork and relies on trust, not hierarchy.

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "Steve Jobs on Managing People" (opens in new window) or the text alternative for "Steve Jobs on Managing People" (opens in new window).

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25.2: Introduction to Teams

What you'll learn to do: differentiate between groups and teams, and describe the characteristics of different types of teams

Not every group of people is a team! Teams within organizations have unique characteristics and are often created for specific purposes. In this section you'll learn about the difference between groups and teams and some types of teams that companies commonly use.

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25.3: Differences Between Groups and Teams

Learning Objectives

- Differentiate between a group and a team

Groups and Teams

Is there a difference between a group and a team? Isn't a collection of people just a collection of people regardless of what we call them? A **group** is comprised of two or more individuals who share common interests or characteristics, and its members identify with one another due to similar traits. A **team**, on the other hand, is a group of people with different skills and different tasks, who work together on a common project, service, or goal, combining their functions and providing mutual support along the way. Watch the following video, keeping those two definitions in mind.

Access the text alternative for "Coca-cola Heist" (opens in new window).

How many groups could you identify in the video? The bees were a group, the butterflies were a group, and the dung beetle who got the cap off the bottle was, well, sort of a group of one. What you saw in this commercial was the transformation of individuals, small groups, and even some larger groups into a *team***.** In a team, the members work together toward a common goal and share responsibility for the team's success. In our video example, no group *alone* could have achieved the desired outcome of getting that bottle of Coca Cola open. Instead of focusing on enterprising insects, our discussion will focus on a specific kind of team: the work team.

Practice Question

https://assessments.lumenlearning.co...essments/14443

Why Organizations Build Teams

In the last twenty years or so, teams have become a ubiquitous feature of corporate America. The primary benefit of teams and teamwork is that they allow an organization to achieve goals that individuals working alone may not. This advantage arises from several factors, each of which contributes to the overall benefit of teams. Two of these—higher-quality outcomes and individual context—are described below:

Higher-Quality Outcomes

Teamwork produces outcomes that make better use of resources and yield richer ideas.

- Higher efficiency: Since teams combine the efforts of individuals, they can accomplish more than an individual working alone.
- Faster speed: Because teams draw on the efforts of many contributors, they can often complete tasks and activities in less time.
- More thoughtful ideas: Each person who works on a problem or set of tasks may bring different information and knowledge to bear, which can result in solutions and approaches an individual may not have identified.
- Greater effectiveness: When people coordinate their efforts, they can divide up roles and tasks to more thoroughly address an issue. For example, in hospital settings teamwork has been found to increase patient safety more than when only individual efforts are made to avoid mishaps.

Better Context for Individuals

The social aspect of teamwork provides a superior work experience for team members, which can motivate higher performance.

- Mutual support: Because team members can rely on other people with shared goals, they can receive assistance and encouragement as they work on tasks. Such support can encourage people to achieve goals they may not have had the confidence to have reached on their own.
- Greater sense of accomplishment: When members of a team collaborate and take collective responsibility for outcomes, they can feel a greater sense of accomplishment when they achieve a goal they could not have achieved if they had worked by themselves.

The total value created by teamwork depends on the overall effectiveness of the team effort.

Contributors and Attributions

25.4: Types of Teams

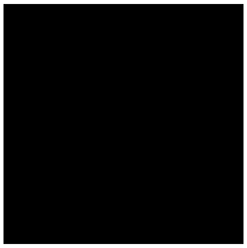
Learning Objectives

- Differentiate between manager-led teams, self-managed teams, functional teams, cross-functional, virtual teams, and project teams

There are many types of work teams, and they range in the degree of autonomy afforded to team members. As with the different styles of management (e.g., autocratic, democratic), there are trade-offs with each kind of team structure, so it's important to understand when each type of team should be used.

Self-Managed Teams

A **self-managed team** is a group of employees working together who are accountable for most or all aspects of their task. These work teams determine how they will accomplish assigned objectives and decide what route they will take to meet them. They are granted the responsibility of planning, scheduling, organizing, directing, controlling and evaluating their own work process. They also select their own members and evaluate the members' performance. In this way they share both the managerial and technical tasks. As a result, supervisory positions take on decreased importance and may even be eliminated.



EA

Electronic Arts Inc. is a leading global video game company. EA develops, publishes, and distributes interactive software worldwide for video game systems, personal computers, wireless devices, and the Internet. The company's 2018 revenues were more than $5 billion[1], and it has over 9,000 employees in more than 23 countries[2].

Electronic Arts launched internal collaborative communities (i.e., self-managed teams) in 2009 across its globally distributed workforce. Its goal was to gain the efficiencies of a large enterprise without compromising local teams' autonomy or creativity. The communities formed at EA were empowered to make decisions and to deliver. EA's communities could recommend the next technology road map or they could change a business process to become more effective or efficient. There were no limits placed on the types of communities within EA.

Within the company, the real power of these self-managed teams or communities is to work collaboratively to achieve a common goal – to create a new product or service, improve the effectiveness of a business process, or even to eliminate operational inefficiencies. To achieve its goals and to empower its communities to make decisions, EA explicitly focused on a "light" governance structure that promotes the organic interaction of teams and empowers them to produce a desired business outcome.

Project Teams

A **project team** is a team whose members are assembled for a specific project or business objective. Project team members can be drawn from different departments or can all be from the same functional area (i.e., operations, manufacturing, finance, etc.) depending on the scope of the project. Usually project teams are only used for a defined period of time and are disbanded after the project is deemed complete. The central characteristic of project teams in modern organizations is the autonomy and flexibility given to them in the process of meeting their goals. The project team usually consists of a variety of members working under the direction of a project manager or a senior member of the organization. Project teams need to have the right combination of skills, abilities, and personality types to achieve collaborative tension.

For example, technology companies may take a project team approach when developing a new product or new version of an existing product. The team would consist of developers with appropriate technical expertise, testers for quality control, subject-matter experts to advise on relevant information, change management personnel to group and release work, a product owner to represent the business, and a project manager to run the team.

Cross-Functional Teams

A **cross-functional team** is just what it sounds like—a team that pulls its members from across the different functional areas of an organization. For example, cross-functional teams may be composed of representatives from operations, sales, marketing, finance, and legal. The strength of this type of team lies in its members having different functional backgrounds, education, and experience. The diversity of experience aids innovative problem solving and decision making.

A cross-functional team makes sense for large corporate projects that touch and affect work across entire organizations. For example, a large IT project—implementing an enterprise finance software system—would be a good candidate for a cross-functional team approach. For a successful outcome, IT would assemble members from finance, accounting, operations, and HR at a minimum to represent and participate in the implementation project.

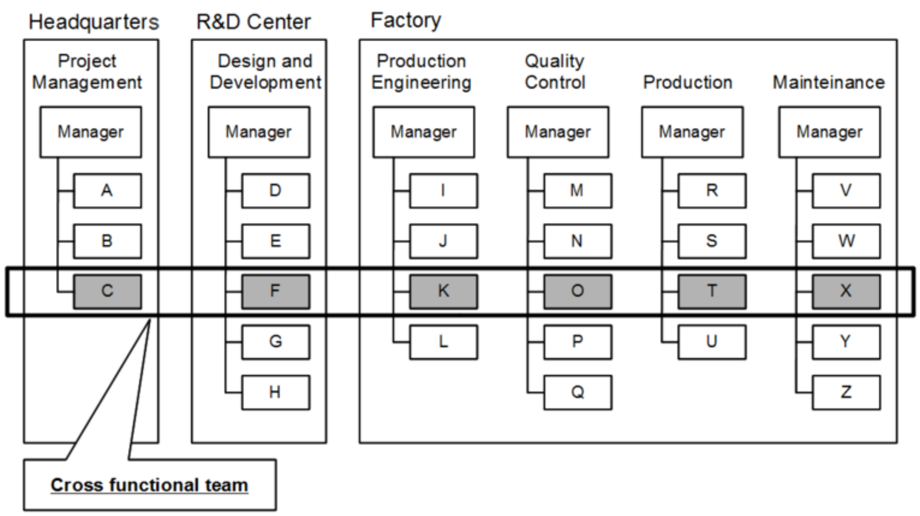


Figure 25.4.1: Copy and Paste Caption here. (Copyright; author via source)

Manager-Led Teams

In a **manager-led team**, the team members complete the required tasks, but someone outside the team (i.e., a manager) performs the executive functions. There is an inevitable tension between the degree of manager control in a team and the ability of team members to guide and manage their own actions. Manager-led teams provide more control, but they can also hamper creativity and individual expression.

The Arts Council of the Albemarle has received a significant gift from a community donor to create a drama workshop for neighborhood youth. As the director of community outreach, Margaret has put together a team to develop the workshop. Among those selected are a program director, a senior program lead, and a program staff member who is studying performing arts at the local university. Margaret assigns each of them specific tasks and responsibilities and creates a schedule for team meetings to discuss progress on the development of the program. She is interested in cultivating a strong relationship with the community donor, and therefore she is very involved in the team’s progress. She meets with the members on a regular basis to ensure that all efforts are on target along the way. While Margaret is, in effect, the team’s manager, the team members must work closely with one another to integrate the elements of the workshop. For example, the play must appeal to the donors, students, parents, and audiences while also being within reach of the instructors’ and students’ abilities.

Virtual Teams

A **virtual team** is a group of individuals in different geographic locations who use technology to collaborate on work tasks and activities. The use of this kind of work team has become prevalent in organizations due to the reduced costs of technology, the increased availability of collaborative technologies (videoconferencing software, etc.), the shift toward globalization in business, and greater use of outsourcing and temporary workers. They offer flexibility around the logistics of doing business since team members can "meet" from any location—wherever they happen to be, such as a home office, coffee shop, etc.—at any time of the day or week. Many of the other types of work teams can also be virtual teams, depending on the organization's needs and resources.

Practice Question

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1. "EA Income Statement." NASDAQ.com, www.nasdaq.com/symbol/ea/financials. ↵
2. Gainer, Earnings. "Everything You Need to Know About Investing in Electronic Arts." U.S. News & World Report. Accessed April 03, 2019. money.usnews.com/investing/stocks/ea-electronic-arts. ↵

Contributors and Attributions

25.5: Introduction to Team Development and Success

What you'll learn to do: explain the stages of team development and the factors that contribute to team success

Building a well-functioning, cohesive team of people doesn't happen overnight—it's a process. In this section you will learn about the stages of team development and the factors that contribute to team success.

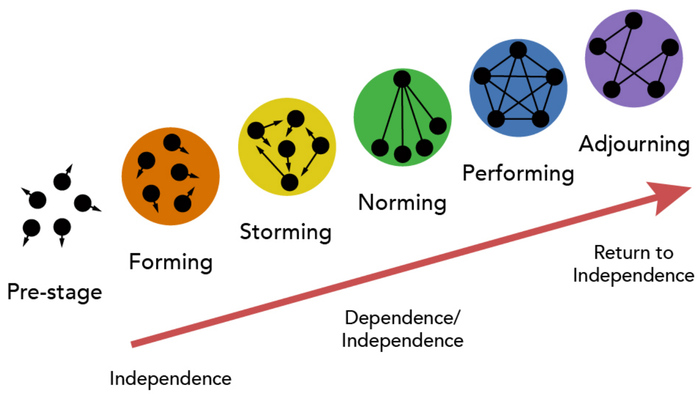
Contributors and Attributions

25.6: Stages of Team Development

Learning Objectives

- Differentiate between the forming, storming, norming, performing, and adjourning stages of team development

When teams develop, they move through a series of stages, beginning when they are formed and ending when they are disbanded. Bruce Tuckman identified four distinct stages of team development: *forming, storming, norming,* and *performing*. He later added a fifth stage, *adjourning,* which is especially important for self-directed teams and project-based teams that form to reach a specific goal. Each stage has a primary purpose and a common set of interpersonal dynamics among team members. Tuckman proposed that all of these stages are inevitable and even necessary parts of a successful team's evolution.



Forming Stage

The first step in a team's life is bringing together a group of individuals. Individuals focus on defining and assigning tasks, establishing a schedule, organizing the team's work, and other start-up matters. In addition to focusing on the scope of the team's purpose and means of approaching it, individuals in the formation stage are also gathering impressions and information about one another. Since people generally want to be accepted by others, during this period they usually avoid conflict and disagreement. Team members may begin to work on their tasks independently, not yet focused on their relationships with fellow team members.

Storming Stage

Once their efforts are underway, team members need clarity about their activities and goals, as well as explicit guidance about how they will work independently and collectively. This leads to a period known as storming—because it can involve brainstorming ideas and also because it usually causes disruption. During the storming stage members begin to share ideas about what to do and how to do it that compete for consideration. Team members start to open up and confront one another's ideas and perspectives.

Because storming can be contentious, members who are averse to conflicts may find it unpleasant or even painful. This can decrease motivation and effort by drawing attention away from tasks. In some cases storming (i.e., disagreements) can be resolved quickly. Other times a team never leaves this stage and becomes stuck and unable to do its work. Patience and consideration toward team members and their views go a long way toward avoiding this problem.

Norming Stage

Successfully moving through the storming stage means that a team has clarified its purpose and its strategy for achieving its goals. It now transitions to a period focused on developing shared values about how team members will work together. These norms of collaboration can address issues ranging from when to use certain modes of communication, such as e-mail versus telephone, to how team meetings will be run and what to do when conflicts arise. Norms become a way of simplifying choices and facilitating collaboration, since members have shared expectations about how work will get done.

Performing Stage

Once norms are established and the team is functioning as a unit, it enters the performing stage. By now team members work together easily on interdependent tasks and are able to communicate and coordinate effectively. There are fewer time-consuming distractions based on interpersonal and group dynamics. For this reason, motivation is usually high and team members have confidence in their ability to attain goals.

While these four stages—forming, storming, norming, and performing—are distinct and generally sequential, they often blend into one another and even overlap. A team may pass through one phase only to return to it. For example, if a new member joins the team, there may be a second brief period of formation while that person is integrated. A team may also need to return to an earlier stage if its performance declines. Team-building exercises are often done to help a team through its development process.

Adjourning Stage

Bruce Tuckman, jointly with Mary Ann Jensen, added the adjourning stage to describe the final stretch of a team's work together. It includes both the last steps of completing the task and breaking up the team. Some work teams are ongoing, like a development team in a software company, for example, so they may not actually "adjourn," but they may still participate in aspects of this stage —by winding up a particularly intense period of collaboration, for example. For project-based teams that have been formed for a limited time period, this stage provides an opportunity to formally mark the end of the project. The team may decide to organize some sort of celebration or ceremony to acknowledge contributions and achievements before it disbands. The adjourning stage is an important way of providing closure, and it can help team members successfully move on to the next work project or team with the sense of a job well done.

? Practice Question

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Let's take a look at an example of these stages in action!

✔ Bug Banisher

Marcus Enterprises has a new product—the Bug Banisher—that it believes could revolutionize home pest control. Mr. Marcus, the founder of the company has decided that putting together a product launch team is the way to proceed. He selects a group of five employees from across the company and creates the Bug Banisher Team. He holds a kickoff meeting and shares with them his vision for the product and what he wants them to accomplish as a team: successfully introduce the product to the market within six months, maintain the company's target profit margin of 25 percent, and ship at least ten thousand units from the warehouse in Poughkeepsie, New York. The team is formed at this initial meeting, and when Mr. Marcus leaves the meeting his confidence in the project is high.

Rina, the leader of the Bug Banisher Team, comes to Mr. Marcus thirty days after the initial meeting. She has a laundry list of issues to discuss, and none of them is pleasant. Nicole from marketing has scheduled focus group sessions, but the final prototype of the Banisher will not be completed in time for the first session. Sebastián from production is having to pay overtime to get the prototype finished, which has angered Petar from finance because now he has to account for higher front-end costs that will eat into the targeted 25 percent profit margin. Alba from sales has missed the last two team meetings, and Rina thinks it's because Nicole and Petar got into a heated discussion at an earlier team meeting, which led to Petar slamming his fist on the table and storming out of the room. At this point Rina just wants to get the project moving again.

Mr. Marcus sees Rina in the break room sixty days into the project and casually asks how things are going with the team and the Banisher. Rina reports that things have settled down and she feels like the team is working well together. She says that she met with each team member individually and explained their role in the project and gave them a chance to share any concerns they had. She spent a lot of time listening and taking notes. After the individual meetings, she had Jada from human resources come to a team meeting and conduct some team-building exercises and engaging teamwork activities. The result of the session with Jada was a Bug Banisher Team vision statement that everyone agreed upon.

The Bug Banisher Team begins to hold weekly meetings to share and track progress with all of the members. They have created a channel on the mobile app Slack so the team can instant-message all or some of the members. Communication is flowing in all directions, everyone is engaged, and it looks like they will meet the launch date originally set by Mr. Marcus at the first meeting. The cost of the Banisher is within the profit target, and production has assured everyone that they can produce the required number of Banisher canisters. There are still times when members disagree and team leader Rina has to step in to referee, but the disagreements are quickly resolved and everyone is able to get back to the task at hand—getting the Bug Banisher to market.

Six months and three days after the initial formation of the Bug Banisher Team, the loading dock of the Poughkeepsie, New York, the warehouse is buzzing with excitement. There are balloons, music, cake, and streamers everywhere. The entire Bug Banisher Team and Mr. Marcus are surrounded by employees and managers from every level within Marcus Enterprises. The celebration? A case of the Bug Banisher has been loaded onto a UPS truck, and in that case is Bug Banisher canister number 10,000—headed to a local hardware store in Cleveland, Ohio. The Bug Banisher is a tremendous success, and the team has met its goals. After the truck pulls away from the loading dock, Mr. Marcus presents each team member with a company-logo lapel pin and a heartfelt thanks for doing such a good job. Now that the Bug Banisher has launched, the individual team members will go back to their regular duties, but as Rina walks past Alba and Sebastián, she hears Sebastián say, “I wonder what the next project will be?”

Team Mouse Zapper has formed, stormed, normed, performed, and adjourned—successfully.

Contributors and Attributions

25.7: Team Success

Learning Objectives

- Explain the factors that contribute to team success

The way team members function as a group is as important to the team's success as the quality of what it produces. There are many factors that play a role in team success, and the following is by no means an exhaustive list. However, teams that lack the factors below will likely struggle to function well.

Trust

Teams work better when members trust one another. Trust helps people be more willing to share ideas, ask questions, seek guidance, and admit mistakes. Lack of trust can hinder effective communication and efficient work processes.

Effective Communication

Effective communication is vital to team success; it's important for the team to communicate well among its own members, as well as outside the team with relevant parts of the organization. Communication affects nearly every aspect of teamwork—from interpersonal discussions and the exchange of ideas to communication about progress and results.

Common Goal

Having a common goal helps team members build group cohesion and understand that they are working together with a common purpose. If the goal is vague or isn't shared by all, team members may be confused about where their efforts should be directed or reluctant to contribute at all.

Defined Team Roles and Responsibilities

When team members have well-defined roles and responsibilities, they are better able to understand what is expected, stay on track, make appropriate contributions, and avoid duplicating other team members' efforts.

Group Cohesion

Group cohesion arises when bonds link members of a team to one another and to the team as a whole. Members of strongly cohesive teams are more inclined to participate readily and to stay with the team. Cohesion is thought to develop from a heightened sense of belonging, task commitment, interpersonal and group-level attraction, and group pride. In a highly cohesive team, the members like being in the group and find it satisfying.

Practice Question

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25.8: Introduction to Effective Communication and Barriers

What you'll learn to do: explain the importance of effective communication within an organization, and describe common barriers to effective communication

In this section you'll learn why effective communication is so important in business and what can get in the way of it.

Contributors and Attributions

25.9: Effective Communication and Barriers

Learning Objectives

- Explain the importance of effective communication within an organization
- Describe common barriers to effective communication

Importance of Effective Communication

The simplest model of communication relies on three distinct parts: sender, message, and receiver. More complex models add a fourth element: the channel used to send the message. We'll talk more about channels later in this module, but for now, you can think of the channel as the medium, or form, of the message. Channels can take verbal, nonverbal, and written forms. Emails, conversations, video conferences, television ads, and Web site publications are all examples of specific communication channels.

In business, the sender and receiver roles can be filled by many people within and outside of the organization: For example, a manager (sender) holds a meeting with an employee (receiver) to discuss the employee's performance. The marketing department (sender) publishes a product launch announcement to reach potential customers (receivers).

There is also an enormous range in the kinds of communication that take place within and to and from an organization. For example, business communication is used to promote products, services, or an organization; relay information within a business; or deal with legal and similar issues. It encompasses a variety of topics including consumer behavior, advertising, public relations, event management, corporate communication, research and measurement, and reputation management. Business communication may also refer to internal communication.

In a large company, for instance, a communications director may be in charge of managing internal communication and crafting the messages sent to employees. From an HR point of view, effective communication within an organization is vital to building trust and job satisfaction among employees.

Practice Question

https://assessments.lumenlearning.co...essments/14447

The following short video touches on some additional benefits of good communication in the workplace:

You can view the transcript for “Workplace Communication” (opens in new window).

Barriers to Effective Communication

Failures of human communication can become amplified in professional settings. In business transactions, especially those involving large amounts of money, a small miscommunication can have devastating effects. Or, if a company fails to lay out a clear, comprehensible set of objectives, the employees tasked with meeting them will probably also fail. If a business makes inaccurate or misleading claims about its products, that can have damaging consequences, as well—possibly causing it to lose customers or, worse, find itself in a lawsuit. For these reasons and many more, it’s important for businesses to communicate clearly, consistently, and honestly. It’s also important to be informed about the things that get in the way of communication and seek to overcome them. The following is a list of common barriers to communication:

- **The use of jargon**: The use of unfamiliar, overcomplicated, or technical terms can generate confusion and obscure meaning of the sender’s message. The solution is to use clear and concise messages that are easy to understand.
- **Withholding information**: Within an organization, some information is kept confidential due to company policies. Make sure the information that is needed is readily available and easily accessible.
- **Chain of command**: The maintenance of an organization’s hierarchy is essential, but its very presence can reduce the flow of communication. To counteract that tendency, it’s important to reduce unnecessary hierarchical levels and increase departmental interaction and communication.
- **Lack of trust**: In companies with a competition-driven culture, there may be a lack of trust among employees, which can hamper communication. Companies should strive to involve their employees in decisions, emphasize the importance of sharing information, and communicate openly and honestly.
- **Physical barriers or disabilities**: Hearing, vision, or speech problems can make communication challenging. Organizations need to be aware of accessibility issues for both internal and external communication.
- **Bias**: Preconceptions or prejudice can lead to stereotyping or false assumptions. Using care to choose unambiguous, neutral language and explain things clearly can help reduce bias.
- **Filtering**: People may hear what they expect to hear or want to hear, rather than what is said. Because filters are present in every system of communication, the message that the receiver receives is rarely the same as the one the sender sends. Some distortion of the message is almost inevitable.
- **Language and cultural differences**: Language use and social norms vary enormously from culture to culture. Companies need to educate themselves about cultural sensitivities and gear their messages to their audiences.

PRactice Question

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In the next section, we'll look more closely at the patterns and uses of business communication—who sends the messages, who receives them, and the different types of messages businesses typically use.

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25.10: Introduction to Communication Channels, Flows, and Networks

What you'll learn to do: describe typical communication channels, flows, and networks within an organization, and explain when different channels are appropriate

In this section, we'll look more closely at the patterns of communication in business—who sends the messages, who receives them, and the different types of messages businesses typically use.

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25.11: Communication Channels

Learning Objectives

- Differentiate between face-to-face, written, oral, Web-based, and other common channels of business communication
- Differentiate between appropriate and inappropriate uses of different communication channels

In communications, a channel is the means of passing information from a sender to a recipient. Determining the most appropriate channel, or medium, is critical to the effectiveness of communication. Channels include oral means such as telephone calls and presentations, and written modes such as reports, memos, and email.

Communication channels differ along a scale from rich to lean. Think about how you would select a steak—some have more fat than others; they are **rich** and full of flavor and body. If, however, you are on a diet and just want the meat, you will select a **lean** steak. Communication channels are the similar: rich channels are more interactive, provide opportunities for two-way communication, and allow both the sender and receiver to read the nonverbal messages. The leanest channels, on the other hand, trim the "fat" and present information without allowing for immediate interaction, and they often convey "just the facts." The main channels of communication are grouped below from richest to leanest:

- Richest channels: face-to-face meeting; in-person oral presentation
- Rich channels: online meeting; video conference
- Lean channels: teleconference; phone call; voice message; video (e.g., Facetime)
- Leanest channels: blog; report; brochure; newsletter; flier; email; phone text; social media posts (e.g., Twitter, Facebook)

Oral communications tend to be richer channels because information can be conveyed through speech as well as nonverbally through tone of voice and body language. Oral forms of communication can range from a casual conversation with a colleague to a formal presentation in front of many employees. Richer channels are well suited to complex (or potentially unsettling) information, since they can provide opportunities to clarify meaning, reiterate information, and display emotions.

While written communication does not have the advantage of immediacy and interaction, it can be the most effective means of conveying large amounts of information. Written communication is an effective channel when context, supporting data, and detailed explanations are necessary to inform or persuade others. One drawback to written communications is that they can be misunderstood or misinterpreted by an audience that doesn't have subsequent opportunities to ask clarifying questions or otherwise respond.

The following are some examples of different types of communication channels and their advantages:

- **Web-based communication**, such as email, chat, IM, text, and video conferencing, allows people in different locations to communicate and even "meet" despite differences in geography. Email provides instantaneous written communication; effective for formal notices and updates, as well as informal exchanges. Social media, message boards and forums allow people to instantly post information to a centralized location. Other Web-based communication, such as information presented on a company Web site, is suited for sharing transaction details (such as order confirmation) or soliciting contact information (such as customer phone number and address)
- **Letters** are a more formal method of written communication usually reserved for important messages such as proposals, inquiries, agreements, and recommendations.
- **Presentations** are usually oral and usually include an audiovisual component, like copies of reports, or material prepared in Microsoft PowerPoint or Adobe Flash.
- **Telephone meetings/conference calls** allow for long-distance interaction.

- **Face-to-face meetings** are personal, interactive exchanges that provide the richest communication and are still the preferred method of communication in business.

? Practice Question

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So, we have written and oral channels, channels that range from rich to lean, and then, within those, multiple channels from which the sender can choose. How do you decide the best channel for your message? When deciding which communication channel to use, the following are some of the important factors to consider:

- the audience and their reaction to the message;
- the length of time it will take to convey the information;
- the complexity of the message;
- the need for a permanent record of the communication;
- the degree to which the information is confidential; and
- the cost of the communication.

If you choose the wrong channel—that is, if the channel is not effective for the type of message and meaning you want to create—you are likely to generate misunderstanding and possibly end up making matters worse. Using the wrong channels can impede communication and can even create mistrust. For example, a manager wants to compliment an employee for his work on a recent project. She can use different approaches and channels to do this. She could send the an employee a text: “Hey, nice work on the project!” Or she could send him an email containing the same message. She could also stop by his desk and personally compliment him. She could also praise him in front of the whole department during a meeting. In each case the message is the same, but the different channels alter the way the message is perceived. If the employee spent months working on the project, getting a “Hey, nice work on the project!” text message or email might seem like thin praise—insulting even. If the employee is shy, being singled out for praise during a departmental meeting might be embarrassing. A face-to-face compliment during a private meeting might be received better. As you can see, getting the channel right is just as important as sending the right message.

? PRactice Question

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25.12: Communication Flows

Learning Objectives

- Differentiate between downward, upward, horizontal, diagonal, and external communication flows

Communication within a business can involve different types of employees and different functional parts of an organization. These patterns of communication are called **flows**, and they are commonly classified according to the direction of interaction: downward, upward, horizontal, diagonal, external. As you learn about each of these, we will discuss how these flows function at Little Joe's Auto.

Downward Communication

When leaders and managers share information with lower-level employees, it's called **downward,** or **top-down communication**. In other words, communication from superiors to subordinates in a chain of command is a downward communication. This communication flow is used by the managers to transmit work-related information to the employees at lower levels. Ensuring effective downward communication isn't always easy. Differences in experience, knowledge, levels of authority, and status make it possible that the sender and recipient do not share the same assumptions or understanding of context, which can result in messages being misunderstood or misinterpreted. Creating clearly worded, unambiguous communications and maintaining a respectful tone can facilitate effective downward communication.

Little Joe's Auto: Downward Communication

Little Joe holds a meeting every morning with his entire sales staff. In this meeting he gives them information on new cars on the lot, current interest rates available to customers, and how close they are to meeting the company's monthly sales goals. The most important information shared is a "hot sheet" that lists the cars that need to be sold ASAP because they have been on the lot for more than forty-five days. Every car sold from the hot sheet earns the salesperson a $500 bonus, adding more than a little motivation to the mix.

As Little Joe goes through his morning briefing, the sales staff listen, take notes, and sometimes ask a few clarifying questions, but clearly the purpose of this daily pow-wow is for Little Joe to convey the information his staff need to perform their jobs and meet the expectations of management.

Upward Communication

Upward communication is the transmission of information from lower levels of an organization to higher ones; the most common situation is employees communicating with managers. Managers who encourage upward communication foster cooperation, gain support, and reduce frustration among their employees. The content of such communication can include requests, estimations, proposals, complaints, appeals, reports, and any other information directed from subordinates to superiors. Upward communication is often made in response to downward communication; for instance, when employees answer a question from their manager. In this respect, upward communication is a good measure of whether a company's downward communication is effective.

The availability of communication channels affects employees' overall satisfaction with upward communication. For example, an open-door policy sends the signal to employees that the manager welcomes impromptu conversations and other communication. This is likely to make employees feel satisfied with their level of access to channels of upward communication and less apprehensive about communicating with their superiors. For management, upward communication is an important source of information that can inform business decisions. It helps to alert management of new developments, levels of performance, and other issues that may require their attention.

Little Joe's Auto: Upward Communication

One afternoon, Frances knocks at Little Joe's office door, which is always open. Frances wants Little Joe to know that he has a couple interested in one of the new cars on the hot sheet, a 2015 Sonata, but the car is out of their price range by just a hair. Frances knows the couple from his church and really wants to help them get reliable transportation, but he also knows he needs to get the deal past the finance manager. Frances wants to know if it's possible for him to cut the price to his customers and give up his $500 bonus for selling the car. Little Joe agrees, since it really makes no difference who gets the $500—Frances or the customer.

Horizontal Communication

Horizontal communication, also called lateral communication, involves the flow of messages between individuals and groups on the same level of an organization, as opposed to up or down. Sharing information, solving problems, and collaborating horizontally is often more timely, direct, and efficient than up or down communication, since it occurs directly between people working in the same environment. Communication within a team is an example of horizontal communication; members coordinate tasks, work together, and resolve conflicts. Horizontal communication occurs formally in meetings, presentations, and formal electronic communication, and informally in other, more casual exchanges within the office.

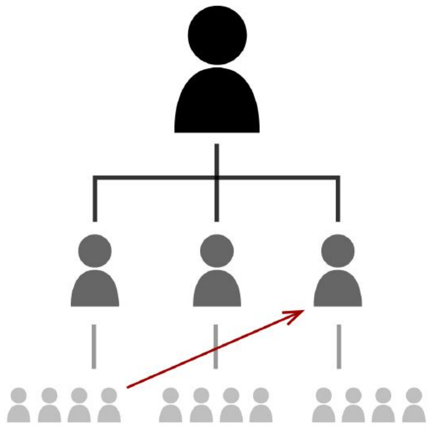
When there are differences in style, personality, or roles among coworkers, horizontal communication may not run smoothly. According to Professor Michael Papa, horizontal communication problems can occur because of territoriality, rivalry, specialization, and simple lack of motivation. Territoriality occurs when members of an organization regard other people's involvement in their area as inappropriate or unwelcome. Rivalry between individuals or teams can make people reluctant to cooperate and share information. Specialization is a problem that occurs when there is a lack of uniform knowledge or vocabulary within or between departments. Finally, horizontal communication often fails simply because organization members are unwilling to expend the additional effort needed to reach out beyond their immediate team.

Little Joe's Auto: Horizontal Communication

Little Joe picks up his phone and calls Brian, the finance manager. He explains that Frances is going to send a deal through on a hot-sheet car that is $500 less than the bottom line, but if the rest of the deal is solid, Brian should approve it. Brian immediately begins to object, when Little Joe cuts him off and says that Frances is waiving his hot-sheet bonus. When Little Joe hangs up with Brian, he tells Frances he's set—now go sell that car!

Diagonal Communication

Diagonal communication is the sharing of information among different structural levels within a business. This kind of communication flow is increasingly the norm in organizations (in the same way that cross-functional teams are becoming more common), since it can maximize the efficiency of information exchange. The shortest distance between two points is a straight line. Diagonal communication routes are the straight lines that speed communications directly to their recipients, at the moment communication is necessary. Communications that zigzag along horizontal and vertical routes, on the other hand, are vulnerable to the schedules and availability of the individuals who reside at each level.



Little Joe's Auto: Diagonal Communication

Frances returns to his customers and tells him he thinks he's got a way to make the deal work. Brian, the finance manager, approves the deal per his conversation with Little Joe, so all that's left is the final inspection in the service department. The customers have told Frances they need to be home by 3 pm, but when Frances sees the time and looks over at the line of cars waiting for final inspection, his stomach drops. There's no way he is going to get them out of the dealership by three, and he's afraid he'll lose the sale. He heads over to the service department to find Marcie, the service manager. He finds her in one of the service bays and explains his situation, asking if there's any way his customer can be moved ahead in the line. Marcie checks her clipboard, does some quick calculations, and calls over one of the service techs. She tells him to locate the 2015 Sonata and get it up on the lift next. Smiling, she turns to Frances and says, "Mission accomplished."

External Communication

Another type of communication flow is **external**, when an organization communicates with people or organizations outside the business. Recipients of external communication include customers, lawmakers, suppliers, and other community stakeholders. External communication is often handled by marketing and sales. Annual reports, press releases, product promotions, financial reports are all examples of external communication.

Little Joe's Auto: External Communication

The last thing Frances does before he hands the keys to his customers is to affix a Little Joe's Auto license plate frame to the front and back of the Sonata. Now everyone who sees his customers driving their new car will know where they bought it. He hopes this sale will generate more business for himself and the dealership, so along with the keys to the car, he gives them several business cards and a coupon for a free oil change. At 2:30, Frances waves good-bye to his customers as they drive their new Sonata off the lot.

In order to close this deal, the communication at Little Joe's Auto has flowed in every direction—upward, downward, horizontally, diagonally, and externally.

Practice Question

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25.13: Communication Networks

Learning Objectives

- Differentiate between formal and informal communication networks

By now you know that business communication can take different forms and flow between different kinds of senders and receivers. Another way to classify communication is by network.

An organization's **formal communication network** is comprised of all the communication that runs along its official lines of authority. In other words, the formal network matches the organizational structure of an organization. As you might expect, when a manager sends an email to her sales team describing the new commission structure for the next set of sales targets, that email (an example of downward communication) is being sent along the company's formal network that connects managers to their subordinates.

An **informal communication network**, on the other hand, doesn't follow authority lines and is established around the social affiliation of members of an organization. Such networks are also described as "grapevine communication." They may come into being through the rumor mill, social networking, graffiti, spoof newsletters, and spontaneous water-cooler conversations.

Informal versus Formal Networks

- Formal communication follows practices shaped by hierarchy, technology systems, and official policy.
- Formal communication usually involves documentation, while informal communication may not leave a recorded trace for others to find or share.
- Formal communications in traditional organizations are frequently "one-way": They are initiated by management and received by employees.
- Formal Communication content is perceived as authoritative because it originates from the highest levels of the company.
- Informal communication occurs in any direction and takes place between individuals of different status and roles.
- Informal communication frequently crosses boundaries within an organization and is commonly separate from work flows. That is, it often occurs between people who do not work together directly but share an affiliation or a common interest in the organization's activities and/or a motivation to perform their jobs well.
- Informal communication occurs outside an organization's established channels for conveying messages and transmitting information.

In the past, many organizations considered informal communication (generally associated with interpersonal, horizontal communication) a hindrance to effective organizational performance and tried to stamp it out. This is no longer the case. The maintenance of personal networks and social relationships through information communication is understood to be a key factor in how people get work done. It might surprise you to know that 75 percent of all organizations' practices, policies, and procedures are shared through grapevine communication.[1]

While informal communication is important to an organization, it also may have disadvantages. When it takes the form of a "rumor mill" spreading misinformation, informal communication is harmful and difficult to shut down because its sources cannot be identified by management. Casual conversations are often spontaneous, and participants may make incorrect statements or promulgate inaccurate information. Less accountability is expected from informal communications, which can cause people to be indiscreet, careless in their choice of words, or disclose sensitive information.

? Practice Question

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1. Keith Davis, "Grapevine Communication Among Lower and Middle Managers," Personnal Journal, April, 1969, p. 272. ↵

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25.14: Introduction to Electronic Communication

What you'll learn to do: identify common risks and ethical issues associated with electronic communication in business

In this section we'll touch on some of the risks and ethical issues business face when they rely on electronic communication.

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25.15: Electronic Communication

Learning Objectives

- Identify common risks associated with electronic communication
- Identify common ethical issues associated with electronic communication in business

Starting in the 1980s with the development of information and communications technologies, businesses have increasingly come to rely on electronic channels as a primary means of communicating and of conducting business. Such technological advances have been a tremendous boon, as businesses are now able to transmit and store vast amounts of information cheaply and quickly. At the same time, these developments are not without risks or challenges, particularly where ethics and security are concerned. In this section we discuss some of the concerns surrounding the use of electronic communication technologies.

Risks of Electronic Communication

Electronic communication and eCommerce have presented businesses with exciting opportunities that couldn't have existed even a couple decades ago. At the same time, they've brought unexpected challenges. Some of the biggest risks of using modern digital and electronic technology for communication and commerce are identity theft, unauthorized credit card or bank account use, and even demand for ransom for the return of stolen data.

When businesses allow customers to shop online, receive discounts by providing personal information, use live chat to communicate with customer service, they are hoping to enhance their image and provide a customer experience that is superior to the competition. But, what happens when the information a customer shares with a business is compromised or stolen by a third party? Consider what Home Depot endured when their customer database was breached in 2014:

You can view the transcript for "Home Depot Security Breach" (opens in new window) or the text alternative for "Home Depot Security Breach" (opens in new window).

Data security is on everyone's mind these days, and the ways that electronic communication can be compromised seem to evolve as quickly as the technology. The following are just a few of the illicit and illegal ways that people get their hands on sensitive and private information:

- **Viruses, worms, and Trojan horses**. A computer virus is a type of malicious software program ("malware") that, when executed, replicates by reproducing itself (copying its own source code) and/or infecting other computer programs by modifying them. A computer worm is a stand-alone malware computer program that replicates itself in order to spread to other computers. A Trojan horse, or Trojan, is any malicious computer program or phony site that is used to hack into computers by misleading users about its true intent or identity.
- **Spoofing or phishing**. Phishing is the attempt to obtain sensitive information such as usernames, passwords, and credit card details (and, indirectly, money), often for malicious reasons. Often the sender of the electronic communication is disguised as a trustworthy entity.
- **Denial-of-service attacks**. A denial-of-service attack (DoS attack) is a cyber attack in which the perpetrator seeks to make a machine or network resource unavailable to its intended users by temporarily or indefinitely disrupting the services of a host connected to the Internet.

The low cost and rapid delivery of electronic communication makes it the preferred method of communication for both business and consumers, but there can be hidden hazards and costs. The following are common ones:

- **Electronic communications are forever.** Electronic messages are permanent (this includes communications such as email and also audio recordings such as voice mail). Even if a person deletes the communications from his or her own server or account, there are generally other servers that still hold this information. One way that these types of communications live in perpetuity is when they are sent or forwarded to multiple individuals.
- **Someone may be watching.** In many cases, confidential information is leaked by someone else sifting through his or her messages. The culprit may be a disgruntled employee or even a competitor. Workstations left unattended, employees remaining logged on to networks and email accounts when they are away from their desk, and even sharing passwords with coworkers all make it easy for prying eyes to see information not intended to be shared.
- **Innocent messages can still harm you.** Civil litigation lawyers will warn you that even innocent messages can get you in trouble you if they are taken out of context. When a person writes an email or text, he or she may have only one intent or meaning in mind. However, messages can be misconstrued to apply to a completely different scenario.
- **Email avalanche.** Managers, in particular, are vulnerable to relying on email too heavily for communication. People use email because it's quick and easy, and they can send the same information to a lot of people at the same time. This can lead to information overload and misunderstandings by recipients, however. Words alone account for only 7 percent of communication,[1] so it's important for managers to be aware of the limitations of email in getting their messages across.

? Practice Question

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Ethical Issues in Electronic Communication

Technology enables businesses to communicate and store information more readily and efficiently than ever. However, as much as technology impacts the *way* that companies do business, it also raises important new issues for the employer-employee relationship. If you send personal emails from your office computer, do you have the right to expect that they're private? Does your employer have a legal and ethical right to "cyber-peek" at what you are doing with company assets? Twenty years ago this was not an issue; in 2010, it was a case before the Supreme Court. The case concerned the extent to which the right to privacy applies to electronic communications in a government workplace, and the city narrowly won. The U.S. Supreme Court has generally found in favor of employers, giving them the right to monitor any communication that occurs on their equipment (computers, smartphones, or pagers).

You can view the transcript for “Cell Phone Privacy” (opens in new window).

Employers want to use technology to help them screen applicants and verify information about their workforce, which is understandable. In the module on Human Resource Management you learned about the cost of recruiting, hiring, and training employees. However, what if the company believes that one of the quickest ways to gather information about an employee is to access their social media accounts? A company would never ask for your login credentials for Facebook, Twitter, Instagram, LinkedIn . . . or would they? And if they did, is it legally and ethically justified? What would you do if you found yourself in the situation presented in the following video?

You can view the transcript for “US Employers Banned From Asking for Social Media Logins” (opens in new window).

The fact is that technology has put our information at the fingertips of businesses—there for the taking and, in some cases, the selling. Is it ethical for a business to collect data about a person and then sell that information to another business? Many organizations collect data for their own purposes, but they also realize that your data has value to others. As a result, selling data has become an income stream for many organizations. If you didn’t realize that your data was collected by Company A, it’s even less likely you knew that it was sold to Company B.

You can view the transcript for “Selling You As Data” (opens in new window) or the text alternative for “Selling You As Data” (opens in new window).

? Practice Question

https://assessments.lumenlearning.co...essments/14454

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1. Mehrabian, Albert (1981). *Silent Messages: Implicit Communication of Emotions and Attitudes* (2nd ed.). Belmont, CA: Wadsworth. ↵

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25.16: Putting It Together- Teamwork and Communication

Synthesis

What did it take for eight people to jump out of a perfectly good airplane and join hands to form a figure eight? Yes, nerves of steel and a measure of pure insanity. But it also took something else—the very thing you learned about in this module: teamwork and communication.

For the skydivers, the consequences of poor teamwork and faulty communication can be serious and even deadly. Defective parts can wind up in automobiles and airplanes, the wrong medications can be given to patients in a hospital, food can be contaminated . . . all as a result of poor teamwork and communication.

Understanding the ways in which people communicate and overcome potential barriers can help you be a more effective communicator and a better team member. Moreover, the skills you've learned in this module are not only important in business—they're useful in skydiving and life.

Summary

In this module you learned about the importance of teamwork and communication in business. Below is a summary of the key points that we covered.

Teams

Teams are groups of individuals with complementary skills who come together to achieve a specific goal. Teams can be manager-led, self-directed, cross-functional, or even virtual. Companies use teams because they are an effective means of achieving objectives, and they bring increased efficiency to operations.

Team Development and Success

When teams are formed they evolve from individuals into a cohesive unit. The stages of team development are forming, storming, norming, performing, and adjourning.

What differentiates a successful team from an unsuccessful one? Some of the hallmarks of successful teams are the following: the members trust one another, common goals, defined team roles and responsibilities, good communication, and group cohesion.

Effective Communication and Barriers

Effective communications are thoughtful, clear, specific, brief, and timely. "Getting one's message across" can be tricky and challenging due to barriers that impede communication. Among the barriers to effective communication are filtering, bias, jargon, language and cultural differences, the chain of command, physical disabilities, and lack of trust.

Communication Channels, Flows, and Networks

Communication involves a sender, a message, and a receiver. The form a message takes is called a channel. Communication can occur between different kinds of senders and receivers within (and outside of) an organization. Communication can flow upward, downward, horizontally, diagonally, and externally. It can also flow through different networks, both informal and formal.

Electronic Communication

The rise of information technology that makes business communication faster and more efficient brings unique ethical challenges and risks. Businesses must take steps to keep employee and customer data safe; they must also establish security measures to protect against cyber threats such as malware, hacking, and theft.

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25.17: Discussion- What You Heard Was Not What I Meant

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

For the third time in less than a week, Wanda has received a phone call from a customer who is upset that when her order arrived, it was incorrect. Wanda refunded money to all three customers in order to keep them happy. She is not sure what's causing these errors, but she knows it has to be remedied or she will lose customers.

When you meet for coffee, Wanda mentions these problems and wonders aloud what the issue is. Is the customer service staff not writing things down correctly, or is production not reading the orders correctly? Alternatively, the mistake could be in shipping with the young man who comes in after school to package and prepare orders for shipment. Salty Pawz can't afford an automated system yet, so everyone must rely on person-to-person communication to get order details right.

For Discussion

1. Explain to Wanda common reasons why organizational communications can become ineffective and break down. Suggest specific things to watch for in her organization that can indicate poor communication skills.
2. Make at least one specific recommendation that Wanda can implement to improve communication among Salty Pawz departments and individual employees.
3. Now that you have improved communication at Salty Pawz, think about a time when you were on the receiving end of poor communication, such as when the message was not clear or the wrong information was conveyed. What was the consequence of this poor communication? How did you or would you keep this from happening again in the future?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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25.18: Discussion- The Ultimate Cost of Poor Communication

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Research an example from the news of a situation in which the breakdown of teamwork and/or communication had serious or disastrous consequences. For example, I found an article from the U.K. that described the case of two-year-old boy who died from internal bleeding as the direct result of a total breakdown in communication between his physicians – Toddler Bleeds to Death after a Complete Failure of Communication between Doctors.

For Discussion

1. Provide a brief description of the situation. Include a link to the article or site, as I have above, where we can find and read the details. (In order to insert this link, copy and paste the URL from your browser window into the text box where you are making your post. You do not have to do anything special; it will automatically be converted to a Web link.)
2. Describe or discuss the result of the breakdown in communication and/or teamwork.
3. What, if anything, do you believe could have been done to prevent this breakdown?
4. What can we learn from your example?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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25.19: Assignment- Teamwork at Salty Pawz

Scenario

Wanda has been running Salty Pawz out of her home with the help of just a few friends. She is now considering expanding the business, which means hiring new people and delegating tasks. She read a magazine article about the effectiveness of teams in the workplace, and she has decided to create teams as soon as she hires her new staff. However, the only teams Wanda knows much about are NFL teams.

She has provided you with a list of the positions she is thinking of adding as she expands Salty Pawz:

- 1 full-time treat baker
- 2 part-time baking assistants
- 1 full-time sales manager
- 2 part-time retail clerks
- 1 part-time bookkeeper
- 1 full-time office/administrative assistant
- 1 customer service representative
- 1 part-time marketing and promotions manager
- 1 part-time shipping/receiving clerk
- 1 part-time Web master/tech support person

She asks you to recommend a structure and organize her employees into teams, since she doesn't think letting them pick which team they want to be on is a good idea.

Your Task

1. Explain to Wanda the team structure options she can consider once she expands the business, and make specific suggestions about how you would organize her workforce based on the type/structure of teams you recommend.
2. Give Wanda concrete and specific information about the developmental stages she should expect her new teams to go through once they are established. Be sure to consider the types of work each employee will be performing and, when describing the stages of team development, explain how he or she will need to interact to become a high-functioning team member.
3. When providing Wanda with the information above, also be certain to point out the consequences of poor teamwork and give her **specific** ways she can support these teams to make them successful.

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain team structures appropriate for Salty Pawz expansion.	0 points	11 points	16 points	20 points	20%
Explain the developmental stages expected for new teams.	0 points	11 points	16 points	20 points	20%
Explain the consequences of poor teamwork.	0 points	11 points	16 points	20 points	20%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Provide examples of strategies to support successful teamwork.	0 points	11 points	16 points	20 points	20%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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25.20: Assignment- Multicultural Virtual Work Teams

Preparation

You work for Mike, a global company that specializes in manufacturing and selling athletic shoes for both competition athletes and casual users. You are called into your supervisor's office where he tells you that you have been assigned to be the leader of a virtual team. The team has been tasked with assessing the feasibility of the company manufacturing and marketing an inexpensive athletic shoe to be sold in Brazil. You will be responsible for getting the team up and running, maintaining open and clear lines of communications, and ultimately launching the product if it is found to be feasible.

Your supervisor hands you a list of the team members—twelve of them. Three work in the United States (two in Beaverton, Oregon, and one in New York City). Two work in England, two in China, two in India, and three in Brazil. All are Mike employees, and all were born in the country in which they work. All speak English, though some speak it better than others.

Your Task

Since you are team's leader, your supervisor has asked you to meet with the members and then prepare a written report that addresses the following:

1. What challenges do you expect the team will face because of its multicultural makeup?
2. How can you help the team overcome these challenges?
3. What are the opportunities presented by the multicultural makeup of the team?

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25.21: Assignment- Formal and Informal 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 the learning outcomes of Introduction to Business 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 Objectives

- Differentiate between formal and informal communication networks

In the module on Teamwork and Communication, we provide a general overview about the role of informal and formal communication in a business setting. For this assignment, you are going to work with a small group to hunt down useful links and resources for your fellow students about a local business. This work will become a living document that future students will use.

Think of your audience as friends who just got a job with a local business. You want to help them understand their new employer with the best information you can find. Using the search engine of your choice (Google, Bing, etc) find videos or documents that explain the differences between informal and formal communication.

- In your own words, summarize on a Google Doc, or a similar online tool, why your definition is important to a person learning about teamwork and communication.
- Find an example of informal and formal communication definitions. Provide the link to your source.
- What is your experience with these two types of communication? You can use examples from your work experience or you cite examples in television shows and movies.What are the advantages and disadvantages of each form of communication? Why?

A Note To Teachers: You may want to break your students into groups and let them work on their own document that you will eventually create into one document. You may also want to point them to local businesses or industries that you focus on in your course such as retail or hospitality. If your first term's assignment is to create the document, think of the next term's assignment as checking that all of the links are correct and adding advice. In our analysis of student performance, we found that struggle with this learning outcome, so having a focus on each of these concepts–even in a conversational way–may help them with the summative quizzes.

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CHAPTER OVERVIEW

26: Module 11 Readings - Human Resource Management

26.1: Reading- Human Resource Management

Human Resource Management

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

Human Resource Planning

How does Starbucks ensure that its worldwide retail locations are staffed with just the right number of committed employees? How does Walt Disney World make sure it has enough qualified "cast members" to provide visitors with a "magical" experience? How does Norwegian Cruise Lines make certain that when the *Norwegian Dawn* pulls out of New York harbor, it has a complete, fully trained crew on board to feed, entertain, and care for its passengers? Managing these tasks is a matter of strategic human resource planning—the process of developing a plan for satisfying an organization's human resources (HR) needs.

A strategic HR plan lays out the steps that an organization will take to ensure that it has the right number of employees with the right skills in the right places at the right times. HR managers begin by analyzing the company's mission, objectives, and strategies. Starbucks's objectives, for example, include the desire to "develop enthusiastically satisfied customers" as well as to foster an environment in which employees treat both customers and each other with respect. Thus, the firm's HR managers look for people who are "adaptable, self-motivated, passionate, creative team members." Likewise, Disney's overall objectives include not only making all visitors feel as if they're special in a special place but also ensuring that employees' appearance reflects a special image (there's even a forty-seven-page book on the subject). Disney looks for people who best fulfill these job requirements. The main goal of Norwegian Cruise Lines—to lavish passengers with personal attention—determines not only the type of employee desired (one with exceptionally good customer-relation skills and a strong work ethic) but also the number needed (one for every two passengers on the *Norwegian Dawn*).

Job Analysis

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

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

HR Supply and Demand Forecasting

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

Figure 26.1.1: How to Forecast Hiring (and Firing) Needs

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

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

Recruiting Qualified Employees

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

Before going any further, we should point out that, in recruiting and hiring, managers must comply with antidiscrimination laws; violations can have legal consequences. Discrimination occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability. Under federal law, it's illegal to discriminate in recruiting and hiring on the basis of race, color, religion, sex, national origin, age, or disability. (The same rules apply to other employment activities, such as promoting, compensating, and firing.) The Equal Employment Opportunity Commission (EEOC) enforces a number of federal employment laws, including the following:

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

Where to Find Candidates

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

Internal vs. External Recruiting

Where do you find people who satisfy so many criteria? Basically, you can look in two places: inside and outside your own organization. Both options have pluses and minuses. Hiring internally sends a positive signal to employees that they can move up in the company—a strong motivation tool and a reward for good performance. In addition, because an internal candidate is a known quantity, it's easier to predict his or her success in a new position. Finally, it's cheaper to recruit internally. On the other hand, you'll probably have to fill the promoted employee's position. Going outside gives you an opportunity to bring fresh ideas and skills into the company. In any case, it's often the only alternative, especially if no one inside the company has just the right combination of skills and experiences. Entry-level jobs usually have to be filled from the outside.

How to Find Candidates

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

Recruiting people from outside is more complicated. It's a lot like marketing a product to buyers: in effect, you're marketing the virtues of working for your company. Starbucks uses the following outlets to advertise openings:

- A dedicated section of the corporate Web site ("Job Center," which lists openings, provides information about the Starbucks experience, and facilitates the submission of online applications)
- College campus recruiting (holding on-campus interviews and information sessions and participating in career fairs)
- Internships designed to identify future talent among college students
- Announcements on employment Web sites like Monster.com, Vault.com, Glassdoor.com, and SimplyHired.com
- Newspaper classified ads
- Facebook and Twitter
- Local job fairs
- In-store recruiting posters
- Informative "business cards" for distribution to customers

When asked what it takes to attract the best people, Starbucks's senior executive Dave Olsen replied, "Everything matters." Everything Starbucks does as a company bears on its ability to attract talent. Accordingly, everyone is responsible for recruiting, not just HR specialists. In fact, the best source of quality applicants is the company's own labor force.

The Selection Process

Recruiting gets people to apply for positions, but once you've received applications, you still have to select the best candidate—another complicated process. The selection process entails gathering information on candidates, evaluating their qualifications, and choosing the right one. At the very least, the process can be time-consuming—particularly when you're filling a high-level position—and often involves several members of an organization.

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

Application

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

Employment Tests

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

Interview

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

Physical Exam and Reference Checks

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

Final Decision

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

Contingent Workers

Though most people hold permanent, full-time positions, there's a growing number of individuals who work at temporary or part-time jobs. Many of these are contingent workers hired to supplement a company's permanent workforce. Most of them are independent contractors, consultants, or freelancers who are paid by the firms that hire them. Others are *on-call workers* who work only when needed, such as substitute teachers. Still others are *temporary workers* (or "temps") who are employed and paid by outside agencies or contract firms that charge fees to client companies.

The Positives and Negatives of Temp Work

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

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

KEY TAKEAWAYS

- The process of **human resource management** consists of all the actions that an organization takes to attract, develop, and retain quality employees.
- To ensure that the organization is properly staffed, managers engage in **strategic human resource planning**—the process of developing a plan for satisfying the organization's human resource needs.
- Managers organize information about a given job by performing a **job analysis**, which they use to prepare two documents: a **job description** listing the duties and responsibilities of a position and a **job specification**, which lists the qualifications—skills, knowledge, and abilities—needed to perform the job.

- After analyzing the jobs that must be performed, the HR manager forecasts future hiring needs and begins the **recruiting** process to identify suitable candidates and encourage them to apply.
- In recruiting and hiring, managers must comply with antidiscrimination laws enforced by the **Equal Employment Opportunity Commission (EEOC)**.
- **Discrimination** occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability, such as race, color, religion, sex, national origin, age, or disability.
- Once a pool of suitable candidates has been identified, managers begin the **selection** process, reviewing information provided by candidates on employment **applications** and administering tests to assess candidates' skills and knowledge.
- Candidates who pass this stage may be granted an **interview** and, perhaps, offered a job.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Contributors and Attributions

26.2: Reading- Working with Labor Unions

Unhappy Employees Could Equal Unionization

As the HR manager for a two-hundred-person company, you generally have a pretty good sense of employee morale. Recently you grew concerned because morale has dropped. Employees are unhappy because of pay and the increasing cost of health benefits. You discuss these concerns with upper-level management, but owing to financial pressures, the company cannot address the issue this year.

One afternoon, the manager of the marketing department comes to you with this concern, but also with some news. She tells you that she has heard talk of employees unionizing if they do not receive pay raises within the next few months. She says that the employees are very unhappy, and productivity is suffering as a result. She explains that employees have already started the unionization process by contacting the National Labor Relations Board and are in the process of proving 30 percent worker interest in unionization. As you mull over this news, you are concerned because the organization has always had a family atmosphere, and a union might change this. You are also concerned about the financial pressures to the organization should the employees unionize and negotiate higher pay. You know you must take action to prevent this development. However, you know that you and all managers are legally bound by rules relating to unionization, and you need a refresher on what these rules are. You decide to call a meeting first with the CEO and then with managers to discuss strategy and inform them of the legal implications of this process. You feel confident that a resolution can be reached before the unionization happens.

The Nature of Unions

A labor union, or union, is defined as workers banding together to meet common goals, such as better pay, benefits, or promotion rules. In the United States, 11.9 percent of American workers belong to a union, down from 20.1 percent in 1983 ("Union Members: 2010," Bureau of Labor Statistics, US Department of Labor, news release, January 21, 2011, accessed April 4, 2011). In this section, we will discuss the history of unions, reasons for decline in union membership, union labor laws, and the process employees go through to form a union. First, however, we should discuss some of the reasons why people join unions.

People may feel their economic needs are not being met with their current wages and benefits and believe that a union can help them receive better economic prospects. Fairness in the workplace is another reason why people join unions. They may feel that scheduling, vacation time, transfers, and promotions are not given fairly and feel that a union can help eliminate some of the inequity associated with these processes. Let's discuss some basic information about unions before we discuss the unionization process.

History and Organization of Unions

Trade unions were developed in Europe during the Industrial Revolution, when employees had little skill and thus the employer had most of the power. Many employees were treated unfairly and were underpaid. In the United States, unionization increased with the building of railroads in the late 1860s. Wages in the railroad industry were low and the threat of injury or death was high, as was the case in many manufacturing facilities with few or no safety laws or regulations in place. As a result, the Brotherhood of Locomotive Engineers and several other brotherhoods (focused on specific tasks only, such as conductors and brakemen) were formed to protect workers' rights, although many workers were fired because of their membership.

Labor Union AFL-CIO Perspective

The following video shows a history of labor unions from the perspective of the AFL-CIO:

The first local unions in the United States were formed in the nineteenth century, in the form of the National Labor Union (NLU).

The National Labor Union, formed in 1866, paved the way for other labor organizations. The goal of the NLU was to form a national labor federation that could lobby government for labor reforms on behalf of the labor organizations. Its main focus was to limit the workday to eight hours. While the NLU garnered many supporters, it excluded Chinese workers and only made some attempts to defend the rights of African Americans and female workers. The NLU can be credited with the eight-hour workday, which was passed in 1862. Because of a focus on government reform rather than collective bargaining, many workers joined the Knights of Labor in the 1880s.

The Knights of Labor started as a fraternal organization, and when the NLU dissolved, the Knights grew in popularity as the labor union of choice. The Knights promoted the social and cultural spirit of the worker better than the NLU had. It originally grew as a labor union for coal miners but also covered several other types of industries. The Knights of Labor initiated strikes that were successful in increasing pay and benefits. When this occurred, membership increased. After only a few years, though, membership declined because of unsuccessful strikes, which were a result of a too autocratic structure, lack of organization, and poor management. Disagreements between members within the organization also caused its demise.

The American Federation of Labor (AFL) was formed in 1886, mostly by people who wanted to see a change from the Knights of Labor. The focus was on higher wages and job security. Infighting among union members was minimized, creating a strong organization that still exists today. In the 1930s, the Congress of Industrial Organizations (CIO) was formed as a result of political differences in the AFL. In 1955, the two unions joined together to form the AFL-CIO.

Currently, the AFL-CIO is the largest federation of unions in the United States and is composed of fifty-six national and international unions. The goal of the AFL-CIO isn't to negotiate specific contracts for employees but rather to support the efforts of local unions throughout the country.

Currently in the United States, there are two main national labor unions that oversee several industry-specific local unions. There are also numerous independent national and international unions, such as the following, that are not affiliated with either national union:

1. AFL-CIO: local unions include Airline Pilots Association, American Federation of Government Employees, Associated Actors of America, and Federation of Professional Athletes
2. CTW (Change to Win Federation): includes the Teamsters, Service Employees International Union, United Farm Workers of America, and United Food and Commercial Workers
3. Independent unions: Directors Guild of America, Fraternal Order of Police, Independent Pilots Association, Major League Baseball Players Association

The national union plays an important role in legislative changes, while the local unions focus on collective bargaining agreements and other labor concerns specific to the area. Every local union has a union steward who represents the interests of union members.

Normally, union stewards are elected by their peers.

A national union, besides focusing on legislative changes, also does the following:

1. Lobbies in government for worker rights laws
2. Resolves disputes between unions
3. Helps organize national protests
4. Works with allied organizations and sponsors various programs for the support of unions

For example, in 2011, the national Teamsters union organized demonstrations in eleven states to protest the closing of an Ontario, California, parts distribution center. Meanwhile, Teamster Local 495 protested at the Ontario plant ("Teamsters Escalate BMW Protests across America," PR Newswire, August 2, 2011, accessed August 15, 2011).

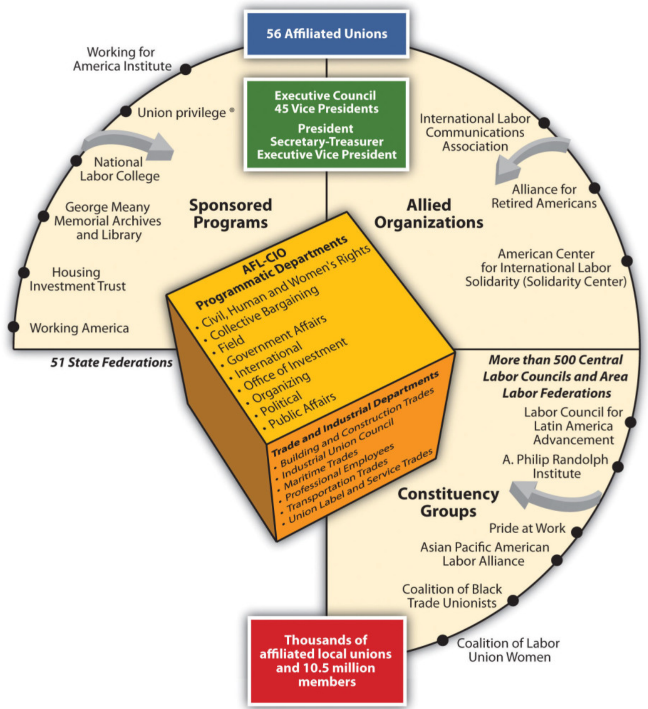


Figure \(\PageIndex{1}\): The Complicated Structure of AFL-CIO. Source: AFL-CIO

Current Union Challenges

The labor movement is currently experiencing several challenges, including a decrease in union membership, globalization, and employers' focus on maintaining nonunion status. As mentioned in the opening of this section, the United States has seen a steady decline of union membership since the 1950s. In the 1950s, 36 percent of all workers were unionized, as opposed to just over 11 percent today (Gerald Friedman, "Labor Unions in the United States," *Economic History Association*, February 2, 2010, accessed April 4, 2011).

Claude Fischer, a researcher from University of California Berkeley, believes the shift is cultural. His research says the decline is a result of American workers preferring individualism as opposed to collectivism (Claude Fischer, "Why Has Union Membership Declined?" *Economist's View*, September 11, 2010, accessed April 11, 2011). Other research says the decline of unions is a result of globalization and the fact that many formerly unionized jobs in the manufacturing arena have now moved overseas. Other reasoning points to management and that its unwillingness to work with unions has caused the decline in membership. Others suggest that unions are on the decline because of themselves. Past corruption, negative publicity, and hard-line tactics have made joining a union less desirable.

To fully understand unions, it is important to recognize their global aspect. Statistics from worldwide data unions in all countries declining but still healthy in some countries. For example, in eight of the twenty-seven European Union member states, more than half the working population is part of a union. In fact, in the most populated countries, unionization rates are still at three times the unionization rate of the United States (Federation of European Employers, "Trade Unions across Europe," accessed April 4, 2011).

Italy has a unionization rate of 30 percent of all workers, while the UK has 29 percent, and Germany has a unionization rate of 27 percent.

In March 2011, Wisconsin governor Scott Walker proposed limiting the collective bargaining rights of state workers to save a foundering budget. Some called this move “union busting” and said this type of act is illegal, as it takes away the basic rights of workers. The governor defended his position, saying that there was no other choice, since the state was in a budget crisis. Other states such as Ohio have considered similar measures. Whatever happens, there is a clear shift for unions today.

Globalization is also a challenge in labor organizations today. As more and more goods and services are produced overseas, unions lose not only membership but union values in the stronghold of worker culture. As globalization has increased, unions have continued to demand more governmental control but have been only somewhat successful in these attempts. For example, free trade agreements such as the North American Free Trade Agreement (NAFTA) have made it easier and more lucrative for companies to manufacture goods overseas. For example, La-Z-Boy and Whirlpool closed production facilities in Dayton and Cleveland, Ohio, and built new factories in Mexico to take advantage of cheaper labor and less stringent environmental standards. Globalization creates options for companies to produce goods wherever they think is best to produce them. As a result, unions are fighting the globalization trend to keep jobs in the United States.

There are a number of reasons why companies do not want unions in their organizations, which we will discuss in greater detail later. One of the main reasons, though, is increased cost and less management control. As a result, companies are on a quest to maintain a union-free work environment. In doing so, they try to provide higher wages and benefits so workers do not feel compelled to join a union. Companies that want to stay union-free constantly monitor their retention strategies and policies.

Labor Union Laws

The Railway Labor Act (RLA) of 1926 originally applied to railroads and in 1936 was amended to cover airlines. The act received support from both management and unions. The goal of the act is to ensure no disruption of interstate commerce. The main provisions of the act include alternate dispute resolution, arbitration, and mediation to resolve labor disputes. Any dispute must be resolved in this manner before a strike can happen. The RLA is administered by the National Mediation Board (NMB), a federal agency, and outlines very specific and detailed processes for dispute resolution in these industries.

The Norris-LaGuardia Act of 1932 (also known as the anti-injunction bill), barred federal courts from issuing injunctions (a court order that requires a party to do something or refrain from doing something) against nonviolent labor disputes and barred employers from interfering with workers joining a union. The act was a result of common yellow-dog contracts, in which a worker agreed not to join a union before accepting a job. The Norris-LaGuardia Act made yellow-dog contracts unenforceable in courts and established that employees were free to join unions without employer interference.

In 1935, the Wagner Act (sometimes called the National Labor Relations Act) was passed, changing the way employers can react to several aspects of unions. The Wagner Act had the following features:

1. Employers must allow freedom of association and organization and cannot interfere with, restrain, or coerce employees who form a union.
2. Employers may not discriminate against employees who form or are part of a union, or those who file charges.
3. An employer must bargain collectively with representation of a union.

The National Labor Relations Board (NLRB) oversees this act, handling any complaints that may arise from the act. For example, in April 2011, the NLRB worked with employees at Ozburn-Hessey Logistics in Tennessee after they had been fired because of their involvement in forming a union. The company was also accused of interrogating employees about their union activities and threatened employees with loss of benefits should they form a union. The NLRB utilized their attorney to fight on behalf of the employees, and a federal judge ordered the company to rehire the fired employees and also to desist in other antiunion activities (“Federal Judge Orders Employer to Reinstate Three Memphis Warehouse Workers and Stop Threatening Union Supporters While Case Proceeds at NLRB,” Office of Public Affairs, National Labor Relations Board, news release, April 7, 2011, accessed April 7, 2011).

The Taft-Hartley Act also had major implications for unions. Passed in 1947, Taft-Hartley amended the Wagner Act. The act was introduced because of the upsurge of strikes during this time period. While the Wagner Act addressed unfair labor practices on the part of the company, the Taft-Hartley Act focused on unfair acts by the unions. For example, it outlawed strikes that were not authorized by the union, called wildcat strikes. It also prohibited secondary actions (or secondary boycotts) in which one union goes on strike in sympathy for another union. The act allowed the executive branch of the federal government to disallow a strike should the strike affect national health or security. One of the most famous injunctions was made by President Ronald Reagan in 1981. Air traffic controllers had been off the job for two days despite their no-strike oath, and Reagan ordered all of them (over eleven thousand) discharged because they violated this federal law.

The Landrum Griffin Act, also known as the Labor Management Reporting and Disclosure (LMRDA) Act, was passed in 1959. This act required unions to hold secret elections, required unions to submit their annual financial reports to the U.S. Department of Labor, and created standards governing expulsion of a member from a union. This act was created because of racketeering charges and corruptions charges by unions. In fact, investigations of the Teamsters Union found they were linked to organized crime, and the Teamsters were banned from the AFL-CIO. The goal of this act was to regulate the internal functioning of unions and to combat abuse of union members by union leaders.

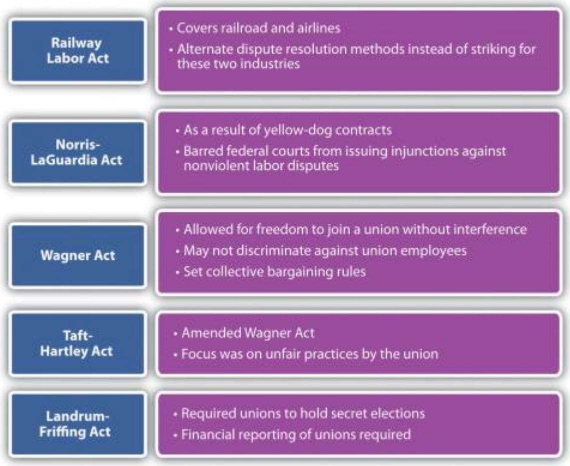


Figure 26.2.2: Major Acts Regarding Unions, at a Glance

The Unionization Process

There are one of two ways in which a unionization process can begin. First, the union may contact several employees and discuss the possibility of a union, or employees may contact a union on their own. The union will then help employees gather signatures to show that the employees want to be part of a union. To hold an election, the union must show signatures from over 30 percent of the employees of the organization.

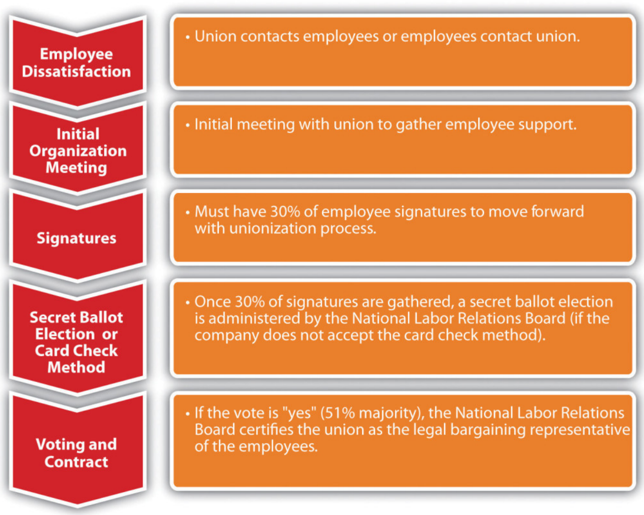


Figure 26.2.3: The Unionization Process

Once the signatures are gathered, the National Labor Relations Board is petitioned to move forward with a secret-ballot election. An alternative to the secret-ballot election is the card check method, in which the union organizer provides the company with authorization cards signed by a simple majority (half plus one). The employer can accept the cards as proof that the employees desire a union in their organization. The NLRB then certifies the union as the employees' collective bargaining representative.

If the organization does not accept the card check method as authorization for a union, the second option is via a secret ballot. Before this method is used, a petition must be filed by the NLRB, and an election is usually held two months after the petition is filed. In essence, the employees vote whether to unionize or not, and there must be a simple majority (half plus one). The NLRB is responsible for election logistics and counting of ballots. Observers from all parties can be present during the counting of votes. Once votes are counted, a decision on unionization occurs, and at that time, the collective bargaining process begins.

Once the NLRB is involved, there are many limits as to what the employer can say or do during the process to prevent unionization of the organization. It is advisable for HR and management to be educated on what can legally and illegally be said during this process. It is illegal to threaten or intimidate employees if they are discussing a union. You cannot threaten job, pay, or benefits loss as a result of forming a union. Figure 4, "Things That Shouldn't Be Said to Employees during a Unionization Process," below includes information on what should legally be avoided if employees are considering unionization.

Figure 26.2.4: Things That Shouldn't Be Said to Employees during a Unionization Process

Obviously, it's in the best interest of the union to have as many members as possible. Because of this, unions may use many tactics during the organizing process. For example, many unions are also politically involved and support candidates who they feel best represent labor. They provide training to organizers and sometimes even encourage union supporters to apply for jobs in nonunion environments to actively work to unionize other employees when they are hired. This practice is called union salting. Unions, especially on the national level, can be involved in corporate campaigns that boycott certain products or companies because of their labor practices. The United Food and Commercial Workers (UFCW), for example, has a "Wake Up Walmart Campaign" that targets the labor practices of this organization.

Strategies Companies Use to Avoid Unionization

Most organizations feel the constraints of having a union organization are too great. It affects the cost to the organization and operation efficiency. Collective bargaining at times can put management at odds with its employees and cost more to produce products and services. Ideally, companies will provide safe working conditions, fair pay, and benefits so the employees do not feel they need to form a union. There are three main phases of unionization, as follows:

1. **Phase 1:** Your organization is union-free and there is little or no interest in unionizing.
2. **Phase 2:** You learn that some employees are discussing unionization or you learn about specific attempts by the union to recruit employees.
3. **Phase 3:** You receive a petition from the National Labor Relations Board filed by a union requesting a unionization vote.

Because of increased costs and operational efficiency, it is normally in a company's best interest to avoid unionization. While in phase 1, it is important to review employee relations programs including pay, benefits, and other compensation. Ensure the compensation plans are fair so employees feel fairly treated and have no reason to seek the representation of a union.

Despite your best efforts, you could hear of unionization in your organization. The goal here is to prevent the union from gaining support to ask for a National Labor Relations Board election. Since only 30 percent of employees need to sign union cards for a vote to take place, this phase to avoid unionization is very important. During this time, HR professionals and managers should respond to the issues the employees have and also develop a specific strategy on how to handle the union vote, should it get that far.

In phase 3, familiarization with all the National Labor Relations Board rules around elections and communications is important. With this information, you can organize meetings to inform managers on these rules. At this time, you will likely want to draw up an antiunion campaign and communicate that to managers, but also make sure it does not violate laws. To this end, develop specific strategies to encourage employees to vote "no" for the union. Some of the arguments that might be used include talking with the employee and mentioning the following:

1. Union dues are costly.

2. Employees could be forced to go on strike.
3. Employees and management may no longer be able to discuss matters informally and individually.
4. Unionization can create more bureaucracy within the company.
5. Individual issues may not be discussed.
6. Many decisions within a union, such as vacation time, are based on seniority only.

With unionization in decline, it is likely you may never need to handle a new union in your organization. However, organizations such as Change to Win are in the process of trying to increase union membership. This organization has four affiliated unions, with a goal to strengthen the labor movement. Teamsters, United Food and Commercial Workers, United Farm Workers, and Service Employees International Union are all unions affiliated with this organization (Change to Win website, accessed April 7, 2011). The next few years will be telling as to the fate of unions in today's organizations.

Fortune 500 Focus

Perhaps no organization is better known for its antiunion stance than Walmart. Walmart has more than 3,800 stores in the United States and more than 4,800 internationally with $419 billion in sales ("Investors," Walmart Corporate, 2011, accessed August 15, 2011). Walmart employs more than 2 million associates worldwide ("Investors," Walmart Corporate, 2011, accessed August 15, 2011). The billions of dollars Walmart earns do not immunize the company against trouble. In 2005, the company's vice president, Tom Coughlin, was forced to resign after admitting that between $100,000 and $500,000 was spent for undeclared purposes, but it was eventually found that the money was spent to keep the United Food and Commercial Workers union (UFCW) out of Walmart (Los Angeles Times Wire Services, "Wal-Mart Accused of Unfair Labor Practices," accessed September 15, 2011). (He was found guilty and sentenced to two years of house arrest).

Other claims surrounding union busting are the closing of stores, such as the Walmart Tire and Lube Express in Gatineau, Quebec, UFCW Canada, when discussions of unionization occurred. Other reports of union busting include the accusation that company policy requires store managers to report rumors of unionizing to corporate headquarters. Once the report is made, all labor decisions for that store are handled by the corporate offices instead of the store manager. According to labor unions in the United States, Walmart is willing to work with international labor unions but continues to fiercely oppose unionization in the United States. In one example, after butchers at a Jacksonville, Texas, Walmart voted to unionize, Walmart eliminated all U.S. meat-cutting departments.

A group called OUR Walmart (Organization United for Respect), financed by the United Food and Commercial Workers* (UFCW) union, has stemmed from the accusations of union busting. Walmart spokesperson David Tovar says he sees the group as a Trojan horse assembled by labor organizations to lay the groundwork for full-fledged unionization and seek media attention to fulfill their agenda. While the organization's activities may walk a fine line between legal and illegal union practices under the Taft-Hartley Act, this new group will certainly affect the future of unionization at Walmart in its US stores.

*Note: UFCW was part of the AFL-CIO until 2005 and now is an independent national union.

The Impact of Unions on Organizations

You may wonder why organizations are opposed to unions. As we have mentioned, since union workers do receive higher wages, this can be a negative impact on the organization. Unionization also impacts the ability of managers to make certain decisions and limits their freedom when working with employees. For example, if an employee is constantly late to work, the union contract will specify how to discipline in this situation, resulting in little management freedom to handle problems themselves. In 2010, for example, the Art Institute of Seattle faculty filed signatures and voted on unionization ("Union Push in For-Profit Higher Ed,"*Inside Higher Ed*, May 24, 2010, accessed August 15, 2011). Some of the major issues were scheduling difficulties and office space, not necessarily pay and benefits. While the particular National Labor Relations Board vote was no to unionization, a yes vote could have given less freedom to management in scheduling, since scheduling would be based on collective bargaining contracts. Another concern about unionization for management is the ability to promote workers. A union contract may stipulate certain terms (such as seniority) for promotion, which means the manager has less control over the employees he or she can promote.

KEY TAKEAWAYS

- Union membership in the United States has been slowly declining. Today, union membership consists of about 11.9 percent of the workforce, while in 1983 it consisted of 20 percent of the workforce.

- The reasons for decline are varied, depending on whom you ask. Some say the moving of jobs overseas is the reason for the decline, while others say unions' hard-line tactics put them out of favor.
- Besides declining membership, union challenges today include globalization and companies' wanting a union-free workplace.
- The United States began its first labor movement in the 1800s. This was a result of low wages, no vacation time, safety issues, and other issues.
- Many labor organizations have disappeared, but the *American Federation of Labor (AFL)* still exists today, although it merged with the *Congress of Industrial Organizations (CIO)* and is now known as the AFL-CIO. It is the largest labor union and represents local labor unions in a variety of industries.
- The United States has a low number of union members compared with other countries. Much of Europe, for example, has over 30 percent of their workforce in labor unions, while in some countries as much as 50 percent of the workforce are members of a labor union.
- Legislation has been created over time to support both labor unions and the companies who have labor unions. The *Railway Labor Act* applies to airlines and railroads and stipulates that employees may not strike until they have gone through an extensive dispute resolution process. The *Norris-LaGuardia Act*made *yellow-dog contracts* illegal and barred courts from issuing injunctions.
- The *Wagner Act* was created to protect employees from retaliation should they join a union. The *Taft-Hartley Act* was developed to protect companies from unfair labor practices by unions.
- The *National Labor Relations Board* is the overseeing body for labor unions, and it handles disputes between companies as well as facilitates the process of new labor unions in the developing stages. Its job is to enforce both the Wagner Act and the Taft-Hartley Act.
- The *Landrum Griffin Act* was created in 1959 to combat corruption in labor unions during this time period.
- To form a union, the organizer must have signatures from 30 percent of the employees. If this occurs, the National Labor Relations Board will facilitate a card check to determine more than 50 percent of the workforce at that company is in agreement with union representation. If the company does not accept this, then the NLRB holds secret elections to determine if the employees will be unionized. A collective bargaining agreement is put into place if the vote is yes.
- Companies prefer to not have unions in their organizations because it affects costs and operational productivity. Companies will usually try to prevent a union from organizing in their workplace.
- Managers are impacted when a company does unionize. For example, management rights are affected, and everything must be guided by the contract instead of management prerogative.

Contributors and Attributions

26.3: Reading- Collective Bargaining

The Process of Collective Bargaining

When employees of an organization vote to unionize, the process for collective bargaining begins. Collective bargaining is the process of negotiations between the company and representatives of the union. The goal is for management and the union to reach a contract agreement, which is put into place for a specified period of time. Once this time is up, a new contract is negotiated. In this section, we will discuss the components of the collective bargaining agreement.

In any bargaining agreement, certain management rights are not negotiable, including the right to manage and operate the business, hire, promote, or discharge employees. However, in the negotiated agreement there may be a process outlined by the union for how these processes should work. Management rights also include the ability of the organization to direct the work of the employees and to establish operational policies. As an HR professional sits at the bargaining table, it is important to be strategic in the process and tie the strategic plan with the concessions the organization is willing to make and the concessions the organization will not make.

Another important point in the collective bargaining process is the aspect of union security. Obviously, it is in the union's best interest to collect dues from members and recruit as many new members as possible. In the contract, a checkoff provision may be negotiated. This provision occurs when the employer, on behalf of the union, automatically deducts dues from union members' paychecks. This ensures that a steady stream of dues is paid to the union.

To recruit new members, the union may require something called a union shop. A union shop requires a person to join the union within a certain time period of joining the organization. In right-to-work states a union shop may be illegal. Twenty-two states have passed right-to-work laws, as you can see below in Figure 5, "Map of Right-to-Work States." These laws prohibit a requirement to join a union or pay dues and fees to a union. To get around these laws, agency shops were created. An agency shop is similar to a union shop in that workers do not have to join the union but still must pay union dues. Agency shop union fees are known as agency fees and may be illegal in right-to-work states. A closed shop used to be a mechanism for a steady flow of membership. In this arrangement, a person must be a union member to be hired. This, however, was made illegal under the Taft-Hartley Act. According to a study by CNBC, all twenty-two right-to-work states are in the top twenty-five states for having the best workforces ("Best Workforces Are in Right to Work States," Redstate, June 30, 2011, accessed August 14, 2011). However, according to the AFL-CIO, the average worker in a right-to-work state makes $5,333 less per year than other workers ("Right to Work for Less," AFL-CIO, accessed August 14, 2011).

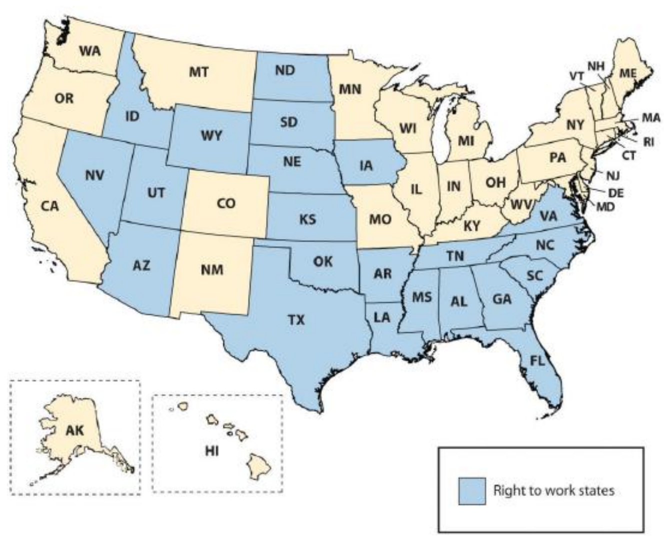


Figure 26.3.1: Map of Right-to-Work States

In a collective bargaining process, both parties are legally bound to bargain in good faith. This means they have a mutual obligation to participate actively in the deliberations and indicate a desire to find a basis for agreement. There are three main classification of bargaining topics: mandatory, permissive, and illegal. Wages, health and safety, management rights, work conditions, and benefits fall into the mandatory category. Permissive topics are those that are not required but may be brought up during the process. An example might include the requirement of drug testing for candidates or the required tools that must be provided to the employee to perform the job, such as a cellular phone or computer. It is important to note that while management is not required by labor laws to bargain on these issues, refusing to do so could affect employee morale. We can also classify bargaining issues as illegal topics, which obviously cannot be discussed. These types of illegal issues may be of a discriminatory nature or anything that would be considered illegal outside the agreement.

Examples of Bargaining Topics

- Pay rate and structure
- Health benefits
- Incentive programs
- Job classification
- Performance assessment procedure
- Vacation time and sick leave
- Health plans
- Layoff procedures
- Seniority
- Training process
- Severance pay
- Tools provided to employees
- Process for new applicants

The collective bargaining process has five main steps; we will discuss each of these steps next. The first step is the preparation of both parties. The negotiation team should consist of individuals with knowledge of the organization and the skills to be an effective negotiator. An understanding of the working conditions and dissatisfaction with working conditions is an important part of this preparation step. Establishing objectives for the negotiation and reviewing the old contract are key components to this step. The management team should also prepare and anticipate union demands, to better prepare for compromises.

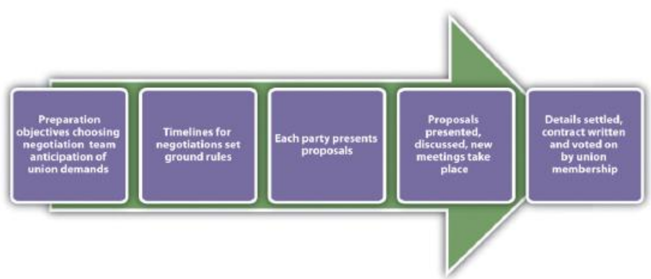


Figure 26.3.2: Steps in Collective Bargaining

The second step of the process involves both parties agreeing on how the time lines will be set for the negotiations. In addition, setting ground rules for how the negotiation will occur is an important step, as it lays the foundation for the work to come.

In the third step, each party comes to the table with proposals. It will likely involve initial opening statements and options that exist to resolve any situations that exist. The key to a successful proposal is to come to the table with a "let's make this work" attitude. An initial discussion is had and then each party generally goes back to determine which requests it can honor and which it can't. At this point, another meeting is generally set up to continue further discussion.

Once the group comes to an agreement or settlement (which may take many months and proposals), a new contract is written and the union members vote on whether to accept the agreement. If the union doesn't agree, then the process begins all over again.

Ramifications of a Bargaining Impasse

When the two parties are unable to reach consensus on the collective bargaining agreement, this is called a bargaining impasse. Various kinds of strikes are used to show the displeasure of workers regarding a bargaining impasse. An economic strike is a strike stemming from unhappiness about the economic conditions during contract negotiations. For example, 45,000 Verizon workers rallied in the summer of 2011 when contract negotiations failed (Dan Goldberg, "Verizon Strike Could Last Months," *New Jersey News*, August 7, 2011). The two unions, Communications Workers of America and the International Brotherhood of Electric Workers, claim that the new contract is unfair, as it asks Verizon workers to contribute more to health plans, and the company is also looking to freeze pensions at the end of the year and reduce sick time (Dan Goldberg, “Verizon Strike Could Last Months,” *New Jersey News*, August 7, 2011). Verizon says the telecommunications business is changing, and it cannot afford these expenses.

An unfair labor practices strike can happen during negotiations. The goal of an unfair labor practices strike is to get the organization to cease committing what the union believes to be an unfair labor practice. A bargaining impasse could mean the union goes on strike or a lockout occurs. The goal of a lockout, which prevents workers from working, is to put pressure on the union to accept the contract. A lockout can only be legally conducted when the existing collective bargaining agreement has expired and there is truly an impasse in contract negotiations. In summer 2011, the National Basketball Association locked out players when the collective bargaining agreement expired, jeopardizing the 2011–12 season while putting pressure on the players to accept the agreement (Steve Kyler, “Division among Owners?” *Hoops World*, August 8, 2011, accessed August 15, 2011). Similarly, the goal of a strike is to put pressure on the organization to accept the proposed contract. Some organizations will impose a lockout if workers engage in slowdowns, an intentional reduction in productivity. Some unions will engage in a slowdown instead of a strike, because the workers still earn pay, while in a strike they do not.

A sick-out is when members of a union call in sick, which may be illegal since they are using allotted time, while a walk-out is an unannounced refusal to perform work. However, this type of tactic may be illegal if the conduct is irresponsible or indefensible, according to a judge. Jurisdictional strikes are used to put pressure on an employer to assign work to members of one union versus another (if there are two unions within the same organization) or to put pressure on management to recognize one union representation when it currently recognizes another. The goal of a sick-out strike is to show the organization how unproductive the company would be if the workers did go on strike. As mentioned under the Taft-Hartley Act, wildcat strikes are illegal, as they are not authorized by the union and usually violate a collective bargaining agreement. Sympathy strikes are work stoppages by other unions designed to show support for the union on strike. While they are not illegal, they may violate the terms of the collective bargaining agreement.

KEY TAKEAWAYS

- A union has two goals: to add new members and to collect dues. A *check-off provision* of a contract compels the organization to take union dues out of the paycheck of union members.
- In a *union shop*, people must join the union within a specified time period after joining the organization. This is illegal in *right-to-work states*. An *agency shop* is one where union membership is not required but union dues are still required to be paid. This may also be illegal in *right-to-work states*.
- Made illegal by the Taft-Hartley Act, a *closed shop* allows only union members to apply and be hired for a job.
- *Collective bargaining* is the process of negotiating the contact with union representatives. Collective bargaining, to be legal, must always be done in good faith.
- There are three categories of collective bargaining issues. *Mandatory issues* might include pay and benefits. *Permissive bargaining* items may include things such as drug testing or the required equipment the organization must supply to employees. *Illegal issues* are those things that cannot be discussed, which can include issues that could be considered discriminatory.
- The collective bargaining process can take time. Both parties prepare for the process by gathering information and reviewing the old contract. They then set time lines for the bargaining and reveal their wants and negotiate those wants. A *bargaining impasse* occurs when members cannot come to an agreement.
- When a bargaining impasse occurs, a *strike* or *lockout* of workers can occur. An *economic strike* occurs during negotiations, while an *unfair labor practices strike* can occur anytime, and during negotiations. A *sick-out* can also be used, when workers call in sick for the day. These strategies can be used to encourage the other side to agree to collective bargaining terms.
- Some tips for working with unions include knowing and following the contract, involving unions in company decisions, and communicating with transparency.

Contributors and Attributions

26.4: Reading- Employee Rights- Job Protection and Privacy

Job Protection Rights

Employee rights is defined as the ability to receive fair treatment from employers. This section will discuss employee rights surrounding job protection and privacy.

If HR doesn't understand or properly manage employee rights, lawsuits are sure to follow. It's the HR professional's job to understand and protect the rights of employees. In the United States, the employment-at-will principle (EAW) is the right of an employer to fire an employee or an employee to leave an organization at any time, without any specific cause. The EAW principle gives both the employee and employer freedom to terminate the relationship at any time. There are three main exceptions to this principle, and whether they are accepted is up to the various states:

1. **Public policy exception.** With a public policy exception, an employer may not fire an employee if it would violate the individual state's doctrine or statute. For example, in *Borse v. Piece Goods Shop* in Pennsylvania, a federal circuit court of appeals ruled that Pennsylvania law may protect at-will employees from being fired for refusing to take part in drug test programs if the employee's privacy is invaded. Borse contended that the free speech provisions of the state and of the First Amendment protected the refusal to participate. Some public policy exceptions occur when an employee is fired for refusing to violate state or federal law.
2. **Implied contract exception.** In a breach of an implied contract, the discharged employee can prove that the employer indicated that the employee has job security. The indication does not need to be formally written, only implied. In *Wright v. Honda*, an Ohio employee was terminated but argued that the implied contract exception was relevant to the employment-at-will doctrine. She was able to prove that in orientation, Honda stressed to employees the importance of attendance and quality work. She was also able to prove that the language in the associate handbook implied job security: "the job security of each employee depends upon doing your best on your job with the spirit of cooperation." Progress reports showing professional development further solidified her case, as she had an implied contract that Honda had altered the employment-at-will doctrine through its policies and actions.
3. **Good faith and fair dealing exception.** In the good faith and fair dealing exception, the discharged employee contends that he was not treated fairly. This exception to the employment-at-will doctrine is less common than the first two. Examples might include firing or transferring of employees to prevent them from collecting commissions, misleading employees about promotions and pay increases, and taking extreme actions that would force the employee to quit.

Table $26.4.1$. State's Acceptance of Employment-at-Will Exceptions

State	Public-Policy Exception	Implied-Contract Exception	Good Faith and Fair Dealing Exception
Alabama	no	yes	yes
Alaska	**yes**	**yes**	**yes**
Arizona	**yes**	**yes**	**yes**
Arkansas	yes	yes	no
California	**yes**	**yes**	**yes**
Colorado	yes	yes	no
Connecticut	yes	yes	no
Delaware	yes	no	yes
District of Columbia	yes	yes	no
Florida	*no*	*no*	*no*
Bold text indicates a state with all three exceptions.			
Italic text indicates a state with none of the three exceptions.			

State	Public-Policy Exception	Implied-Contract Exception	Good Faith and Fair Dealing Exception
Georgia	*no*	*no*	*no*
Hawaii	yes	yes	no
Idaho	**yes**	**yes**	**yes**
Illinois	yes	yes	no
Indiana	yes	no	no
Iowa	yes	yes	no
Kansas	yes	yes	no
Kentucky	yes	yes	no
Louisiana	*no*	*no*	*no*
Maine	no	yes	no
Maryland	yes	yes	no
Massachusetts	yes	no	yes
Michigan	yes	yes	no
Minnesota	yes	yes	no
Mississippi	yes	yes	no
Missouri	yes	no	no
Montana	yes	no	no
Nebraska	no	yes	no
Nevada	**yes**	**yes**	**yes**
New Hampshire	yes	yes	no
New Jersey	yes	yes	no
New Mexico	yes	yes	no
New York	no	yes	no
North Carolina	yes	no	no
North Dakota	yes	yes	no
Ohio	yes	yes	no
Oklahoma	yes	yes	no
Oregon	yes	yes	no
Pennsylvania	yes	no	no
Rhode Island	*no*	*no*	*no*
South Carolina	yes	yes	No
South Dakota	yes	yes	no
Bold text indicates a state with all three exceptions.			
Italic text indicates a state with none of the three exceptions.			

State	Public-Policy Exception	Implied-Contract Exception	Good Faith and Fair Dealing Exception
Tennessee	yes	yes	no
Texas	yes	no	no
Utah	**yes**	**yes**	**yes**
Vermont	yes	yes	no
Virginia	yes	no	no
Washington	yes	yes	no
West Virginia	yes	yes	no
Wisconsin	yes	yes	no
Wyoming	**yes**	**yes**	**yes**
Bold text indicates a state with all three exceptions.			
Italic text indicates a state with none of the three exceptions.			

When one of the exceptions can be proven, wrongful discharge accusations may occur. The United States is one of the few major industrial powers that utilize an employment-at-will philosophy. Most countries, including France and the UK, require employers to show just cause for termination of a person's employment (USLegal, "Employment at Will," accessed March 15, 2011). The advantage of employment at will allows for freedom of employment; the possibility of wrongful discharge tells us that we must be prepared to defend the termination of an employee, as to not be charged with a wrongful discharge case.

Employees also have job protection if they engage in whistleblowing. Whistleblowing refers to an employee's telling the public about ethical or legal violations of his or her organization. This protection was granted in 1989 and extended through the Sarbanes-Oxley Act of 2002. Many organizations create whistleblowing policies and a mechanism to report illegal or unethical practices within the organization (Lilanthi Ravishankar, "Encouraging Internal Whistle Blowing," Santa Clara University, accessed March 15, 2011).

Another consideration for employee job protection is that of an implied contract. It is in the best interest of HR professionals and managers alike to avoid implying an employee has a contract with the organization. In fact, many organizations develop employment-at-will policies and ask their employees to sign these policies as a disclaimer for the organization.

A constructive discharge means the employee resigned, but only because the work conditions were so intolerable that he or she had no choice. For example, if James is being sexually harassed at work, and it is so bad he quits, he would need to prove not only the sexual harassment but that it was so bad it required him to quit. This type of situation is important to note; should James's case go to court and sexual harassment and constructive discharge are found, James may be entitled to back pay and other compensation.

The Worker Adjustment and Retraining Notification Act (WARN) requires organizations with more than one hundred employees to give employees and their communities at least sixty days' notice of closure or layoff affecting fifty or more full-time employees. This law does not apply in the case of unforeseeable business circumstances. If an employer violates this law, it can be subject to back pay for employees (US Department of Labor, "WARN Fact Sheet," accessed March 15, 2011). This does not include workers who have been with the organization for less than six months, however.

Retaliatory discharge means punishment of an employee for engaging in a protected activity, such as filing a discrimination charge or opposing illegal employer practices. For example, it might include poor treatment of an employee because he or she filed a workers' compensation claim. Employees should not be harassed or mistreated should they file a claim against the organization.

Privacy Rights

Technology makes it possible to more easily monitor aspects of employees' jobs, although a policy on this subject should be considered before implementing it. In regard to privacy, there is a question about whether an employer should be allowed to monitor an employee's online activities. This may include work e-mail, websites visited using company property, and also personal activity online.

Digital Footprints, Inc. is a company that specializes in tracking the digital movements of employees and can provide reports to the organization by tracking these footprints. This type of technology might look for patterns, word usage, and other communication patterns between individuals. This monitoring can be useful in determining violations of workplace policies, such as sexual harassment. This type of software and management can be expensive, so before launching it, it's imperative to address its value in the workplace.

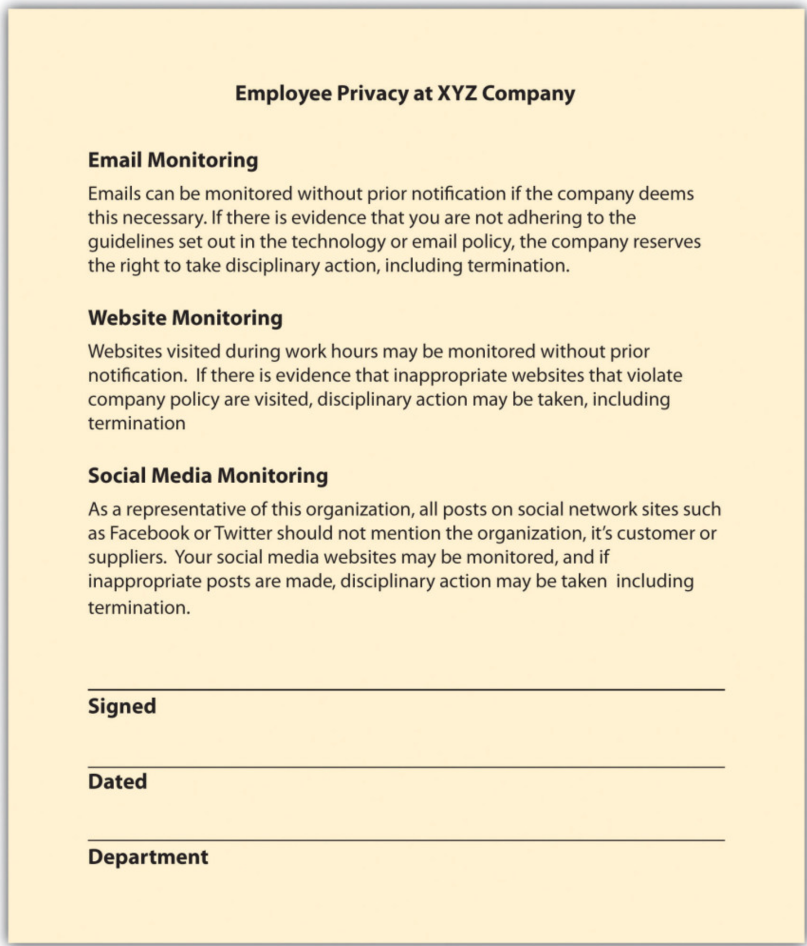
Another privacy concern can include monitoring of employee postings on external websites. Companies such as Social Sentry, under contract, monitor employee postings on sites such as Facebook, Twitter, LinkedIn, and YouTube (Teneros Corporation, "Social Sentry Lets Employers Track Their Workers across the Internet," accessed March 17, 2011). Lawyers warn, however, that this type of monitoring should only be done if the employee has consented (People Management, "Employers Should Have Monitoring Policy for Social Networks," accessed March 17, 2011). A monitoring company isn't always needed to monitor employees' movements on social networking. And sometimes employees don't even have to tweet something negative about their own company to lose their job. A case in point is when Chadd Scott, who does Atlanta sports updates for 680/The Fan, was fired for tweeting about Delta Airlines. In his tweet, he complained about a Delta delay and said they did not have enough de-icing fluid. Within a few hours, he was fired from his job, because Delta was a sponsor of 680/The Fan (Rodney Ho, "Chadd Scott Said He Was Fired for Tweets about Delta," *Access Atlanta* (blog), accessed March 16, 2011).

The US Patriot Act also includes caveats to privacy when investigating possible terrorist activity. The Patriot Act requires organizations to provide private employee information when requested. Overall, it is a good idea to have a clear company policy and perhaps even a signed waiver from employees stating they understand their activities may be monitored and information shared with the US government under the Patriot Act.

Depending on the state in which you live, employees may be given to see their personnel files and the right to see and correct any incorrect information within their files. Medical or disability information should be kept separate from the employee's work file, per the Americans with Disabilities Act. In addition, the Health Insurance Portability and Accountability Act (HIPAA) mandates that health information should be private, and therefore it is good practice to keep health information in a separate file as well.

Finally, drug testing and the right to privacy is a delicate balancing act. Organizations that implement drug testing often do so for insurance or safety reasons. Because of the Drug-Free Workplace Act of 1988Requires that some federal contractors and all federal grantees agree they will provide a drug-free workplace as a condition of obtaining a contract., some federal contractors and all federal grantees must agree they will provide a drug-free workplace, as a condition of obtaining the contract. The ADA does not view testing for illegal drug use as a medical examination (making them legal), and people using illegal drugs are not protected under the ADA (US Equal Employment Opportunity Commission, "The ADA, Your Responsibilities as an Employer," accessed August 1, 2011). However, people covered under ADA laws are allowed to take medications directly related to their disability. In a recent case, *Bates v. Dura Automotive Systems*, an auto parts manufacturer had a high accident rate and decided to implement drug testing to increase safety. Several prescription drugs were banned because they were known to cause impairment. The plaintiffs in the case had been dismissed from their jobs because of prescription drug use, and they sued, claiming the drug-testing program violated ADA laws (Jackson lewis, "Employees' ADA Claims on Prescription-Drug-Use Dismissals Rejected by Federal Court," December 1, 2010, accessed August 1, 2011). However, the Sixth Circuit Court reversed the case because the plaintiffs were not protected under ADA laws (they did not have a documented disability).

In organizations where heavy machinery is operated, a monthly drug test may be a job requirement. In fact, under the Omnibus Transportation Employee Testing Act of 1991, employers are legally required to test for drugs in transportation-related businesses such as airlines, railroads, trucking, and public transportation, such as bus systems. Medical marijuana is a relatively new issue that is still being addressed in states that allow its use. For example, if the company requires a drug test and the employee shows positive for marijuana use, does asking the employee to prove it is being used for medical purposes violate HIPAA privacy laws? This issue is certainly one to watch over the coming years.



Employee Privacy at XYZ Company

Email Monitoring

Emails can be monitored without prior notification if the company deems this necessary. If there is evidence that you are not adhering to the guidelines set out in the technology or email policy, the company reserves the right to take disciplinary action, including termination.

Website Monitoring

Websites visited during work hours may be monitored without prior notification. If there is evidence that inappropriate websites that violate company policy are visited, disciplinary action may be taken, including termination

Social Media Monitoring

As a representative of this organization, all posts on social network sites such as Facebook or Twitter should not mention the organization, it's customer or suppliers. Your social media websites may be monitored, and if inappropriate posts are made, disciplinary action may be taken including termination.

Signed

Dated

Department

Figure 26.4.1: Sample Policies on Privacy Relating to Technology

KEY TAKEAWAYS

- The *employment-at-will principle* means that an employer can separate from an employee without cause, and vice versa.
- Even though we have employment at will, a wrongful discharge can occur when there are violations of public policy, an employee has a contract with an employer, or an employer does something outside the boundaries of good faith.
- *Whistleblowing* is when an employee notifies organizations of illegal or unethical activity. Whistleblowers are protected from discharge due to their activity.
- A *constructive discharge* means the conditions are so poor that the employee had no choice but to leave the organization.
- The *Worker Adjustment and Retraining Notification Act (WARN)* is a law that requires companies of one hundred or more employees to notify employees and the community if fifty or more employees are to be laid off.
- A *retaliatory discharge* is one that occurs if an employer fires or lays off an employee owing to a charge the employee filed. For example, if an employee files a workers' compensation claim and then is let go, this could be a retaliatory discharge.
- The privacy of employees is an issue that HR must address. It is prudent to develop policies surrounding what type of monitoring may occur within an organization. For example, some organizations monitor e-mail, computer usage, and even postings on social network sites.
- Drug testing is also a privacy issue, although in many industries requiring safe working conditions, drug testing can be necessary to ensure the safety of all employees.

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26.5: Reading- Multiculturalism and the Law

Multiculturalism and the Law

As we already know, it is in an organization's best interest to hire and promote a multicultural and diverse workforce. Sometimes though, people are still discriminated against at work. As a result, a federal agency has been established to ensure employees have a place to file complaints should they feel discriminated against.

Equal Employment Opportunity Commission (EEOC)

The Equal Employment Opportunity Commission (EEOC) is a federal agency charged with the task of enforcing federal employment discrimination laws. The laws include those that protect people from discrimination in all areas of employment, such as discrimination based on race, color, religion, sex, national origin, age, and disability. People who have filed a discrimination charge are also protected against discrimination under the EEOC. Employers with at least fifteen employees (twenty for age discrimination) are covered under the EEOC. This agency covers not only discrimination in hiring but also discrimination in all types of work situations such as firing, promotions, harassment, training, wages, and benefits. The EEOC has the authority to investigate charges of discrimination against employers. The agency investigates the claims, makes a finding, and then tries to settle the charge. If they are unsuccessful in settling the charge, the EEOC has the right to file a lawsuit on behalf of the complainants. The EEOC has headquarters in Washington, DC, with fifty-three field offices throughout the United States.

If a company has more than one hundred employees, a form called the EEO-1 must be filled out yearly. This form confirms the demographics of an organization based on different job categories (Equal Opportunity Employment Commission, *2011 EEO-1 Survey*, accessed December 20, 2010). An organization that employs more than fifty people and works for the federal government must also file an EEO-1 yearly, with the deadline normally in September. In addition, organizations must post the EEOC notice, which you have probably seen before, perhaps in the company break room. Finally, organizations should keep on file records such as hiring statistics in the event of an EEOC investigation.

It is necessary to mention here that while there is a legal compliance concern, as discussed before, it is in the company's best interest to hire a diverse workforce. So while we can discuss the legal aspects, remember that the purpose of having a diverse workforce is not just to meet EEOC requirements but to create a better, more profitable workplace that better serves customers.

Table 26.5.1. How the EEOC Process Works and Requirements for Employers

Requirements by EEOC
Post Federal and State EEOC notices
File yearly report called EEO-1
Keep copies of documents on file
Process for Investigation
1. The EEOC complaint is filed.
2. The EEOC notifies the organization of the charges.
3. The EEOC acts as a mediator between the employee and the employer to find a solution.
4. If step 3 is unsuccessful, the EEOC will initiate an investigation.
5. The EEOC makes a determination, and then the employer has the option of remedying the situation or face a potential lawsuit.

EEOC Federal Legislation

While the EEOC is the larger governing body, many pieces of legislation relating to multicultural practices are part of the EEOC family of laws. Many of these laws began with Title VII of the Civil Rights Act in 1964. This act, enforced by the EEOC, covers several areas in which discrimination was rampant. However, a bona fide occupational qualification (BFOQ) is a quality or attribute employers are allowed to consider when making decisions during the selection process. Examples of BFOQs are a maximum age limit for airline pilots for safety reasons and a Christian college's requirement that the president of the college be Christian.

EEOC laws relate specifically to the following:

1. Age
2. Disability
3. Equal pay
4. Genetic information
5. National origin
6. Pregnancy
7. Race/color
8. Religion
9. Retaliation
10. Sex
11. Sexual harassment

Age

Age discrimination involves treating someone less favorably because of his or her age. Created in 1967, the Age Discrimination in Employment Act (ADEA) is enforced by the EEOC. This law covers people who are age forty or older. It does not cover favoring an older worker over a younger worker, if the older worker is forty years or older. The law covers any aspect of employment such as hiring, firing, pay, job assignments, promotions, layoffs, training, fringe benefits, and any other condition or term of employment.

The law also goes deeper by forbidding harassment of someone based on age. While simple teasing or offhand comments are not covered, more serious offensive remarks about age are covered by this EEOC law.

Disability

The Americans with Disabilities Act (ADA) prohibits discrimination against those with disabilities and is enforced by the EEOC. Discrimination based on disability means treating a qualified person unfavorably because of a disability. For example, if someone has AIDS that is controlled, the employee cannot be treated unfavorably. The law requires an employer to provide reasonable accommodation to an employee or applicant with a disability, unless this accommodation would cause significant difficulty or expense for the employer. A reasonable accommodation is defined by the EEOC as any change in the work environment or in the way things are customarily done that enables an individual with a disability to enjoy equal employment opportunities. A reasonable accommodation might include making the workplace accessible for wheelchair use or providing equipment for someone who is hearing or vision impaired.

This law does not mean that organizations are required to hire unqualified people. The law specifically states the person must be qualified for the job and have a disability defined by the law. A disability defined by the law can include the following:

1. Physical or mental condition that limits a major life activity (walking, talking, seeing, hearing, or learning)
2. History of a disability (e.g., cancer that is in remission)
3. Physical or mental impairment that is not transitory (lasting or expected to last less than six months)

The law places limits on employers when it comes to asking job applicants questions about medical history or asking a person to take a medical exam.

Equal Pay/Compensation

The basis of this law is that people are paid the same for the same type of work, and the law specifically addresses gender pay differences. Rather than job title, job content is used to determine if the job is the same work. In addition to covering salary, it deals with overtime pay, bonus, stock options, profit sharing, and other types of bonus plans such as vacation and holiday pay. If inequality in pay is found, the employer cannot reduce the wages of either sex to equalize the pay.

An employee who files an equal pay charge has the option to go directly to court rather than the EEOC.

Genetic Information

This law is one of the newer EEOC laws, which took effect in November 2009. The EEOC's definition of genetic information includes family medical information or information about the manifestation of a disease or disorder in an individual's family. For example, an employer cannot discriminate against an employee whose family has a history of diabetes or cancer. This information could be used to discriminate against an employee who has an increased risk of getting a disease and may make health-care costs more expensive for the organization.

In addition, the employer is not allowed to seek out genetic information by requesting, requiring, or purchasing this information. However, there are some situations in which receiving this information would not be illegal:

1. A manager or supervisor overhears an employee talking about a family member's illness.
2. Information is received based on wellness programs offered on a voluntary basis.
3. If the information is required as documentation to receive benefits for the Family and Medical Leave Act (FMLA). FMLA is discussed in Section 3 "Pregnancy".
4. If the information is commercial, such as the appearance of information in a newspaper, as long as the employer is not specifically searching those sources for the purpose of finding genetic information.
5. If genetic information is required through a monitoring program that looks at the biological effects of toxic substances in the workplace.
6. For those professions that require DNA testing, such as law enforcement agencies. In this case, the genetic information may only be used for analysis in relation to the specific case at hand.

This law also covers how information about genetics should be kept. For example, genetic information must be kept separate from an employee's regular file.

National Origin

It is illegal to treat people unfavorably because they are from a particular country or part of the world, because of their accent, or because they appear to be of a particular descent (even if they are not). The law protecting employees based on national origin refers to all aspects of employment: hiring, firing, pay, job assignments, promotions, layoffs, training, and fringe benefits. An employer can require an employee to speak English only if it is necessary to perform the job effectively. An English-only policy is allowed only if it is needed to ensure the safe or efficient operations of the employer's business. An employer may not base an employment decision on a foreign accent, unless the accent seriously interferes with job performance.

Pregnancy

This section of the EEOC refers to the unfavorable treatment of a woman because of pregnancy, childbirth, or a medical condition related to pregnancy or childbirth. The Pregnancy Discrimination Act of 1978, added to the Civil Rights Act of 1964, is enforced by the EEOC. The woman who is unable to perform her job owing to pregnancy must be treated the same as other temporarily disabled employees. For example, modified tasks or alternative assignments should be offered. This law refers not only to hiring but also to firing, pay, job assignments, promotions, layoffs, training, and fringe benefits. In addition to this law against discrimination of pregnant women, the Family and Medical Leave Act (FMLA) is enforced by the US Department of Labor (US Department of Labor, *Leave Benefits: Family and Medical Leave*, US Department of Labor, accessed December 20, 2010). The FMLA requires companies with fifty or more employees to provide twelve weeks of unpaid leave for the following:

1. Birth and care of a newborn child
2. Care of an adopted child
3. Care for immediate family members (spouse, child, or parent) with a serious health condition
4. Medical leave for the employee who is unable to work because of a serious health condition

In addition to the company size requirement, the employee must have worked at least 1,250 hours over the past 12 months.

Race/Color

This type of discrimination refers to treating someone unfavorably because he or she is of a certain race or because of certain characteristics associated with race. These characteristics might include hair texture, skin color, or facial features. Discrimination can occur when the person discriminating is the same race or color of the person who is being discriminated against. EEOC law also protects people who are married to or associated with someone of a certain race or color. As with the other types of antidiscrimination laws we have discussed, this law refers not only to the initial hiring but also to firing, pay, job assignments, promotions, layoffs, training, and fringe benefits.

Religion

This part of the EEOC refers to treating a person unfavorably because of their religious beliefs. This law requires a company to reasonably accommodate an employee's religious beliefs or practices, unless doing so would burden the organization's operations. For example, allowing flexible scheduling during certain religious periods of time might be considered a reasonable accommodation. This law also covers accommodations in dress and grooming, such as a headscarf, religious dress, or uncut hair and a beard in the case of a Sikh. Ideally, the employee or applicant would notify the employer that he or she needs such an accommodation for religious reasons, and then a discussion of the request would occur. If it wouldn't pose hardship, the employer should honor the request. If the request might cause a safety issue, decrease efficiency, or infringe on the rights of other employees, it may not be honored.

Retaliation

In all the laws mentioned, the EEOC set of laws makes it illegal to fire, demote, harass, or retaliate against people because they filed a charge of discrimination, complained about discrimination, or participated in employment discrimination proceedings. Perhaps one of the most high-profile sexual harassment and retaliation cases was that of *Sanders v. Thomas*. Isiah Thomas, then coach of the New York Knicks, fired Anucha Browne Sanders because she hired an attorney to file sexual harassment claims charges. The jury awarded Browne Sanders $11.6 million in punitive charges because of the hostile work environment Thomas created and another $5.6 million because Browne Sanders was fired for complaining (Michael Schmidt, "Jury Awards $11.6 Million to Former Knicks Executive," *New York Times*, October 2, 2007, accessed July 12, 2011). A portion of the lawsuit was to be paid by Madison Square Garden and James Dolan, chairman of Cablevision, the parent company of Madison Square Garden and the Knicks. Browne Sanders's lawyers successfully argued that the inner workings of Madison Square Garden were hostile and lewd, and that the former marketing executive of the organization subjected her to hostility and sexual advances. Thomas left the organization as coach and president in 2008. As in this case, there are large financial and public relations penalties not only for sexual harassment but for retaliation after a harassment suit has been filed.

Sex and Sexual Harassment

Sex discrimination involves treating someone unfavorably because of their sex. As with all EEOC laws, this relates to hiring, firing, pay, job assignments, promotions, layoffs, training, and fringe benefits. This law directly ties into sexual harassment laws, which include unwelcome sexual advances, requests for sexual favors, and other verbal or physical harassment of a sexual nature. The victim can be male or female, and sexual harassment can occur female to female, female to male, male to female, and male to male.

Harassment at Yale? The following 2011 video outlines a sexual harassment lawsuit at Yale University. It shows that the lawsuit blamed Yale not for the harassment but for not taking a harder stand on this type of harassment.

Military Service

The Uniformed Services Employment and Reemployment Rights Act (USERR) protects people who serve or have served in the armed forces, Reserves, National Guard, or other uniformed services. The act ensures these individuals are not disadvantaged in their civilian careers because of their service. It also requires they be reemployed in their civilian jobs upon return to service and prohibits discrimination based on past, present, or future military service.

KEY TAKEAWAYS

- The *Equal Employment Opportunity Commission (EEOC)* is a federal agency charged with the development and enforcement of laws relating to multiculturalism and diversity in the workplace.
- The EEOC covers discrimination based on several areas. Companies cannot discriminate based on age; EEOC law covers people who are forty years or older.

- Employers cannot discriminate against people with disabilities and must provide reasonable accommodations, such as the addition of a wheelchair ramp to accommodate those with disabilities.
- Equal pay refers to the fact people should legally be paid the same amount for performing the same type of work, even if the job title is different.
- The newest addition to EEOC law prohibits discrimination based on genetic information, such as a history of cancer in a family.
- Unfavorable treatment of people because they are from a particular country or part of the world or have an accent is covered by the EEOC. An organization cannot require people to speak English, unless it is a requirement for the job or needed for safety and efficient operation of the organization.
- Women can't be discriminated against because they are pregnant. The inability to perform certain tasks due to pregnancy should be treated as a temporary disability; accommodation can be in the form of modified tasks or alternative assignments.
- The EEOC protects people from discrimination based on their race or color.
- Religion is also an aspect of the EEOC family of laws. The protection of religion doesn't allow for discrimination; accommodations include modifications of work schedules or dress to be made for religious reasons.
- Discrimination on the basis of sex is illegal and covered by the EEOC. Sexual harassment is also covered by the EEOC and states that all people, regardless of sex, should work in a harassment-free environment.
- Retaliation is also illegal. An organization cannot retaliate against anyone who has filed a complaint with the EEOC or a discrimination lawsuit.
- The US Department of Labor oversees some aspects of EEOC laws, such as the *Family and Medical Leave Act (FMLA)*. This act requires organizations to give twelve weeks of unpaid leave in the event of an adoption, a birth, or a need to provide care to sick family members.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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26.6: Reading- The Recruitment Process

The Recruitment Process

The recruitment process is an important part of human resource management (HRM). It doesn't happen without proper strategic planning. Recruitment is defined as a process that provides the organization with a pool of qualified job candidates from which to choose. Before companies recruit, they must implement proper staffing plans and forecasting to determine how many people they will need. The basis of the forecast will be the annual budget of the organization and the short- to long-term plans of the organization—for example, the possibility of expansion. Forecasting is based on both internal and external factors. Internal factors include the following:

1. Budget constraints
2. Expected or trend of employee separations
3. Production levels
4. Sales increases or decreases
5. Global expansion plans

External factors might include the following:

1. Changes in technology
2. Changes in laws
3. Unemployment rates
4. Shifts in population
5. Shifts in urban, suburban, and rural areas
6. Competition

Once the forecasting data are gathered and analyzed, the HR professional can see where gaps exist and then begin to recruit individuals with the right skills, education, and backgrounds. This section will discuss this step in HR planning.

Recruitment Strategy

Although it might seem easy, recruitment of the right talent, at the right place and at the right time, takes skill and practice, but more important, it takes strategic planning. An understanding of the labor market and the factors determining the relevant aspects of the labor market is key to being strategic about your recruiting processes.

Based on this information, when a job opening occurs, the HRM professional should be ready to fill that position. Here are the aspects of developing a recruitment strategy:

1. Refer to a staffing plan.
2. Confirm the job analysis is correct through questionnaires.
3. Write the job description and job specifications.
4. Have a bidding system to recruit and review internal candidate qualifications for possible promotions.
5. Determine the best recruitment strategies for the position.
6. Implement a recruiting strategy.

The first step in the recruitment process is acknowledgment of a job opening. At this time, the manager and/or the HRM look at the job description for the job opening (assuming it isn't a new job).

Assuming the job analysis and job description are ready, an organization may decide to look at internal candidates' qualifications first. Internal candidates are people who are already working for the company. If an internal candidate meets the qualifications, this person might be encouraged to apply for the job, and the job opening may not be published. Many organizations have formal job posting procedures and bidding systems in place for internal candidates. For example, job postings may be sent to a listserv or other avenue so all employees have access to them. However, the advantage of publishing open positions to everyone in and outside the company is to ensure the organization is diverse.

Then the best recruiting strategies for the type of position are determined. For example, for a high-level executive position, it may be decided to hire an outside head-hunting firm. For an entry-level position, advertising on social networking websites might be the best strategy. Most organizations will use a variety of methods to obtain the best results.

Another consideration is how the recruiting process will be managed under constraining circumstances such as a short deadline or a low number of applications. In addition, establishing a protocol for how applications and résumés will be processed will save time later. For example, some HRM professionals may use software such as Microsoft Excel to communicate the time line of the hiring process to key managers.

Once these tasks are accomplished, the hope is that you will have a diverse group of people to interview (called the selection process). Before this is done, though, it is important to have information to ensure the right people are recruited. This is where the job analysis and job description come in.

Job Analysis and Job Descriptions

The job analysis is a formal system developed to determine what tasks people actually perform in their jobs. The purpose of a job analysis is to ensure creation of the right fit between the job and the employee and to determine how employee performance will be assessed. A major part of the job analysis includes research, which may mean reviewing job responsibilities of current employees, researching job descriptions for similar jobs with competitors, and analyzing any new responsibilities that need to be accomplished by the person with the position. According to research by Hackman and Oldham, a job diagnostic survey should be used to diagnose job characteristics prior to any redesign of a job (J. Richard Hackman and Greg R. Oldham, "Motivation through the Design of Work: Test of a Theory," *Organizational Behavior and Human Performance* 16, no. 2, August 1976, pp 250–79).

To start writing a job analysis, data need to be gathered and analyzed, keeping in mind Hackman and Oldham's model. Figure 1, "Process for Writing the Job Analysis," below shows the process of writing a job analysis. Please note, though, that a job analysis is different from a job design. Job design refers to how a job can be modified or changed to be more effective—for example, changing tasks as new technology becomes available.

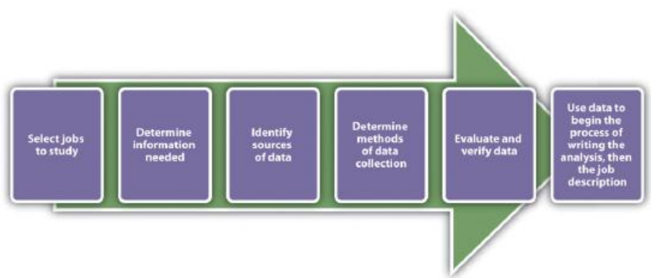


Figure 26.6.1: Process for Writing the Job Analysis

The information gathered from the job analysis is used to develop both the job description and the job specifications. A job description is a list of tasks, duties, and responsibilities of a job. Job specifications, on the other hand, discuss the skills and abilities the person must have to perform the job. The two are tied together, as job descriptions are usually written to include job specifications. A job analysis must be performed first, and then based on that data, we can successfully write the job description and job specifications. Think of the analysis as "everything an employee is required and expected to do." HR professionals might use paper or online questionnaires to gather data for a job analysis.

Two types of job analyses can be performed: a task-based analysis and a competency- or skills-based analysis. A task-based analysis focuses on the duties of the job, as opposed to a competency-based analysis, which focuses on the specific knowledge and abilities an employee must have to perform the job. An example of a task-based analysis might include information on the following:

1. Write performance evaluations for employees.
2. Prepare reports.
3. Answer incoming phone calls.
4. Assist customers with product questions.
5. Cold-call three customers a day.

With task job analysis, the specific tasks are listed and it is clear. With competency based, it is less clear and more objective. However, competency-based analysis might be more appropriate for specific, high-level positions. For example, a competency-based analysis might include the following:

1. Able to utilize data analysis tools
2. Able to work within teams

3. Adaptable
4. Innovative

You can clearly see the difference between the two. The focus of task-based analyses is the job duties required, while the focus of competency-based analyses is on how a person can apply their skills to perform the job. One is not better than the other but is simply used for different purposes and different types of jobs. For example, a task-based analysis might be used for a receptionist, while a competency-based analysis might be used for a vice president of sales position. Consider the legal implications, however, of which job analysis is used. Because a competency-based job analysis is more subjective, it might be more difficult to tell whether someone has met the criteria.

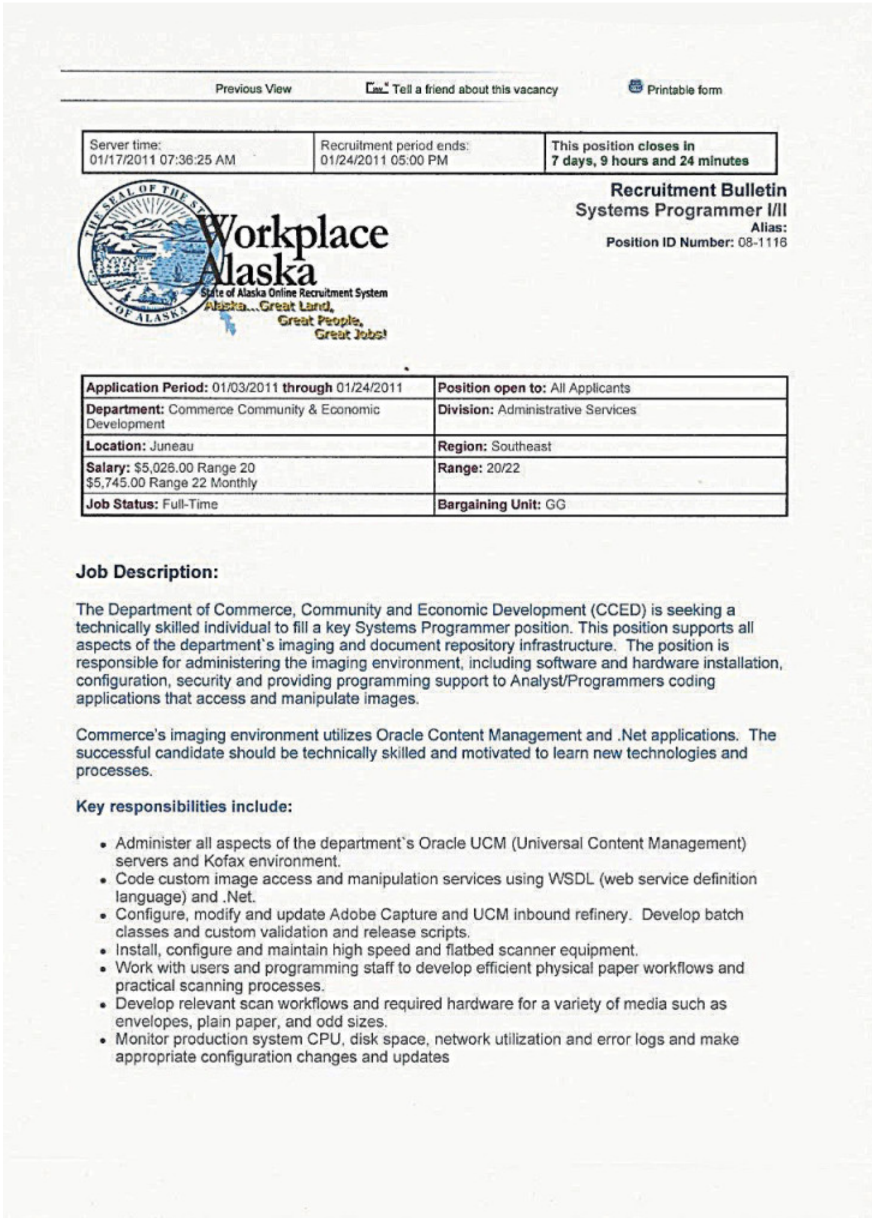
Once you have decided if a competency-based or task-based analysis is more appropriate for the job, you can prepare to write the job analysis. Of course, this isn't something that should be done alone. Feedback from managers should be taken into consideration to make this task useful in all levels of the organization. Organization is a key component to preparing for your job analysis. For example, will you perform an analysis on all jobs in the organization or just focus on one department? Once you have determined how you will conduct the analysis, a tool to conduct the analysis should be chosen. Most organizations use questionnaires (online or hard copy) to determine the duties of each job title. Some organizations will use face-to-face interviews to perform this task, depending on time constraints and the size of the organization. A job analysis questionnaire usually includes the following types of questions, obviously depending on the type of industry:

1. Employee information such as job title, how long in position, education level, how many years of experience in the industry
2. Key tasks and responsibilities
3. Decision making and problem solving: this section asks employees to list situations in which problems needed to be solved and the types of decisions made or solutions provided.
4. Level of contact with colleagues, managers, outside vendors, and customers
5. Physical demands of the job, such as the amount of heavy lifting or ability to see, hear, or walk
6. Personal abilities required to do the job—that is, personal characteristics needed to perform well in this position
7. Specific skills required to do the job—for example, the ability to run a particular computer program
8. Certifications to perform the job

Once all employees (or the ones you have identified) have completed the questionnaire, you can organize the data, which is helpful in creating job descriptions. If there is more than one person completing a questionnaire for one job title, the data should be combined to create one job analysis for one job title. There are a number of software packages available to help human resources perform this task, such as AutoGOJA.

Once the job analysis has been completed, it is time to write the job description and specifications, using the data you collected. Job descriptions should always include the following components:

1. Job functions (the tasks the employee performs)
2. Knowledge, skills, and abilities (what an employee is expected to know and be able to do, as well as personal attributes)
3. Education and experience required
4. Physical requirements of the job (ability to lift, see, or hear, for example)



Previous View | Tell a friend about this vacancy | Printable form

Server time: 01/17/2011 07:36:25 AM	Recruitment period ends: 01/24/2011 05:00 PM	**This position closes in 7 days, 9 hours and 24 minutes**

Workplace Alaska
State of Alaska Online Recruitment System
Alaska...Great Land, Great People, Great Jobs!

Recruitment Bulletin
Systems Programmer I/II
Alias:
Position ID Number: 08-1116

Application Period: 01/03/2011 **through** 01/24/2011	**Position open to:** All Applicants
Department: Commerce Community & Economic Development	**Division:** Administrative Services
Location: Juneau	**Region:** Southeast
Salary: $5,026.00 Range 20 $5,745.00 Range 22 Monthly	**Range:** 20/22
Job Status: Full-Time	**Bargaining Unit:** GG

Job Description:

The Department of Commerce, Community and Economic Development (CCED) is seeking a technically skilled individual to fill a key Systems Programmer position. This position supports all aspects of the department's imaging and document repository infrastructure. The position is responsible for administering the imaging environment, including software and hardware installation, configuration, security and providing programming support to Analyst/Programmers coding applications that access and manipulate images.

Commerce's imaging environment utilizes Oracle Content Management and .Net applications. The successful candidate should be technically skilled and motivated to learn new technologies and processes.

Key responsibilities include:

- Administer all aspects of the department's Oracle UCM (Universal Content Management) servers and Kofax environment.
- Code custom image access and manipulation services using WSDL (web service definition language) and .Net.
- Configure, modify and update Adobe Capture and UCM inbound refinery. Develop batch classes and custom validation and release scripts.
- Install, configure and maintain high speed and flatbed scanner equipment.
- Work with users and programming staff to develop efficient physical paper workflows and practical scanning processes.
- Develop relevant scan workflows and required hardware for a variety of media such as envelopes, plain paper, and odd sizes.
- Monitor production system CPU, disk space, network utilization and error logs and make appropriate configuration changes and updates

Figure 26.6.2: Sample Job Description

Notice how the job description includes the job function; knowledge, skills, and abilities required to do the job; education and experience required; and the physical requirements of the job. Once the job description has been written, obtaining approval from the hiring manager is the next step. Then the HR professional can begin to recruit for the position.

KEY TAKEAWAYS

- The *recruitment process* provides the organization with a pool of qualified applicants.
- Some companies choose to hire *internal candidates*—that is, candidates who are already working for the organization. However, diversity is a consideration here as well.
- A *job analysis* is a systematic approach to determine what a person actually does in his or her job. This process might involve a questionnaire to all employees. Based on this analysis, an accurate *job description* and *job specifications* can be written. A job description lists the components of the job, while job specifications list the requirements to perform the job.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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26.7: Reading- Performance Appraisal

Performance Appraisal

Employees generally want their managers to tell them three things: what they should be doing, how well they're doing it, and how they can improve their performance. Good managers address these issues on an ongoing basis. On a semiannual or annual basis, they also conduct formal performance appraisals to discuss and evaluate employees' work performance.

The Basic Three-Step Process

Appraisal systems vary both by organization and by the level of the employee being evaluated, but as you can see in Figure 1, "How to Do a Performance Appraisal," below, it's generally a three-step process:

1. Before managers can measure performance, they must set goals and performance expectations and specify the criteria (such as quality of work, quantity of work, dependability, initiative) that they'll use to measure performance.
2. At the end of a specified time period, managers complete written evaluations that rate employee performance according to the predetermined criteria.
3. Managers then meet with each employee to discuss the evaluation. Jointly, they suggest ways in which the employee can improve performance, which might include further training and development.

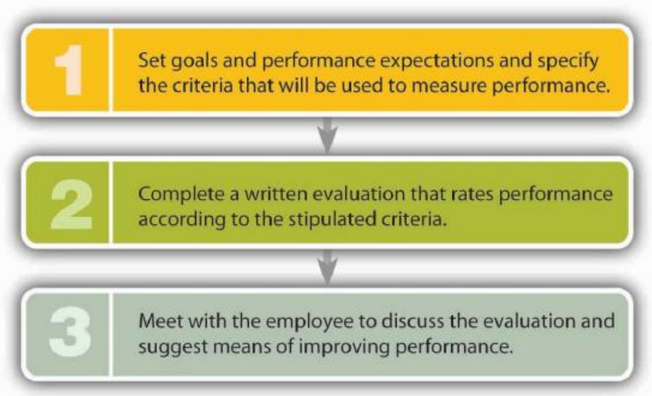

Figure 26.7.1: How to Conduct a Performance Appraisal

It sounds fairly simple, but why do so many managers report that, except for firing people, giving performance appraisals is their least favorite task? To get some perspective on this question, we'll look at performance appraisals from both sides, explaining the benefits and identifying potential problems with some of the most common practices.

Among other benefits, formal appraisals provide the following:

- An opportunity for managers and employees to discuss an employee's performance and to set future goals and performance expectations
- A chance to identify and discuss appropriate training and career-development opportunities for an employee
- Formal documentation of the evaluation that can be used for salary, promotion, demotion, or dismissal purposes

As for disadvantages, most stem from the fact that appraisals are often used to determine salaries for the upcoming year. Consequently, meetings to discuss performance tend to take on an entirely different dimension: the manager appears judgmental (rather than supportive), and the employee gets defensive. It's the adversarial atmosphere that makes many managers not only uncomfortable with the task but also unlikely to give honest feedback. (They tend to give higher marks in order to avoid delving into critical evaluations.) HR professionals disagree about whether performance appraisals should be linked to pay increases. Some experts argue that the connection eliminates the manager's opportunity to use the appraisal to improve an employee's performance. Others maintain that it increases employee satisfaction with the process and distributes raises on the basis of effort and results.

360-Degree and Upward Feedback

Instead of being evaluated by one person, how would you like to be evaluated by several people—not only those above you in the organization but those below and beside you? The approach is called *360-degree feedback*, and the purpose is to ensure that employees (mostly managers) get feedback from all directions—from supervisors, reporting subordinates, coworkers, and even customers. If it's conducted correctly, this technique furnishes managers with a range of insights into their performance in a number of roles.

Some experts, however, regard the 360-degree approach as too cumbersome. An alternative technique, called *upward feedback*, requires only the manager's subordinates to provide feedback. Computer maker Dell uses this approach as part of its manager-development plan. Every six months, forty thousand Dell employees complete a survey in which they rate their supervisors on a number of dimensions, such as practicing ethical business principles and providing support in balancing work and personal life. Like most companies using this technique, Dell uses survey results for development purposes only, not as direct input into decisions on pay increases or promotions.

Retaining Valuable Employees

When a valued employee quits, the loss to the employer can be serious. Not only will the firm incur substantial costs to recruit and train a replacement, but it also may suffer temporary declines in productivity and lower morale among remaining employees who have to take on heavier workloads. Given the negative impact of turnover—the permanent separation of an employee from a company—most organizations do whatever they can to retain qualified employees. Compensation plays a key role in this effort: companies that don't offer competitive compensation packages (including benefits) tend to lose employees. But other factors come into play, some of which we discussed earlier, such as training and development, as well as helping employees achieve a satisfying work/nonwork balance. In the following sections, we'll look at a few other strategies for reducing turnover and increasing productivity.

Creating a Positive Work Environment

Employees who are happy at work are more productive, provide better customer service, and are more likely to stay with the company. A study conducted by Sears, for instance, found a positive relationship between customer satisfaction and employee attitudes on ten different issues: a 5 percent improvement in employee attitudes results in a 1.3 percent increase in customer satisfaction and a 0.5 percent increase in revenue.

The Employee-Friendly Workplace

What sort of things improve employee attitudes? The twelve thousand employees of software maker SAS Institute fall into the category of "happy workers." They choose the furniture and equipment in their own (private) offices; eat subsidized meals at one of three on-site restaurants; enjoy free soft drinks, fresh fruit on Mondays, M&M's on Wednesdays, and a healthy breakfast snack on Fridays in convenient break rooms; and swim and work out at a seventy-seven-thousand-square-foot fitness center. They set their own work hours, and they're encouraged to stay home with sick children. They also have job security: no one's ever been laid off because of an economic downturn. The employee-friendly work environment helps SAS employees focus on their jobs and contribute to the attainment of company goals. Not surprisingly, it also results in very low 3 percent turnover.

Recognizing Employee Contributions

Thanking people for work done well is a powerful motivator. People who feel appreciated are more likely to stay with a company than those who don't.Robert McGarvey, "A Tidal Wave of Turnover," *American Way*, December 15, 2004, 32–36. While personal thank-yous are always helpful, many companies also have formal programs for identifying and rewarding good performers. The Container Store, a national storage and container retailer, rewards employee accomplishments in a variety of ways. Recently, for example, twelve employees chosen by coworkers were rewarded with a Colorado vacation with the company's owners, and the seven winners of a sales contest got a trip to visit an important supplier—in Sweden. The company is known for its supportive environment and has frequently been selected as one of the top U.S. companies to work for.

Involving Employees in Decision Making

Companies have found that involving employees in decisions saves money, makes workers feel better about their jobs, and reduces turnover. Some have found that it pays to take their advice. When General Motors asked workers for ideas on improving manufacturing operations, management was deluged with more than forty-four thousand suggestions during one quarter. Implementing a few of them cut production time on certain vehicles by 15 percent and resulted in sizable savings (Freda Turner, "An Effective Employee Suggestion Program Has a Multiplier Effect," WebPro News, March 4, 2003, accessed October 11, 2011).

Similarly, in 2001, Edward Jones, a personal investment company, faced a difficult situation during the stock-market downturn. Costs had to be cut, and laying off employees was one option. Instead, however, the company turned to its workforce for solutions.

As a group, employees identified cost savings of more than $38 million. At the same time, the company convinced experienced employees to stay with it by assuring them that they'd have a role in managing it.

Why People Quit

As important as such initiatives can be, one bad boss can spoil everything. The way a person is treated by his or her boss may be the primary factor in determining whether an employee stays or goes. People who have quit their jobs cite the following behavior by superiors:

- Making unreasonable work demands
- Refusing to value their opinions
- Failing to be clear about what's expected of subordinates
- Rejecting work unnecessarily
- Showing favoritism in compensation, rewards, or promotions

Holding managers accountable for excessive turnover can help alleviate the "bad-boss" problem, at least in the long run. In any case, whenever an employee quits, it's a good idea for someone—someone other than the individual's immediate supervisor—to conduct an exit interview to find out why. Knowing why people are quitting gives an organization the opportunity to correct problems that are causing high turnover rates.

Involuntary Termination

Before we leave this section, we should say a word or two about *termination*—getting fired. Though turnover—voluntary separations—can create problems for employers, they're not nearly as devastating as the effects of involuntary termination on employees. Losing your job is what psychologists call a "significant life change," and it's high on the list of "stressful life events" regardless of the circumstances. Sometimes, employers lay off workers because revenues are down and they must resort to downsizing—to cutting costs by eliminating jobs. Sometimes a particular job is being phased out, and sometimes an employee has simply failed to meet performance requirements.

Employment at Will

Is it possible for you to get fired even if you're doing a good job and there's no economic justification for your being laid off? In some cases, yes—especially if you're not working under a contract. Without a formal contract, you're considered to be *employed at will*, which means that both you and your employer have the right to terminate the employment relationship at any time. *You* can quit whenever you want (which is good for you), but your *employer* can fire you whenever he or she wants (which is obviously bad for you).

Fortunately for you, over the past several decades, the courts have undercut employers' rights under the employment-at-will doctrine. By and large, management can no longer fire employees at will: usually, employers must show just cause for termination, and in some cases, they must furnish written documentation to substantiate the reasons for terminating an employee. If it's a case of poor performance, the employee is generally warned in advance that his or her current level of performance could result in termination. As a rule, managers give employees who have been warned a reasonable opportunity to improve performance. When termination is unavoidable, it should be handled in a private conversation, with the manager explaining precisely why the action is being taken.

KEY TAKEAWAYS

- Managers conduct **performance appraisals** to evaluate work performance, usually following a three-step process:
  - Setting goals and performance expectations and specifying the criteria for measuring performance
  - Completing written evaluations to rate performance according to predetermined criteria
  - Meeting with employees to discuss evaluations and ways to improve performance
- **Turnover**—the permanent separation of an employee from a company—has a negative effect on an organization.
- In addition to offering competitive compensation, companies may take a variety of steps to retain qualified employees:
  - Providing appropriate training and development
  - Helping employees achieve a satisfying work/nonwork balance in their lives
  - Creating a positive work environment
  - Recognizing employee efforts

- Involving employees in decision making
- On the other hand, employers may have to terminate the employment of (that is, fire) some workers.
  - They may lay off workers because revenues are down and they have to **downsize**—to cut costs by eliminating jobs.
  - Sometimes a job is phased out, and sometimes an employee simply fails to meet performance requirements.
- If there's no written employment contract, the employment relationship falls under the principle of **employment-at-will**, by which an employer can end it at any time. Usually, however, the employer must show just cause.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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26.8: Reading- Today’s HRM Challenges

Containing Costs

All departments within an organization must prove their value and contributions to the overall business strategy, and the same is true with HRM. As companies are becoming more concerned with cutting costs, HRM departments must show the value they add to the organization through alignment with business objectives. Being able to add value starts with understanding some of the challenges of businesses and finding ways to reduce a negative impact on the business. If you were to ask most business owners what their biggest challenges are, they will likely tell you that cost management is a major factor in the success or failure of their business. In most businesses today, the people part of the business is the most likely place for cuts when the economy isn’t doing well. Expenses that involve the people part of any business include benefits, hiring process costs, and many more . . .

Benefits

These costs cut into the bottom line of any business. The trick is to figure out how much, how many, or how often benefits should be offered, without sacrificing employee motivation. A company can cut costs by not offering benefits or 401(k) plans, but if its goal is to hire the best people, a hiring package without these items will most certainly not get the best people. Containment of costs, therefore, is a balancing act. An HR manager must offer as much as he or she can to attract and retain employees, but not offer too much, as this can put pressure on the company’s bottom line.

Hiring and Turnover

Another consideration is the cost of hiring and turnover. The hiring process and the cost of turnover in an organization can be very expensive. Turnover refers to the number of employees who leave a company in a particular period of time. By creating a recruiting and selection process with cost containment in mind, HR can contribute directly to cost-containment strategies company wide. In fact, the cost of hiring an employee or replacing an old one (turnover) can be as high as $9,777 for a position that pays $60,000 (James Del Monte, “Cost of Hiring and Turnover,” JDA Professional Services, Inc., 2010, accessed October 1, 2010). By hiring smart the first time, HR managers can contain costs for their organization.

Offshoring

One cost-containment strategy for U.S. businesses has been offshoring. Offshoring is the process of moving jobs overseas to contain costs. It is estimated that 3.3 million U.S. jobs will be moved overseas by 2015 (Vivek Agrawal and Diana Farrell, “Who Wins in Offshoring?” in “Global Directions,” special issue, *McKinsey Quarterly*, 2003, pp 36–41). According to the U.S. Census Bureau, most of these jobs are Information Technology (IT) jobs as well as manufacturing jobs. This issue is unique to HR, as the responsibility for developing training for new workers and laying off domestic workers will often fall under the realm of HRM. Of course, cost containment isn’t only up to HRM and managers, but as organizations look at various ways to contain costs, human resources can certainly provide solutions.

Technology

Technology has greatly affected human resources and will continue to do so as new technology is developed. Through use of technology, many companies have virtual workforces that perform tasks from nearly all corners of the world. When employees are not located just down the hall, management of these human resources creates some unique challenges. For example, technology creates an even greater need to have multicultural or diversity understanding. Since many people will work with individuals from across the globe, cultural sensitivity and understanding is the only way to ensure the use of technology results in increased productivity rather than decreased productivity due to miscommunications.

Technology also creates a workforce that expects to be mobile. Because of the ability to work from home or anywhere else, many employees may request and even demand a flexible schedule to meet their own family and personal needs. Productivity can be a concern for all managers in the area of flextime, and another challenge is the fairness to other workers when one person is offered a flexible schedule. Many companies, however, are going a step further and creating virtual organizations, which don’t have a physical location (cost containment) and allow all employees to work from home or the location of their choice. As you can imagine, this creates concerns over productivity and communication within the organization.

The use of smartphones and social networking has impacted human resources, as many companies now disseminate information to employees via these methods. Of course, technology changes constantly, so the methods used today will likely be different one year or even six months from now. Of course, the major challenge with technology is its constantly changing nature, which can impact all practices in HRM.

The Economy

Tough economic times in a country usually results in tough times for business, too. High unemployment and layoffs are clearly HRM and managerial issues. If a human resource manager works for a unionized company, union contracts are the guiding source when having to downsize owing to a tough economy. Besides union restrictions, legal restrictions on who is let go and the process followed to let someone go should be on the forefront of any manager's mind when he or she is required to lay off people because of a poor economy. Dealing with performance issues and measuring performance can be considerations when it is necessary to lay off employees.

Likewise, in a growth economy, the HR manager may experience a different kind of stress. Massive hiring to meet demand might occur if the economy is doing well. For example, McDonald's restaurants had to fill six hundred positions throughout Las Vegas and held hiring day events in 2010 ("McDonald's Readies for Massive Hiring Spree," Fox 5 News, Las Vegas, May 2010, accessed October 5, 2010). Imagine the process of hiring this many people in a short period of time The same recruiting and selection processes used under normal circumstances will be helpful in mass hiring situations.

The Changing and Diverse Workforce

Human resources should be aware that the workforce is constantly changing. It is expected that over the next ten years, more than 40 percent of the workforce will retire, and there will not be enough younger workers to take the jobs once held by the retiring workers (Alvaro Fernandez, "Training the Aging Workforce," *SharpBrains*, August 10, 2007, accessed October 6, 2010). In fact, the American Society of Training and Development says that in the next twenty years, seventy-six million Americans will retire, and only forty-six million will replace them. First, the retirement of baby boomers results in a loss of a major part of the working population, and there are not enough people to fill those jobs that are left vacant. Second, the baby boomers' knowledge is lost upon their retirement. Much of this knowledge isn't formalized or written down, but it contributes to the success of business. Third, elderly people are living longer, and this results in higher health-care costs for all currently in the workforce.

KEY TAKEAWAYS

Whether it is changes in health care laws, an aging workforce, changes in technology or an increasingly diverse workforce the fact remains that human resource managers must always be attuned to the changes in the external environment in order to plan for and maintain the workforce necessary for the company to achieve its goals.

- One of the major challenges of HRM is containment of costs. This can be done in several ways, for example, in the way health care and benefits are offered.
- Hiring is a very expensive part of human resources, and therefore HRM should take steps to ensure they are hiring the right people for the job the first time. *Turnover* is a term used to describe the departure of an employee.
- Technology is also a challenge to be met by human resources. For example, employees may request alternative work schedules because they can use technology at home to get their work done.
- The economy is a major factor in human resource management. HR managers, no matter what the state of the economy, must plan effectively to make sure they have the right number of workers at the right time. When we deal with a down economy, the legal and union implications of layoffs must be considered, and in an up economy, hiring of workers to meet the internal demand is necessary.
- The retirement of *baby boomers* is creating a gap in the workplace, related to not only the number of people available but also the skills people have. *Multigenerational* companies, or companies with workers of a variety of ages, must find ways to motivate employees, even though those employees may have different needs. HR must be aware of this and continually plan for the challenge of a changing workforce.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

27: Module 12- Managing Processes

27.1: Why It Matters- Managing Processes

Why explain how operations management contributes to organizational success?

Operations management is just what it sounds like: managing the operations of the business. The role of an operations manager is broad and encompasses multiple operational areas. While other employees can focus on a specialized area of operation (for example, finance and marketing), an operations manager wears many hats and does a bit of everything. While the term may be unfamiliar, you have probably already seen operations management in action—it even played a role in creating the beautiful turkey dinner in the photo below.

What does it take to make Thanksgiving dinner happen? Planning, scheduling, technology, logistics, supply chain management, quality assurance—all the aspects of operations management. As an overview to this module, let's take Turkey Day as an example:

- *Planning.* Turkey dinner for fifteen people doesn't just happen. It takes careful planning and possibly the delegation of tasks and duties to others. Who sets the table? Who brings the green bean casserole? What time should everyone arrive?
- *Scheduling.* A turkey can take up to six hours to cook, and if you have only one oven, you'll need to schedule what time the bird goes in and comes out so the rolls and sweet potatoes get a turn in the oven.
- *Technology.* Obviously you'll need an oven (or maybe a high-tech turkey fryer) and any number of cooking gadgets. Even the humble thermometer counts as technology. Unless you're preparing a raw, paleo Thanksgiving dinner, technology will be essential.
- *Logistics.* Fifteen people won't all fit around your current table. What should you do? Seat the children at a card table? Rent a larger table? And where should Uncle Stanley sit so he can't pick a fight with your spouse or your dad? Logistics, logistics.
- *Supply Chain Management.* Aunt Sue is bringing pies, Bob is responsible for rolls, Margaret is bringing the green beans. The host has to secure a fresh turkey before they sell out at the grocery store. If you live in the sea, then you'll want to call the local fisherman and reserve some oysters for the oyster dressing. All are important components of the supply chain—leave one out and you'll miss a dish.
- *Quality Assurance.* Anyone who cooks knows you need to taste, season, and taste again to make sure the food is up to snuff. Quality assurance might also include asking Jean to bring drinks and flowers, since she's a terrible cook.

Any undertaking that involves the coordination of effort, tasks, and resources can be considered operations management. In this module you'll learn how operations management works in both manufacturing and service industries—in short, you'll see how others get their turkey on the table.

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27.2: Introduction to Operations Management

What you'll learn to do: explain operations management in the production of goods and services

Nearly every type of business organization needs to find the most efficient and effective methods of producing the goods or services it sells to its customers. Technological advances, ongoing competition, and consumer expectations force companies to rethink where, when, and how they will produce products or services. In this section you'll get an introduction to the key concepts and functions of operations management.

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27.3: Operations Management

> **Learning Objectives**
>
> - Define operations management
> - Explain the role of the operations manager

It's one thing to be in charge of getting Thanksgiving dinner on the table, but it's another to manage a complex manufacturing process. Before we explore what's involved in such an undertaking, let's begin our study of processes and operations by defining some key terms you will use throughout this module.

Production, the creation of products and services, is an essential function in every firm. Production turns inputs, such as natural resources, raw materials, human resources, and capital, into outputs, which are products and services. This process is shown in Figure 1. Managing this conversion process is the role of **operations management**.

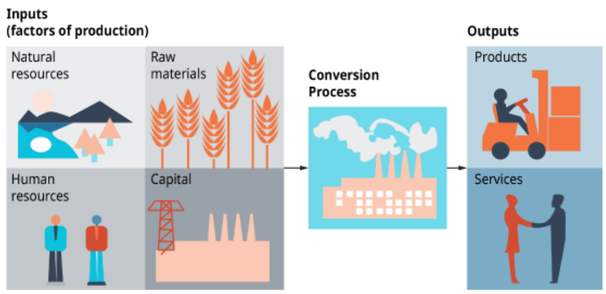

Figure 27.3.1: Production Process for Products and Services (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

> **Practice Question**
>
> https://assessments.lumenlearning.co...essments/14455

Operations managers, the people charged with managing and supervising the conversion process, play a vital role in today's firm. They control about three-fourths of a firm's assets, including inventories, wages, and benefits. They also work closely with other major divisions of the firm, such as marketing, finance, accounting, and human resources, to ensure that the firm produces its goods profitably and satisfies its customers. Marketing personnel help them decide which products to make or which services to offer. Accounting and human resources help them face the challenge of combining people and resources to produce high-quality goods on time and at reasonable cost. They are involved in the development and design of goods and determine what production processes will be most effective.

Production and operations management involve three main types of decisions, typically made at three different stages:

1. *Production planning.* The first decisions facing operations managers come at the *planning stage.* At this stage, managers decide where, when, and how production will occur. They determine site locations and obtain the necessary resources.
2. *Production control.* At this stage, the decision-making process focuses on controlling quality and costs, scheduling, and the actual day-to-day operations of running a factory or service facility.
3. *Improving production and operations*. The final stage of operations management focuses on developing more efficient methods of producing the firm's goods or services.

> **PRactice Question**
>
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27.4: Operations Management in the Service Industry

Learning Objectives

- Explain how operations management relates to the service industry

In businesses that produce services, the need for operations management may seem less obvious, since they don't produce tangible goods. Operations management is all about transformation, though—taking inputs and transforming them into outputs—and it involves things like suppliers, supply chains, and logistics. All of these things are present in service industries. Consider how "operations" play out in a service business—let's say in a theme park like Wally World. Although the company doesn't manufacture products, it is still producing an experience. The following breakdown gives you an idea of how and why operations management is so important to this kind of business:

- How do you control the crowds? How many guests should be let into the park before the line to ride the Tea Cups is intolerably long?
- How many cars should be attached to the Cyclone of Doom rollercoaster to maximize the number of riders but still ensure their safety and security?
- For July 4th weekend, how many tons of ice cream need to be ordered to supply all the ice-cream carts and keep all the hot, tired, and hungry patrons happy?
- Where do you purchase the park's supplies? That's everything from souvenir cups with Wally's picture on them to paper plates and napkins for the restaurants.
- How do you staff entrances and exits? How much security is enough to let guests feel comfortable letting their children roam around?

How do you manage the operations of this type of business that produces fun as its primary product? Answer: You hire an operations manager!

PRactice Question

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27.5: Introduction to Production Processes

What you'll learn to do: describe the four main categories of production processes

Even though you may not spend a lot of time thinking about the processes used to make different products, they surround you every day. Every time you come in your front door or eat a meal or even drive your car, you interact with things that were made by combinations of job-based, batch, mass, and flow production processes: they were all produced or manufactured by someone, somewhere, and a great deal of thought and planning were needed to make them available.

Businesses know what they want to produce, but the challenge is to select a process that will maximize the productivity and efficiency of production. Senior management looks to their operations managers to inform this decision. As we examine the four major types of production processes, keep in mind that the most successful organizations are those that have their process and product aligned.

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27.6: Project- or Job-Based Production

Learning Objectives

- Describe project or job-based production.

Production Process for Products and Services (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)**Project or job-based production** is one-of-a-kind production in which only one type of item is manufactured at a time. This type of production is often used for very large projects or for individual customers. Because the customer's needs and preferences play such a decisive role in the final output, it's essential for the operations manager to maintain open and frequent communication with that customer. The workers involved in this type of production are highly skilled or specialists in their field.

The following are examples of project or job-based production:

- custom home construction
- haircuts
- yachts

Consider the home in which you live. When the house was built, the contractor used a job process, and highly skilled workers were brought in to install the plumbing, heating, and electrical systems.

Custom Prints

A print shop may handle a variety of projects, including newsletters, brochures, stationery, and reports. Each print job varies in quantity, type of printing process, binding, color of ink, and type of paper. A manufacturing firm that produces goods in response to customer orders is called a job shop.

Some types of service businesses also deliver customized services. Doctors, for instance, must consider the illnesses and circumstances of each individual patient before developing a customized treatment plan. Real estate agents may develop a customized service plan for each customer based on the type of house the person is selling or wants to buy.

Practice Question

https://assessments.lumenlearning.co...essments/14458

Advantages

- Unique, high quality products are made.
- Workers are often more motivated and take pride in their work.
- Products are made according to individual customer needs and improve customer satisfaction.
- Production is easy to organize.

Disadvantages

- Very labor-intensive, so selling prices are usually higher.
- Production can take a long time and can have higher production cost, (e.g., if special materials or tools are required).

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27.7: Batch Production

Learning Objectives

- Describe batch production

Batch production is a method used to produce similar items in groups, stage by stage. In batch production, the product goes through each stage of the process together before moving on to the next stage. The degree to which workers are involved in this type of production depends on the type of product. It is common for machinery to be used for the actual production and workers participate only at the beginning and end of the process.

Examples of batch production include the following:

- bakeries
- textiles
- furniture

Customizing Goods

American Leather, a Dallas-based furniture manufacturer, uses mass customization to produce couches and chairs to customer specifications within 30 days. The basic frames in the furniture are the same, but automated cutting machinery precuts the color and type of leather ordered by each customer. Using mass-production techniques, they are then added to each frame.

Practice Question

https://assessments.lumenlearning.co...essments/14459

Advantages

- Unit costs are lower since larger numbers are made.
- Customers are offered some variety and choice.
- Materials can be bought in bulk, so they are less expensive.
- Production is flexible since different batches are made.
- Workers specialize in one process.

Disadvantages

- Workers are often less motivated because the work becomes repetitive.
- Set-up costs are initially high.
- Products are expensive to move around the workplace.
- Storage space will be needed to store raw materials.

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27.8: Mass Production

Learning Objectives

- Describe mass production

Mass production—manufacturing many identical goods at once—was a product of the Industrial Revolution. Henry Ford's Model-T automobile is a good example of early mass production. Each car turned out by Ford's factory was identical, right down to its color. If you wanted a car in any color except black, you were out of luck.

Examples of mass production include the following:

- canned goods
- over-the-counter drugs
- household appliances

The emphasis in mass production is on keeping manufacturing costs low by producing uniform products using repetitive and standardized processes. As products became more complicated to produce, mass production also became more complex. Automobile manufacturers, for example, must now incorporate more sophisticated electronics into their car designs. As a result, the number of assembly stations in most automobile manufacturing plants has increased.

Peeps

Watch the following video on the process used to manufacture the amazing Peep. It will serve as a point of reference because it features many of the process components we will be discussing in this reading.

You can view the transcript for “Giving life to Peeps at the Just Born Factory” (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/14460

Advantages

- Labor costs are usually lower.
- Materials can be purchased in large quantities, so they are often cheaper.
- Goods are produced in large number, lowering unit costs.

Disadvantages

- Machinery is very expensive to buy, so production lines are very expensive to set up.
- Workers are not very motivated, since their work is very repetitive.
- Production lines are not very flexible and are difficult to change.
- Production processes are at risk if any one part of the line breaks. The entire production process will have to stop, pending repair which causes expensive delays.
- Maintenance costs are very high.

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27.9: Introduction to Production Planning

What you'll learn to do: explain the components involved in planning and scheduling the production process

Production doesn't happen by magic. Think about hosting a large party for your parents' anniversary. The first thing you have to do is find a location that is large enough to accommodate all the people you will be inviting. Once you have identified the location, you then need to visit the site and decide how it will be laid out. Where should the tables and chairs go, where will you set up refreshments, and what about a gift table? Once you've decided on the layout, then you need to start making a list of the materials you'll need for the party. This includes everything from plates, cups, and napkins to hiring a DJ and a caterer. Lastly, based on the number of guests, you'll need to calculate how much of everything—food, drinks, etc.—to order.

Operations managers engage in similar planning, but they use different terminology to describe the different parts of the plan. In production planning, the components are facility location, facility layout, materials-requirement planning (MRP), and inventory control.

Contributors and Attributions

27.10: Facility Location and Layout

Learning Objectives

- Explain facility location
- Explain facility layout

Facility Location

Of all the pieces of the planning puzzle, facility location is the most strategic and critical. Once you build a new manufacturing facility, you have made a substantial investment of time, resources, and capital that can't be changed for a long time. Selecting the wrong location can be disastrous. Some of the key factors that influence facility location are the following:

- Proximity to customers, suppliers, and skilled labor
- Environmental regulations
- Financial incentives offered by state and local development authorities
- Quality-of-life considerations
- Potential for future expansion

The next step, after planning the production process, is deciding on plant layout—how equipment, machinery, and people will be arranged to make the production process as efficient as possible.

Practice Question

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Facility Layout

After the site location decision has been made, the next focus in production planning is the facility's layout. The goal is to determine the most efficient and effective design for the particular production process. A manufacturer might opt for a U-shaped production line, for example, rather than a long, straight one, to allow products and workers to move more quickly from one area to another.

Service organizations must also consider layout, but they are more concerned with how it affects customer behavior. It may be more convenient for a hospital to place its freight elevators in the center of the building, for example, but doing so may block the flow of patients, visitors, and medical personnel between floors and departments.

There are four main types of facility layouts: process, product, fixed-position, and cellular.

The **process layout** arranges workflow around the production process. All workers performing similar tasks are grouped together. Products pass from one workstation to another (but not necessarily to every workstation). For example, all grinding would be done in one area, all assembling in another, and all inspection in yet another. The process layout is best for firms that produce small numbers of a wide variety of products, typically using general-purpose machines that can be changed rapidly to new operations for different product designs. For example, a manufacturer of custom machinery would use a process layout.

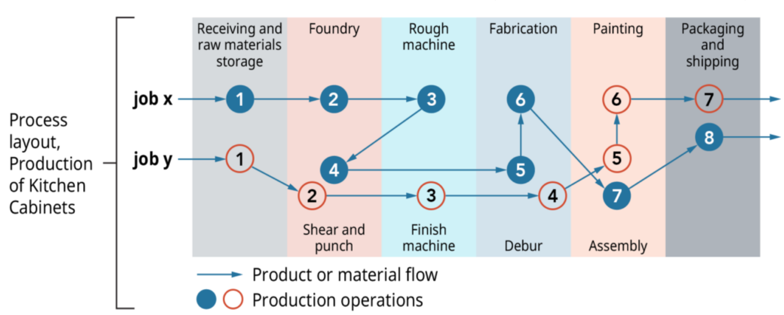

Figure 27.10.1: An Example of a Process Facility Layout. Source: Adapted from Operations Management, 9th edition, by Gaither/Frazier.

Products that require a continuous or repetitive production process use the **product** (or **assembly-line**) **layout**. When large quantities of a product must be processed on an ongoing basis, the workstations or departments are arranged in a line with products moving along the line. Automobile and appliance manufacturers, as well as food-processing plants, usually use a product layout. Service companies may also use a product layout for routine processing operations.

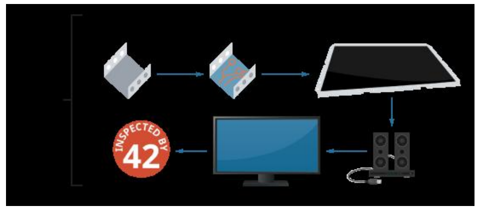

Figure 27.10.2: An Example of a Product Facility Layout. Source: Adapted from Operations Management, 9th edition, by Gaither/Frazier.

In the following video, Jansen, a Swiss steel maker, describes how the company's offices were designed to maximize the productivity and creativity of its engineers:

You can view the transcript for "Office Space – Jansen" (opens in new window) or text alternative for "Office Space – Jansen" (opens in new window).

Some products cannot be put on an assembly line or moved about in a plant. A **fixed-position layout** lets the product stay in one place while workers and machinery move to it as needed. Products that are impossible to move—ships, airplanes, and construction projects—are typically produced using a fixed-position layout. Limited space at the project site often means that parts of the product must be assembled at other sites, transported to the fixed site, and then assembled. The fixed-position layout is also common for on-site services such as housecleaning services, pest control, and landscaping.

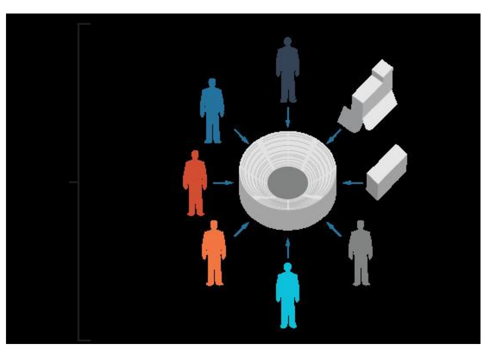

Figure 27.10.3: An Example of a Fixed-Position Facility Layout. Source: Adapted from Operations Management, 9th edition, by Gaither/Frazier.

To see an excellent example of fixed-position layout, watch the following video that shows how Boeing builds an airplane. (Note that this video has no narration; only instrumental music. Access audio description by using the widget below the video.)

Access the text alternative for "Making of a Boeing Airplane" (opens in new window).

Cellular layouts combine some aspects of both product and fixed-position layouts. Work cells are small, self-contained production units that include several machines and workers arranged in a compact, sequential order. Each work cell performs all or most of the tasks necessary to complete a manufacturing order. There are usually five to 10 workers in a cell, and they are trained to be able to do any of the steps in the production process. The goal is to create a team environment wherein team members are involved in production from beginning to end.

? Practice Question

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Contributors and Attributions

27.11: Materials Planning and Inventory Control

> **Learning Objectives**
>
> - Explain materials-requirement planning (MRP)
> - Explain just-in-time inventory control (JIT)

After the facility location has been selected and the best layout has been determined, the next stage in production planning is to determine production material requirements.

Material-Requirements Planning (MRP)

Many manufacturing companies have adopted computerized systems to control the flow of resources and inventory. **Materials requirement planning (MRP)** is one such system. MRP uses a master schedule to ensure that the materials, labor, and equipment needed for production are at the right places in the right amounts at the right times. The schedule is based on forecasts of demand for the company's products. It says exactly what will be manufactured during the next few weeks or months and when the work will take place. Sophisticated computer programs coordinate all the elements of MRP. The computer comes up with materials requirements by comparing production needs to the materials the company already has on hand. Orders are placed so items will be on hand when they are needed for production, while maintaining the lowest possible amount of materials and product to remain in house. MRP helps ensure a smooth flow of finished products.

> **Practice Question**
>
> https://assessments.lumenlearning.co...essments/14463

Some manufacturing firms have moved beyond MRP systems and are now using enterprise resource planning (ERP) systems. ERP systems provides an integrated and continuously updated view of core business processes using shared databases maintained by a database management system. ERP systems track business resources—cash, raw materials, production capacity—and the status of business commitments—orders, purchase orders, and payroll. The applications that make up the system share data from and between various departments (e.g., manufacturing, purchasing, sales, accounting, etc.). ERP facilitates information flow between all business functions and manages connections to outside stakeholders.

Even with the implementation of highly integrated planning software, operations managers still need to plan for and control inventory.

Just-in-Time (JIT) Manufacturing

Just-in-time (JIT) manufacturing is strategy that companies employ to increase efficiency and decrease waste by receiving goods only when they are needed in the production process, thereby reducing inventory costs. In theory, a JIT system would have parts and materials arriving on the warehouse dock at the exact moment they are needed in the production process. To make this happen, manufacturers and suppliers must work together closely to prevent just-in-time from becoming "just-isn't-there". Operations managers must accurately forecast the need for materials, since even the slightest deviation can result in a slowdown of production.

> **PRactice Question**
>
> https://assessments.lumenlearning.co...essments/14464

Unexpected events like the shutdown of ports due to Hurricane Harvey and the devastation and flooding caused by Hurricane Maria in Puerto Rico can cause chaos in the supply chains of manufacturers, resulting in problems for firms relying on JIT. But if employed properly, and in spite of these risks, a JIT system can greatly reduce inventory-holding costs and smooth production highs and lows.

Contributors and Attributions

27.12: Scheduling Tools

Learning Objectives

- Differentiate between Gantt charts, PERT, and the critical path method

As you might expect, operations managers find that complex processes involve complex planning and scheduling. Consider the Izmailovo Hotel in Moscow shown in the photograph at the right. Built to house athletes during the 1980 Olympics, the complex has 7,500 guest rooms and is one of the largest hotels in the world. Think about cleaning all those rooms—in four thirty-story-high towers—or checking in the thousands of guests. No small operation! Although the Izmailovo doesn't produce a tangible good, it relies on many of the same operations management principles used in manufacturing to stay in business. To increase operational efficiency in complex processes like those of running a giant hotel, operations managers use three common planning tools: Gantt charts, PERT, and the critical path method (CPM).

Gantt Charts

A Gantt chart is a timeline. Multiple projects can be added to the timeline with start and finish dates, and milestones and deadlines are also reflected. This chart is used to determine how long a project will take, the resources needed, and the order in which tasks need to be completed.

Let's look at a Gantt chart for producing a birdhouse. Suppose the following activities are required to build and package each birdhouse:

1. Determine which birdhouse the customer has ordered
2. Trace pattern onto wood
3. Cut the pieces of wood from the birdhouse pattern
4. Assemble the pieces into a birdhouse
5. Paint birdhouse
6. Attach decorations to the birdhouse
7. Prepare customer invoice
8. Prepare packing and shipping label
9. Pack birdhouse into shipping carton
10. Deliver carton to shipping department

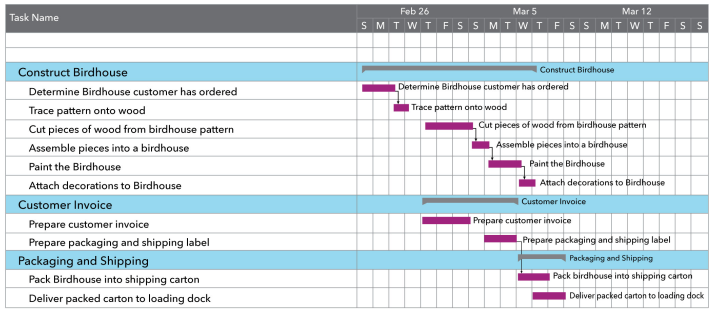

Figure 27.12.1: Gantt chart

Above is the corresponding Gantt chart: As you can see, the tasks on the list are displayed against time. On the left of the chart are all the tasks, and along the top is the time scale. A bar represents each work task; the position and length of the bar indicate the start date, duration, and end date of the task. At a glance, we can determine the following:

- What the various activities are
- When each activity begins and ends
- How long each activity lasts
- Where activities overlap with other ones, and by how much
- The start and end date of the whole project

Critical Path Method (CPM)

In the critical path method (CPM), the manager identifies all of the activities required to complete the project, the relationships between these activities, and the order in which they need to be completed. Then, the manager develops a diagram that uses arrows to show how the tasks are dependent on each other. The longest path through these linked activities is called the critical path. If the tasks on the critical path are not completed on time, the entire project will fall behind schedule.

To better understand how CPM works, look at Figure 2, which shows a CPM diagram for constructing a house. All of the tasks required to finish the house and an estimated time for each have been identified. The arrows indicate the links between the various steps and their required sequence. As you can see, most of the jobs to be done can’t be started until the house’s foundation and frame are completed. It will take five days to finish the foundation and another seven days to erect the house frame.

The activities linked by the solid arrows form the critical path for this project. It tells us that the fastest possible time the house can be built is 41 days, the total time needed for all of the critical path tasks. The noncritical path jobs, those connected with dashed arrows, can be delayed a bit or done early. Short delays in installing appliances or roofing won’t delay construction of the house because these activities don’t lie on the critical path.

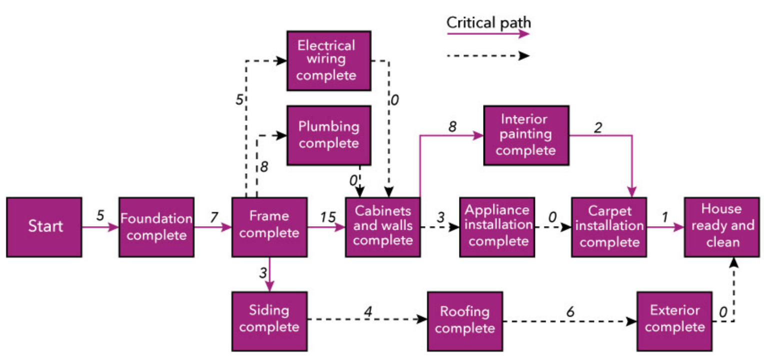

Figure 27.12.1: A CPM Network for Building a House (Attribution: Copyright Rice University, OpenStax, Modification by Lumen Learning: CC BY 4.0 license.)

PERT

Like CPM, the **program evaluation and review technique (PERT)** helps managers identify critical tasks and assess how delays in certain activities will affect operations or production. In both methods, managers use diagrams to see how operations and production will flow. PERT differs from CPM in one important respect. CPM assumes that the amount of time needed to finish a task is known with certainty; therefore, the CPM diagram shows only one number for the time needed to complete each activity. In contrast, PERT assigns three time estimates for each activity: an optimistic time for completion, the most probable time, and a pessimistic time. These estimates allow managers to anticipate delays and potential problems and schedule accordingly.

> **? PRactice Question**
>
> https://assessments.lumenlearning.co...essments/14465

Did you know…?

PERT was developed by the U.S. Navy. The Navy's Special Projects Office devised this statistical technique for measuring and forecasting progress while they were designing the Polaris-Submarine weapon system and the Fleet Ballistic Missile capability.

CPM was first used for major skyscraper development in 1966 for the construction of the former World Trade Center Twin Towers in New York City.[1]

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1. Kerzner, Harold (2003). Project Management: A Systems Approach to Planning, Scheduling, and Controlling (8th ed.) ↵

Contributors and Attributions

27.13: Introduction to New Technologies

What you'll learn to do: identify existing and emerging technologies that are changing the way goods are produced and delivered

Technology has revolutionized the way products are designed, manufactured, and delivered. In this section you'll get a glimpse of some of the latest technological innovations and see how they're changing business operations.

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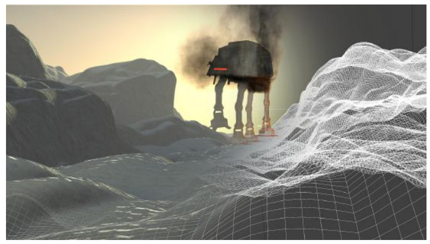
27.14: New Technologies

Learning Objectives

- Describe CAD
- Describe CAM
- Describe 3D printing
- Describe flexible manufacturing



With certain kinds of manufacturing processes—especially ones demanding high precision and mass production—it can be difficult or too costly to find the skilled labor needed to perform the tasks. This pressure has led to a growing reliance on computers and highly specialized software systems. Some of these new, sophisticated technologies are described below.

Computer-Aided Design

Computer-aided design (CAD) is the use of computer systems (or workstations) to aid in the creation, modification, analysis, or optimization of a design. CAD software is used to increase the productivity of the designer, improve the quality of design, improve communications through documentation, and to create a database for manufacturing. CAD is an important industrial art extensively used in many applications, including automotive, shipbuilding, and aerospace industries, industrial and architectural design, prosthetics, and many more. CAD is also widely used to produce computer animation for special effects in movies, advertising, and technical manuals. The ubiquity and power of computers today means that even perfume bottles and shampoo dispensers are designed using techniques unheard of by the engineers of the last century.

Computer-Aided Manufacturing

Computer-aided manufacturing (CAM) is the use of software to control machine tools in the manufacturing of workpieces. Its primary purpose is to speed the production process and produce components and tooling with more precise dimensions and material consistency. In some cases this enables production using only the required amount of raw materials—thus minimizing waste and reducing energy consumption.

In the following video, a CNC carving machine uses a computer program (CAD/CAM) to create an amazing woodcarving. (Note that the video has no narration. Access audio description by using the widget below the video.)

Access the text alternative for "Paradise Box Vcarve on CNC" (opens in new window).

Computer-Integrated Manufacturing

Computer-integrated manufacturing (CIM) is a manufacturing approach that uses computers to control the entire production process. This integration allows individual processes to exchange information with one another and initiate actions. Although CIM can be faster and less error prone than conventional manufacturing, the main advantage is the ability to create automated manufacturing processes.

Watch this short video of a factory in which CIM is used in the factory production line to build the Kia Sportage. (Note that the video has no narration. Access audio description by using the widget below the video.)

Access the text alternative for “Car Factory – Kia Sportage Factory Production Line” (link opens in new window).

Flexible Manufacturing Systems

A **flexible manufacturing system** (**FMS**) offers flexibility in the way the production system reacts to changes, whether planned or unplanned. This flexibility is typically built into one of the following:

- **Machine flexibility**: the system can be changed to produce new product types or alter the order of operations executed on a part.
- **Routing flexibility**: the system has multiple machines that can perform the same operation on a part, or the system can absorb large-scale changes in volume, capacity, or capability.

An FMS has immense advantages over traditional production lines in which machines are set up to produce only one type of good. When the firm needs to switch a production line to manufacture a new product, substantial time and money are often spent modifying the equipment. An FMS makes it possible to change equipment set-ups merely by reprogramming computer-controlled machines. Such flexibility is particularly valuable to companies that produce customized products.

3D Printing

3D printing (or additive manufacturing, AM) is any of various processes used to make a three-dimensional object. In 3D printing, additive processes are used, in which successive layers of material are laid down under computer control. These objects can be of almost any shape or geometry, and are produced from a 3D model or other electronic data source. A 3D printer is a type of industrial robot. Several different 3D printing processes have been invented since the late 1970s. The printers were originally large, expensive, and highly limited in what they could produce; today they are much cheaper and more versatile.

The following short videos show 3D printing in action:

You can view the transcript for “Makerbot” (opens in new window) or the text alternative for “Makerbot” (opens in new window).

You can view the transcript for “Student Builds Prosthetic With 3D Printer” (opens in new window) or the text alternative for “Student Builds Prosthetic With 3D Printer” (opens in new window).

The main differences between 3D printing processes are in the way layers get deposited to create parts and in the materials used to produce those layers. Some methods melt or soften material to produce the layers, while others cure liquid materials using different sophisticated technologies. The primary considerations in choosing a 3D printer are speed, cost of the machine, cost of the printed prototype, cost and choice of materials, and color capabilities.

Regardless of the type of technology being used in the production process, consumers benefit greatly from these advances. Mass customization of everything from Yankee candles to T-shirts to beverage Koozies is possible because of these exciting advances in computer technology.

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27.15: Introduction to Supply Chain Management and Logistics

What you'll learn to do: explain the importance of supply chain management and logistics

In this section you'll learn about the role of supply chain management and logistics in the production of goods and services.

Contributors and Attributions

27.16: Supply Chain Management and Logistics

Learning Objectives

- Summarize the components of supply chain management
- Differentiate between supply chain management and logistics
- Differentiate between inbound and outbound logistics

The following video provides an overview of the importance of supply chain management and logistics.

You can view the transcript for "What is Supply Chain Management?" (opens in new window).

Supply Chain Management

As you saw in the video, **supply chain management** is the process of managing the movement of the raw materials and parts from the beginning of production through delivery to the consumer. 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.[1]

It is important that every part of the supply chain is efficient, nimble, and seamless to allow retailers to deliver product to the customers in the most efficient and profitable way to achieve success and meet its overall goals. Some of the biggest issues in supply chain management are information systems, finance, effective supplier/partner relationships, qualified talent, and proper planning.

In many organizations, operational supply chain decisions are made hundreds of times each day affecting how products are developed, manufactured, moved, and sold. The complexity of the supply chain varies with the size of the business and the intricacy and quantity of items manufactured, but most supply chains have elements in common, such as the following:

- **Customers**: Customers start the chain of events when they decide to purchase a product that has been offered for sale by a company. If the product has to be manufactured, the sales order will include a requirement that needs to be fulfilled by the production facility.
- **Planning**: The planning department will create a production plan to produce the products to fulfill the customer's orders. To manufacture the products, the company will then have to purchase the raw materials needed.
- **Purchasing**: The purchasing department receives a list of raw materials and services required by the production department to complete the customers' orders.
- **Inventory**: The raw materials are received from the suppliers, checked for quality and accuracy, and moved into the warehouse.
- **Production**: Based on a production plan, the raw materials are moved to the production area. These raw materials are used to manufacture the finished products ordered by the customer and then sent to the warehouse where they await shipping.
- **Transportation**: When the finished product arrives in the warehouse, the shipping department determines the most efficient method to ship the products so they are delivered on or before the date specified by the customer.

Take a look at the following video about BYU ice-cream production. Can you identify each of the elements, above, in BYU's supply chain?

You can view the transcript for "BYU Ice Cream's Supply Chain Management" (opens in new window).

Practice Question

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Logistics

Logistics is an important subset of supply chain management. When used in a business sense, logistics is the management of the transportation and flow of things between the point of origin and the point of consumption in order to meet requirements of customers or corporations. The resources managed in logistics can include physical items such as food, materials, animals, equipment, and liquids, as well as abstract items, such as time and information. The logistics of physical items usually involves the integration of information flow, material handling, production, packaging, inventory, transportation, and warehousing.

Logistics may have either an internal focus (inbound logistics) or an external focus (outbound logistics).

A manager in charge of **inbound logistics** manages everything related to the incoming flow of resources that the company needs to produce its goods or services. These activities will include managing supplier relationships, accessing raw materials, negotiating materials pricing, and arranging quicker delivery.

A manager working in **outbound logistics** will be focused on two issues: storage and transportation. He or she will use warehousing techniques to keep the finished goods safe and accessible. Since the products may need to be moved out to a customer at any moment, proper organization is crucial. Having as little product stored as possible can be advantageous since stored products are not making money, so the outbound logistics manager often has to balance company cost savings with consumer demand. The transportation function is by far the most complex part of outbound logistics. Without transport, there simply is no logistics. For that reason it's critical to be able to move the product from one location to another in the fastest, most cost-effective, and efficient way possible. Since transportation involves fluctuations, factors such as delays and changes in fuel costs need to be taken into account in order to cover all possible scenarios that might jeopardize the efficient movement of goods.

? Practice Questions

https://assessments.lumenlearning.co...essments/14471

https://assessments.lumenlearning.co...essments/14472

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1. "Supply Chains." Retail Management. Lumen Learning. https://courses.lumenlearning.com/wm-retailmanagement/chapter/introduction-to-retail-entities-and-business-decisions/#footnote-1634-1↵

Contributors and Attributions

27.17: Introduction to Quality Assurance

What you'll learn to do: summarize common management techniques used to ensure high-quality goods and services

In this section you'll learn about common quality-management techniques used in the production of goods and services. We'll also discuss the role of national and international quality standards in industry.

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27.18: Quality Assurance

Learning Objectives

- Differentiate between statistical process control, benchmarking, lean manufacturing, and Six Sigma.
- Explain the benefits of national and international quality standards in the production of goods and services.

Figure \

What is *quality*? According to the American Society for Quality, quality refers to “the characteristics of a product or service that bear on its ability to satisfy stated or implied needs.”[1]

As a customer, you’re constantly assured that when products and services make it to market, they’re of the highest quality, and if they aren’t—if they fail to meet your expectations or to live up to claims—you may decide to avoid certain brands or give up on those products/services altogether. When companies can’t deliver quality goods or services, they risk losing trust, loyalty, and business.

Nowhere are the high stakes of quality more evident than in the case of a product recall—when a company requests the return of a product after the discovery of safety issues or product defects that might endanger the consumer.

Consider Samsung’s recent recall on its popular tablet computer, the Galaxy Note7, in October 2016:

Samsung has announced an expanded voluntary recall on all original and replacement Galaxy Note7 devices sold or exchanged in the United States in cooperation with the U.S. Consumer Product Safety Commission and in partnership with carriers and retailers. Since the affected devices can overheat and pose a safety risk, we are asking consumers with a Galaxy Note7 to power it down and contact the carrier or retail outlet where they purchased their device.”[2]

If you bought a Galaxy Note7, you probably weren’t expecting that it might catch fire during regular use! If you held shares of Samsung in your stock portfolio, you probably weren’t expecting that the company’s stock price would plummet practically overnight, either. After all, Samsung was the number one manufacturer of smartphones in the world, and as of September 30, 2016, it had sold 2.5 million Galaxy Note7 devices worldwide. Yet this is exactly what happened. Besides affecting millions of customers and taking a toll on shareholders, the recall meant lost income for retailers, who had to pull the device from their shelves, and for many of Samsung’s suppliers. The entire supply chain was impacted by this quality debacle.

Given the devastating financial and, in some cases, legal consequences of selling inferior goods or services, how do companies actually ensure that they’re producing products and offering services that meet customer expectations for quality? We will examine just a few of the ways that companies manage the production of quality goods and services.

Statistical Process Control

Statistical process control (**SPC**) is a method of quality control that uses statistical or mathematical methods to monitor and control a process. The goal of SPC is to ensure that production operates at its full potential. “Full potential” indicates the point where the process produces as much conforming product as possible with a minimum (if not the total elimination) of defective parts, rework, or scrap. SPC can be applied to any process in which the product can be measured. Key tools used in SPC include control charts with a focus on continuous improvement.

Example: Margie is the production manager at Wanda’s Widgets. The company uses SPC as their approach to quality assurance. Several times per day, the quality-assurance team comes to the production floor and takes a sample of widgets from the production line. These widgets are closely inspected to be certain that they meet the company standards. Everything from their weight to the uniformity of the paint is closely inspected and entered into the SPC software program. When the data are analyzed, if the output from the SPC software indicates that the widgets do not meet the standard, Margie is alerted that there is an issue, and production may be stopped until the process is producing as many perfect widgets as possible.

Benchmarking

Benchmarking involves comparing one's business processes and performance metrics to industry bests and best practices from other companies. Dimensions typically measured are quality, time, and cost. In the process of best-practice benchmarking, management identifies the best firms in their industry—or in another industry where similar processes exist—and compares the results and processes of those studied (the "targets") to one's own results and processes. In this way, management learns how well the targets perform and, more importantly, the business processes that explain why those firms are successful.

Benchmarking is used to measure performance using a specific indicator (cost per unit of measure, productivity per unit of measure, cycle time of x per unit of measure or defects per unit of measure) resulting in a metric of performance that is then compared to others. Benchmarking may be a one-time event but is often treated as a continuous process in which organizations continually seek to improve their practices.

Lean Manufacturing

The central idea of **lean manufacturing** is actually quite simple: Work relentlessly to eliminate waste from the manufacturing process. In this context, "waste" is defined as any activity that doesn't add value from the customer's perspective. Almost every company has a tremendous opportunity to improve by using lean manufacturing techniques. Lean principles were developed by the Japanese manufacturing industry—by Toyota and the Toyota Production System (TPS) specifically. Lean manufacturing is based on the following goals and assumptions:

- Continuous improvement
- Respect for people
- Long-term approach to process improvement
- The right process will produce the right results
- Add value to the organization by developing your people and partners
- Continuously solving root problems

Did You Know . . . ?

Toyota originally began sharing the TPS with its parts suppliers in the 1990s. Because of interest in the program from other organizations, Toyota began offering instruction in the methodology to others. Toyota has even "donated" its system to charities, providing its engineering staff and techniques to nonprofits in an effort to increase their efficiency and thus ability to serve people. For example, Toyota assisted the Food Bank For New York City to significantly decrease waiting times at soup kitchens, packing times at a food distribution center, and waiting times in a food pantry.[3]

Six Sigma

In the United States, another approach to quality management was formulated at Motorola in 1986 and was named **Six Sigma**. Six Sigma is a company-wide process that focuses on measuring the number of defects that occur and systematically eliminating them in order to get as close to "zero defects" as possible. In fact, Six Sigma quality aims to have every process produce no more than 3.4 defects per million. Six Sigma focuses on designing products that not only have fewer defects but that also satisfy customer needs.

A key process of Six Sigma is called *DMAIC*. This stands for Define, Measure, Analyze, Improve, and Control. Employees at all levels define what needs to be done to ensure quality, then measure and analyze production results using statistics to see if standards are met. They are also charged with finding ways to improve and control quality. The following features also set Six Sigma apart from other quality-improvement initiatives:

- Focus on measurable financial returns
- Emphasis on good management
- Commitment to making data-driven decisions

General Electric was one of the first companies to institute Six Sigma throughout the organization. GE employees are trained in Six Sigma concepts, and many analysts believe this has given GE a competitive manufacturing advantage. Service firms and government entities have applied Six Sigma to their quality initiatives as well.

Practice Question

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International Quality Standards

As a consumer, wouldn't you like to know which companies ensure that their products meet quality specifications? Or, might you want to know which companies take steps to protect the environment? Some consumers want to know which companies continuously improve their performance in both of these areas—that is, practice both quality management and environmental management. By the same token, if you were a company doing a good job in these areas, wouldn't you want potential customers to be aware of your achievements? It might also be worthwhile to find out whether your suppliers were being conscientious in these areas—and even your suppliers' suppliers.

Through the International Organization for Standardization (ISO), a nongovernmental agency based in Switzerland, it is possible to learn which companies are making efforts to comply with quality and environmental standards. The resources of this organization will enable you to identify those organizations that have people and processes in place for delivering products that satisfy customers' quality requirements. You can also find out which organizations work to reduce the negative impact of their activities on the environment. Working with representatives from various countries, the organization has established the ISO 9000 family of international standards for quality management and the ISO 14000 family of international standards for environmental management.

ISO standards focus on the way a company does its work, not on its output (though there's certainly a strong correlation between the way in which a business functions and the quality of its products). Compliance with ISO standards is voluntary, and the certification process is time-consuming and complex. Even so, hundreds of thousands of organizations around the world are ISO 9000 and ISO 14000 certified.[4] ISO certification has become an internationally recognized symbol of quality management and is increasingly essential to being competitive in the global marketplace.

Malcolm Baldrige National Quality Award

To provide encouragement and a consistent standard, the U.S. government created the Malcolm Baldrige National Quality Award in 1987 to encourage companies to improve quality. The award was named for Malcolm Baldrige, who was the U.S. secretary of commerce from 1981 to 1987.[5] The Commerce Department's National Institute of Standards and Technology (NIST) manages the Baldrige Award in cooperation with the private sector. An organization may compete for the award in one of six categories: manufacturing, service, small business, health care, education, and nonprofit (including government agencies). An independent board of examiners recommends the Baldrige Award recipients after evaluating them in the following seven areas defined by the Baldrige Excellence Framework:

- leadership
- strategy
- customers
- measurement
- analysis and knowledge management
- workforce
- operations
- results

Past recipients of the Baldridge Award include the following:

- Price-Waterhouse-Coopers Public Sector Practice, McLean, VA
- Pewaukee School District, Pewaukee, WI
- Concordia Publishing House, St. Louis, MO
- City of Irving, Irving, TX
- Lockheed Martin Missiles and Fire Control, Grand Prairie, TX
- Nestlé Purina PetCare Co., St. Louis, MO

No one knows the cost of a defective product—don't tell me you do. You know the cost of replacing it, but not the cost of a dissatisfied customer.

—W. Edwards Deming

? Practice Question

https://assessments.lumenlearning.co...essments/14474

1. "Basic Concepts, Definitions," American Society of Quality, (accessed November 3, 2011). http://asq.org/glossary/q.html↵
2. Galaxy Note7 Safety Recall and Exchange Program. (n.d.). Retrieved March 01, 2017, from http://www.samsung.com/us/note7recall/↵
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4. "ISO Survey of Certifications," 2009 International Organization for Standardization, (accessed November 2, 2011). ↵
5. National Institute of Standards and Technology, "Frequently Asked Questions about the Malcolm Baldrige National Quality Award," November 25, 2008, (accessed August 14, 2009). ↵

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27.19: Putting It Together- Managing Processes

Synthesis

In this module you were given an overview of and insight into the world of operations management and the key role it plays in delivering high-quality goods and services to customers. We can sum up operations management by saying that it's the functional area within organizations that makes sure that the right customer gets the right product at the right time for the right price in a form that meets the customer's quality expectations. It's a pretty tall order, and it requires operations managers to be involved in *every* facet of the business process.

Regardless of how much market demand there is for a given product, good, or service, if the organization cannot consistently deliver it, then consumers will either find a substitute or simply do without. Consider the following examples, and you'll begin to register the impact of poor operations management:

Have you ever . . .

- Left a restaurant because the wait was too long or the service too slow?
- Returned an item to the store because it was defective or broke shortly after you bought it?
- Stayed in a hotel and vowed never to go there again because the hot water didn't work or the room wasn't clean?
- Attended a Thanksgiving dinner where the turkey was bone dry and the sweet potato pie was crunchy?

Doing something a little inefficiently one time is no big deal, but when you do something inefficiently over and over, hundreds or even millions of times per year, even little mistakes can add up to incredible waste. Mistakes in an operation that result in defective products, even if they represent only **1 percent** of total output, can alienate millions of customers. Similarly, if poorly designed operations result in habitually serving customers late, a company will eventually lose customers to better-functioning competitors.

As you can see, breakdowns in operations management can be very disappointing to the consumer and costly to the organization!

Summary

In this module you learned about how operations management contributes to organizational success in business. Below is a summary of the key points covered.

Operations Management

Operations management is responsible for all the activities involved in transforming a concept into a finished product or service. Included in these activities are planning and controlling the systems that produce these goods and services.

Production Processes

Operations management includes decisions about the way in which production will proceed. Common production processes include project-based, batch, mass, and continuous production.

The layout of a facility is most often determined by the product being manufactured. The four types of facility layouts are process, product, cellular, and fixed position.

Mining, Warehousing, and Sharing Data

Many aspects of business operations rely on data and information to inform their decisions. Today's companies have sophisticated tools for mining, warehousing, and sharing data on everything from customers to inventory and sales.

Production Planning

Depending on the product being manufactured, operations planning needs to decide where the facility will be located, how the facility will be organized, and the materials needed for production. Another major part of operations planning is scheduling the various activities that go into the production process. Three tools that are used by operations managers to ensure that projects and tasks are completed on time are the Gantt, PERT, and the critical path method.

New Technologies

Just as technology has revolutionized the average home, it has also transformed the way products are manufactured. Using technologies such as CAD (computer-aided design), CAM (computer-aided manufacturing), CIM (computer-integrated manufacturing), flexible manufacturing, and 3D printing, companies are able to manufacture products faster and more efficiently.

Supply Chain Management and Logistics

Supply chain management refers to the management activities that maximize customer value and allow the company to gain a competitive advantage. It represents a conscious effort among firms to work in the most efficient ways possible. Supply chain activities cover everything from product development, sourcing of materials, actual production, and transportation logistics.

Quality Assurance

The cost of poor quality can range from a small refund to a single, dissatisfied customer to global product recalls. In order to ensure that their products, goods, and services meet consumer quality standards, companies can employ quality-control techniques such as SPC, benchmarking, lean manufacturing, and Six Sigma. They can also seek certification through national and international quality-assurance organizations.

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27.20: Discussion- More Than Just Baking Treats

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Baking dog treats seems like a straightforward undertaking, and Wanda has never really given much thought to the process she uses. In fact, she produces her dog treats out of her kitchen the same way she did when she first started—one batch, one cookie sheet at a time.

She measures and mixes the ingredients in her trusty KitchenAid stand-up mixer, rolls them out on her counter using her mother's old wooden rolling pin, and then uses cookie cutters to cut each biscuit out of the dough. Her oven will hold two cookie sheets at a time, and she does paperwork or checks email while they are baking. The only time it gets to be a hassle is when she does special-order "iced treats" and has to use the same mixer for the icing as the dough.

Once the treats are baked and cooled, she places them in a small cellophane treat bag. She threads a ribbon through a hole in a small card that has the company name and logo on one side and the ingredients on the other. She prints the cards off on her home printer, using some stock business card blanks she gets at the local office supply store. She then stacks the bagged treats into tubs she has sitting on her washing machine (which can be a hassle come laundry day), and there they sit until she is ready to pack and ship them to customers. Sometimes she worries that the ones on the bottom of the tubs are stale, but she figures dogs don't know stale from fresh.

She wraps the bags of treats in a layer of bubble wrap so they don't get broken in shipping, packs them in boxes she gets from the office supply store, and prints out shipping labels on her computer. She makes at least one trip a day to Ship & Go to have them picked up by UPS later in the day. Ship & Go does not have "accounts," so she pays for her packages every time she takes orders to be shipped. Once she is finished, it's back home to mix up the next batch of treats!

Wanda doesn't have much storage space, but she put shelving in her garage where she stores the ingredients for the treats. She orders her chicken, bison, and lamb when her supply gets low, but all of the other ingredients usually come from the grocery store, unless Jamie is going to Sam's Club and can pick up larger bags of flour and other ingredients. For the treats that contain vegetables, Wanda usually goes to Ed's Farm Stand early in the morning and buys just what she will need for the day.

Salty Pawz is growing, and Wanda will soon expand to a commercial kitchen, which looks much more like a production facility than her small kitchen. She has never considered how her process will change when she makes the move. In fact, she hasn't planned for it to change at all. She also has not considered inventory, storage, process flow, layout, or anything else related to production and operations management.

For Discussion

1. From what you have read and seen in this module, plus any research you can conduct on the Internet, what changes to Wanda's process would you make now or after she moves? Are there technologies available that can help her become more efficient while still maintaining the high quality of her product? Are there things she could be doing that she isn't currently doing to improve the process? What will need to change about her process if she is truly going to grow the business?
2. As you read about Wanda's process, did it bring to mind a time when you did something—ordered food at a restaurant, got carry-out from the local sub shop, waited to buy things at a store's checkout counter, registered for classes—and thought,

"There has GOT to be a better way to do this"? How is Wanda's situation similar? Why do you think inefficient processes are allowed to continue?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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27.21: Discussion- How Things Are Made

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Do you ever look at something you own and think, “I wonder how they make this thing?” Well, since you have been learning about production and production processes in this module, you are going to investigate that very question here.

For Discussion

1. Go to the YouTube Channel **How Things Are Made,** or some other site where you can see how things are actually made. Select a product or thing, and watch the video and/or read the information provided.
2. Share with your classmates which product or thing you researched (please be sure to provide a link to the video or article, too).
3. Briefly explain the type of process used to make the product or thing (refer back to your course materials for the terminology).
4. Which part(s) of the process surprised you the most?—which part of the video/article made you think, “Ah, so that’s how they do it!”?

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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27.22: Assignment- From Kitchen Baker to Operations Manager

Scenario

Baking dog treats in her kitchen has been a simple process for Wanda to manage. She has two ovens, one sink, a refrigerator, and enough room for two people to work at the same time. However, when Wanda moves her business out of her home, she will have a commercial kitchen that can accommodate as many as six people working simultaneously. She had never thought of her business as "production" until the real estate agent who showed her the space asked how many production workers she needs to accommodate. At that point Wanda realized she would be running a production system. Even worse, she realized that she had never even visited a manufacturing facility or set foot on a real production floor. How will she ever manage this process?

Your Task

Explain the following to Wanda:

- How can she apply principles of operations management to ensure that her business remains successful?
- What decisions does she need to make about how her process will change from making treats in her kitchen?

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Apply principles of operations management to explain at least one recommended expansion strategy for Salty Pawz.	0 points	11 points	16 points	20 points	20%
Describe process decisions required to expand the biscuit-making process beyond Wanda's kitchen.	0 points	11 points	16 points	20 points	20%
Compare biscuit-making processes (e.g., kitchen versus production system).	0 points	11 points	16 points	20 points	20%
Generate a list of process changes required to transition production from the kitchen to a real production system.	0 points	11 points	16 points	20 points	20%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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27.23: Assignment- The Malcolm Baldridge Award

Preparation

The Baldrige Program is the nation's public-private partnership dedicated to performance excellence. The Baldrige Program

- Raises awareness about the importance of performance excellence in driving the U.S. and global economy.
- Provides organizational assessment tools and criteria.
- Educates leaders in businesses, schools, health care organizations, and government and nonprofit agencies about the practices of best-in-class organizations.
- Recognizes national role models and honors them with the only Presidential Award for performance excellence.[1]

Your Task

1. Go to the Baldrige Award website and look through the list of award recipients.

1. Select a recipient. The recipient you choose can be from any industry, any year—whatever interests you.
2. Read the recipient's profile and application summary. Visit the organization's Web site, if possible, and learn as much about their operations and mission as possible.
3. Your written submission should include the following:
   1. The winner's name, industry, and year they received the award.
   2. Some of the key the factors you believe contributed to their winning this prestigious award.
   3. What other businesses in the same industry could learn from the winner.
   4. How you believe this award differs from awards given based purely on consumer-opinion surveys and customer. satisfaction ratings (i.e., JD Powers, Consumer Reports, Good Housekeeping).
   5. Whether or not your opinion of a company would be affected if it won the Baldridge award.

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1. How Baldrige Works. https://www.nist.gov/baldrige/how-baldrige-works↵

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CHAPTER OVERVIEW

28: Module 13- Marketing Function

28.1: Why It Matters- Marketing Function

Why explain the key components of the marketing function?

How did your day begin? If you are like most people, you woke up to an alarm that rang on a Smartphone, and you climbed out of bed and stumbled over to your favorite morning beverage, be it coffee, soda, or tea. You may have turned on your TV to check the weather while you got ready for your shower. You washed your hair, brushed your teeth, and got dressed. If you headed out to work or school, you probably got in your car or someone else's car for the drive. If you were rushed, maybe you went through the drive-thru of a fast-food restaurant and grabbed breakfast on your way to your final destination. In between these activities there were probably a hundred other small things that happened as part of your routine. Things like giving the dog a treat, applying makeup, making your lunch, packing up your book bag or briefcase.

All of these activities have one thing in common: they are all directly related to a company's marketing efforts.

How is that possible? What type of phone do you have: iPhone, Android, Google, or Windows? Which brand of coffee or sofa did you drink? What shampoo did you use? What make and model of car did you ride in or drive? Which fast-food restaurant did you visit? Where do you work or go to school? More important: *Why* do you use the things you use? Buy the things you buy? Eat where you eat? It's simple. It's all marketing.

Companies expend a vast quantity of their resources to get their products into your hands, homes, or stomachs. How? They identify the market for their products, goods, and services and then they market to the consumers (you) who make up that market. By focusing on the consumer, meeting their demands, and keeping them happy, companies expand their market presence and, as a result, increase their sales and profits.

In this section you will explore the role that customers play in today's marketing efforts and learn how companies segment the market to better target prospective customers. You'll also get an introduction to the mix of marketing components a company can use to achieve its sales goals.

In the words of Stanley Marcus, founder of the department store Neiman Marcus, businesses use marketing as a way to ensure that they "sell products that don't come back, to people who do."

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28.2: Introduction to Role of Customers

What you'll learn to do: explain the role of customers in marketing

All marketing centers on creating, delivering, and communicating value to the customer. In this section you'll learn why customers play such an important role in a business's marketing activities.

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28.3: Marketing Defined

Learning Objectives

- Define the term marketing

What Is Marketing?

Marketing is a set of activities related to creating, communicating, delivering, and exchanging offerings that have value for others. In business, the function of marketing is to bring value to customers, whom the business seeks to identify, satisfy, and retain. This module will emphasize the role of marketing in business, but many of the concepts will also apply to non-profit organizations, advocacy campaigns, and other activities aimed at influencing perceptions and behavior.

The Art of the Exchange

In marketing, the act of obtaining a desired object from someone by offering something of value in return is called the **exchange process**. The exchange involves:

- **the customer (or buyer):** a person or organization with a want or need who is willing to give money or some other personal resource to address this need.
- **the product:** a physical good, service, experience or idea designed to fill the customer's want or need.
- **the provider (or seller):** the company or organization offering a need-satisfying thing, which may be a product, service, experience or idea.
- **the transaction:** the terms around which both parties agree to trade value-for-value (most often, money for product).

Individuals on both sides of the exchange try to maximize rewards and minimize costs in transactions, in order to gain the most profitable outcomes. Ideally, everyone achieves a satisfactory level of reward.

Marketing creates a **bundle of goods and services** that the company offers at a price to its customers. The bundle consists of a tangible good, an intangible service or benefit, and the price of the offering. When you compare one car to another, for example, you can evaluate each of these dimensions—the tangible, the intangible, and the price—separately. However, you can't buy one manufacturer's car, another manufacturer's service, and a third manufacturer's price when you actually make a choice. Together, the three make up a single firm's offer or bundle.

Marketing is also responsible for the entire environment in which this exchange of value takes place.

- Marketing identifies customers, their needs, and how much value they place on getting those needs addressed.
- Marketing informs the design of the product to ensure it meets customer needs and provides value proportional to what it costs.
- Marketing is responsible for communicating with customers about products, explaining who is offering them and why they are desirable.
- Marketing is also responsible for listening to customers and communicating back to the provider about how well they are satisfying customer needs and opportunities for improvement.
- Marketing shapes the location and terms of the transaction, as well as the experience customers have after the product is delivered.

Marketing Creates Value for Customers

According to the influential economist and Harvard Business School professor Theodore Levitt, the purpose of all business is to "find and keep customers." Marketing is instrumental in helping businesses achieve this purpose and is much more than just advertising and selling products and collecting money. Marketing generates value by creating the connections between people and products, customers and companies.

How does this happen? Boiled down to its essence, the **role of marketing** is to *identify, satisfy, and retain customers*.

Before you can create anything of value, first you must **identify** a want or need that you can address, as well as the prospective customers who possess this want or need.

Next, you work to **satisfy** these customers by delivering a product or service that addresses these needs at the time customers want it. Key to customer satisfaction is making sure everyone feels they benefit from the exchange. Your customer is happy with the value they get for what they pay. You are happy with the payment you receive in exchange for what you provide.

Effective marketing doesn't stop there. It also needs to **retain** customers by creating new opportunities to win customer loyalty and business.

As you will learn in this module, marketing encompasses a variety of activities focused on accomplishing these objectives. How companies approach and conduct day-to-day marketing activities varies widely. For many large, highly visible companies, such as Disney-ABC, Proctor & Gamble, Sony, and Toyota, marketing represents a major expenditure. Such companies rely on effective marketing for business success, and this dependence is reflected in their organizational strategies, budget, and operations. Conversely, for other organizations, particularly those in highly-regulated or less competitive industries such as utilities, social services, medical care, or businesses providing one-of-a-kind products, marketing may be much less visible. It could even be as simple as a Web site or an informational brochure.

? Practice Question

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There is no one model that guarantees marketing success. Effective marketing may be very expensive, or it may cost next to nothing. What marketing must do in all cases is to help the organization identify, satisfy, and retain customers. Regardless of size or complexity, a marketing program is worth the costs only if it facilitates the organization's ability to reach its goals.

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28.4: How Companies Approach Marketing

Learning Objectives

- Explain the marketing concept

Company Orientation

When companies develop a marketing strategy, they make decisions about the direction that the company and their marketing efforts will take. Companies can focus on the customer, product, sales, or production. As the business environment has changed over time, so has the way that companies focus their marketing efforts.

The Marketing Concept

An organization adopts the marketing concept when it takes steps to know as much about the consumer as possible, coupled with a decision to base marketing, product, and even strategy decisions on this information. These organizations start with the customers' needs and work backward from there to create value, rather than starting with some other factor like production capacity or an innovative invention. They operate on the assumption that success depends on doing better than competitors at understanding, creating, delivering, and communicating value to their target customers.

The Product Concept

Both historically and currently, many businesses do not follow the marketing concept. For many years, companies such as Texas Instruments and Otis Elevator have followed a *product orientation*, in which the primary organizational focus is technology and innovation. All parts of these organizations invest heavily in building and showcasing impressive features and product advances, which are the areas in which these companies prefer to compete. This approach is also known as the *product concept*. Rather than focusing on a deep understanding of customer needs, these companies assume that a technically superior or less expensive product will sell itself. While this approach can be very profitable, there is a high risk of losing touch with what customers actually want. This leaves product-oriented companies vulnerable to more customer-oriented competitors.

The Sales Concept

Other companies follow a *sales orientation*. These businesses emphasize the sales process and try to make it as effective as possible. While companies in any industry may adopt the sales concept, multilevel-marketing companies such as Herbalife and Amway generally fall into this category. Many business-to-business companies with dedicated sales teams also fit this profile. These organizations assume that a good salesperson with the right tools and incentives is capable of selling almost anything. Sales and marketing techniques include aggressive sales methods, promotions, and other activities that support the sale. Often, this focus on the selling process may ignore the customer or view the customer as someone to be manipulated. These companies sell what they make, which isn't necessarily what customers want.

The Production Concept

Figure 28.4.1: Ford assembly line, 1913, Highland Park, Michigan

The *production concept* is followed by organizations that are striving for low-production costs, highly efficient processes, and mass distribution (which enables them to deliver low-cost goods at the best price). This approach came into popularity during the Industrial Revolution of the late 1800s, when businesses were beginning to exploit opportunities associated with automation and mass production. Production-oriented companies assume that customers care most about low-cost products being readily available and less about specific product features. Henry Ford's success with the groundbreaking assembly-line–built Model T is a classic example of the production concept in action. Today this approach is still widely successful in developing countries seeking economic gains in the manufacturing sector.

Seeing the Whole Picture

Savvy businesses acknowledge the importance of product features, production, and sales, but they also realize that in today's business environment a marketing orientation will lead to the greatest success when businesses continuously collect information about customers' needs and competitors' capabilities; share the information across departments; and use the information to create a competitive advantage by increasing value for customers.

> **? Practice Question**
>
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28.5: Value Proposition

Learning Objectives

- Identify and describe an organization's value proposition

What Is Value?

Marketing exists to help organizations understand, reach, and deliver value to their customers. In it's simplest form, **value** is the measure of the benefit gained from a product or service relative to the full cost of the item. In the process of the marketing exchange, value must be created.

Value = benefit − cost

Let's look at a simple example: If you and I decide to give each other a $5 bill at the same moment, is value created? I hand my $5 bill to you, and you hand yours to me. It is hard to say that either of us receives a benefit greater than the $5 bill we just received. There is no value in the exchange.

Now, imagine that you are passing by a machine that dispenses bus tickets. The machine is malfunctioning and will only accept $1 bills. The bus is about to arrive and a man in front of the machine asks if you would be willing to give him four $1 bills in exchange for a $5 bill. You could, of course, decide to make change for him (and give him five $1 bills), making this an "even exchange." But let's say you agree to his proposal of exchanging four $1 bills for a $5. In that moment a $1 bill is worth $1.25 to him. How does that make sense in the value equation? From his perspective, the ability to use the bus ticket dispenser *in that moment* adds value in the transaction.

Value is not simply a question of the financial costs and financial benefits. It includes perceptions of benefit that are different for every person. The marketer has to understand what is of greatest value to the target customer, and then use that information to develop a total offering that *creates value*.

Value Is More Than Price

You will notice that we did not express value as value = benefit – price. Price plays an important role in defining value, but it's not the only consideration. Let's look at a few typical examples:

- Two products have exactly the same ingredients, but a customer selects the higher-priced product because of the name brand

For the marketer, this means that the brand is *adding value* in the transaction.

- A customer shopping online selects a product but abandons the order before paying because there are too many steps in the purchase process

The inconvenience of filling in many forms, or concerns about providing personal information, can *add cost* (which will subtract from the value the customer perceives).

- An individual who is interested in a political cause commits to attending a meeting, but cancels when he realizes that he doesn't know anyone attending and that the meeting is on the other side of town.

For this person, the benefit of attending and participating is lower because of costs related to personal connection and convenience.

As you saw in these examples, the process of determining the value of an offering and then aligning it with the wants and needs of a target customer is challenging. As you continue through this section, think about what *you* value and how that impacts the buying decisions you make every day.

Value in a Competitive Marketplace

As if understanding individual perceptions of value weren't difficult enough, the presence of competitors further complicates perceptions of value. Customers instinctively make choices between competitive offerings based on *perceived value*.

Imagine that you are traveling to Seattle, Washington, with a group of six friends for a school event. You have the option to stay at a Marriott Courtyard Hotel that is located next to the event venue for $95 per night. If you pay the "additional person fee," you could share the room with one friend for a cost of $50 per night. However, one of your friends finds an AirBnB listing for an entire apartment that sleeps six people. Cost: $280 per night. That takes the price down to $40 per night, but the apartment is five miles away from the venue and, since there are seven of you, you would likely be sleeping on a couch or fighting for a bed. It has a more personal feel and a kitchen, but you will really be staying in someone else's place with your friends. It's an interesting dilemma. Regardless of which option you would really choose, consider the differences in the value of each and how the presence of both options generates unavoidable comparisons: the introduction of the AirBnb alternative has the effect of highlighting new shortcomings and benefits of the Marriott Courtyard hotel room.

Competition, Substitutes and Differentiation

Alternatives generally fall into two categories: competitors and substitutes. A **competitor** is providing the same offering but is accentuating different features and benefits. If, say, you are evaluating a Marriott Courtyard hotel room vs. a Hilton Hampton Inn hotel room, then you are looking at *competitive offerings*. Both offerings are hotel rooms provided by different companies. The service includes different features, and the price and location vary, the sum of which creates different perceptions of value for customers.

AirBnb is a service that allows individuals to rent out their homes, apartments, or a single room. AirBnb does not offer hotel rooms; it offers an alternative to, or substitute for, a hotel room. ***Substitute offerings*** are viewed by the user as alternatives. The substitution is not a perfect replication of the offering, which means that it will provide different value to customers.

Competitors and substitutes force the marketer to identify the aspects of the offering that provide unique value vis-à-vis the alternatives. We refer to this as differentiation. **Differentiation** is simply the process of identifying and optimizing the elements of an offering that provide unique value to customers. Sometimes organizations refer to this process as competitive differentiation, since it is very focused on optimizing value in the context of the competitive landscape.

Finally, organizations seek to create an advantage in the marketplace whereby an organization's offerings provide greater value because of a unique strategy, asset, or approach that the firm uses that other cannot easily copy. This is a **competitive advantage**. The American Marketing Association defines competitive advantage as "as total offer, vis-à-vis relevant competition, that is more attractive to customers. It exists when the competencies of a firm permit the firm to outperform its competitors." When a company can create greater value for customers than its competitors, it has a competitive advantage.

What Is a Value Proposition?

We have discussed the complexity of understanding customer perceptions of value. As the company seeks to understand and optimize the value of its offering, it also must communicate the core elements of value to potential customers. Marketers do this through a **value proposition**, defined as follows:

A business or marketing statement that summarizes why a consumer should buy a product or use a service. This statement should convince a potential consumer that one particular product or service will add more value or better solve a problem than other similar offerings.[1]

It is difficult to create an effective value proposition because it requires the marketer to distill many different elements of value and differentiation into one simple statement that can be easily read and understood. Despite the challenge, it is very important to create an effective value proposition. The value proposition focuses marketing efforts on the unique benefit to customers. This helps focus the offering on the customer and, more specifically, on the unique value to the customer. Also, the value proposition is a message, and the audience is the target customer. You want your value proposition to communicate, very succinctly, the promise of unique value in your offering.

A value proposition needs to very simply answer the question: Why should someone buy what you are offering? If you look closely at this question it contains three components:

- **Who?** The value proposition does not name the target buyer, but it must show clear value to the target buyer.
- **What?** The offering needs to be defined in the context of that buyer.
- **Why?** It must show that the offering is uniquely valuable to the buyer.

How Do You Create an Effective Value Proposition?

When creating or evaluating a value proposition, it is helpful to step away from the long lists of features and benefits and deep competitive analysis. Stick to the simple, and strive for focus and clarity. A value proposition should be clear, compelling, and differentiating**.**

- Clear: short and direct; immediately identifies both the offering and the value or benefit.
- Compelling: conveys the benefit in a way that motivates the buyer to act.
- Differentiating: sets the offering apart or differentiates it from other offerings.

Here are some examples of value propositions from company websites:

- "Soundtrack your life" (Spotify)
- "Small Business Accounting Software Designed for You, the Non-Accountant" (FreshBooks)
- "Remember Everything" (Evernote)
- "That Horizon Might Be Closer Than You Think" (Mint)
- "Rides in Minutes" (Lyft)
- "Shorten. Share. Measure." (Bitly)

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1. Kenton, Will. "Value Proposition." Investopedia. March 12, 2019. Accessed April 12, 2019. http://www.investopedia.com/terms/v/valueproposition.asp. ↵

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28.6: Marketing and Customer Relationships

Learning Objectives

- Explain the importance of managing the customer relationship

Why Customers Matter

Marketing exists to help organizations understand, reach, and deliver value to their customers. For this reason, the customer is considered the cornerstone of marketing.

With this in mind, what is likely to happen when an organization doesn't understand or pay attention to what its customers want? What if an organization doesn't even really understand who its customers are?

One of the world's best-known brands, Coca-Cola, provides a high-profile example of misunderstanding customer "wants." In the following video, Roberto Goizueta—in his only on-camera interview on this topic—recounts the disastrous launch of New Coke in 1985 and describes the lessons the company learned. Goizueta was chairman, director, and chief executive officer of the Coca-Cola Company from August 1980 until his death in October 1997.

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "All About New Coke" (opens in new window) or the text alternative for "All About New Coke" (opens in new window).

Customer Relationship Management: A Strategic Imperative

We have stated that the central purpose of marketing is to help organizations identify, satisfy, and retain their customers. These three activities lay the groundwork for what has become a strategic imperative in modern marketing: customer relationship management.

To a student of marketing in the digital age, the idea of relationship building between customers and companies may seem obvious and commonplace. It certainly is a natural outgrowth of the marketing concept, which orients entire organizations around understanding and addressing customer needs. But only in recent decades has technology made it possible for companies to capture and utilize information about their customers to such a great extent and in such meaningful ways. The Internet and digital social media have created new platforms for customers and product providers to find and communicate with one another. As a result, there are more tools now than ever before to help companies create, maintain, and manage customer relationships.

Maximizing Customer Lifetime Value

Central to these developments is the concept of customer lifetime value. Customer lifetime value predicts how much profit is associated with a customer during the course of their lifetime relationship with a company.[1] One-time customers usually have a relatively low customer lifetime value, while frequent, loyal, repeat-customers typically have a high customer lifetime value.

How do companies develop strong, ongoing relationships with customers who are likely to have a high customer lifetime value? Through marketing, of course.

Marketing applies a customer-oriented mindset and, through particular marketing activities, tries to make initial contact with customers and move them through various stages of the relationship—all with the goal of increasing lifetime customer value. These activities are summarized below.

Typical Marketing Activities during each Stage of the Customer Relationship

Stage 1: Meeting and Getting Acquainted

- Find desirable target customers, including those likely to deliver a high customer lifetime value
- Understand what these customers want
- Build awareness and demand for what you offer
- Capture new business

Stage 2: Providing a Satisfying Experience

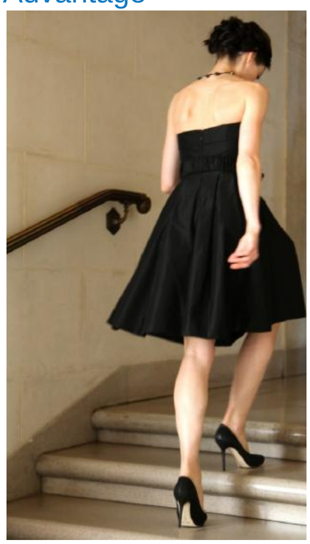
- Measure and improve customer satisfaction
- Track how customers' needs and wants evolve
- Develop customer confidence, trust, and goodwill
- Demonstrate and communicate competitive advantage
- Monitor and counter competitive forces

Stage 3: Sustain a Committed Relationship

- Convert contacts into loyal repeat customers, rather than one-time customers
- Anticipate and respond to evolving needs
- Deepen relationships, expand reach of and reliance on what you offer

Another benefit of effective customer relationship management is that it reduces the cost of business and increases profitability. As a rule, winning a new customer's business takes significantly more time, effort, and marketing resources than it does to renew or expand business with an existing customer.

Customer Relationship As Competitive Advantage



As the global marketplace provides more and more choices for consumers, relationships can become a primary driver of why a customer chooses one company over others (or chooses none at all). When customers feel satisfaction with and affinity for a specific company or product, it simplifies their buying choices.

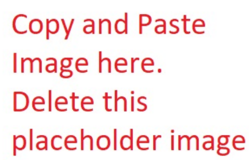
For example, why might a woman shopping for a cocktail dress choose to go to Nordstrom rather than Macy's or Dillard's, or pick from an army of online stores? Possibly because she prefers the selection of dresses at Nordstrom and the store's atmosphere. It's much more likely, though, that thanks to Nordstrom's practices, this shopper has a relationship with an attentive sales associate who has helped her find great outfits and accessories in the past. She also knows about the store's customer-friendly return policy, which might come in handy if she needs to return something.

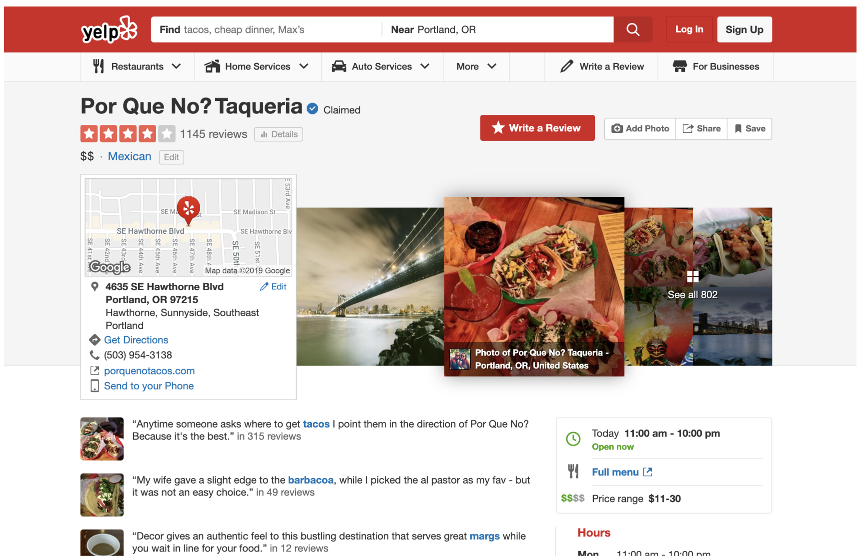
A company like Nordstrom delivers such satisfactory experiences that its customers return again and again. A consistently positive customer experience matures into a relationship in which the customer becomes increasingly receptive to the company and its products. Over time, the customer relationship gives Nordstrom a competitive advantage over other traditional department stores and online retailers.

When Customers Become Your Best Marketing Tool

Customer testimonials and recommendations have always been powerful marketing tools. They often work to persuade new customers to give something a try. In today's digital media landscape there is unprecedented opportunity for companies to engage customers as credible advocates. When organizations invest in building strong customer relationships, these activities become particularly fruitful.

For example, service providers like restaurateurs, physical therapists, and dentists frequently ask regular patrons and patients to write reviews about their real-life experiences on popular recommendation sites like Yelp and Google+. Product providers do the same on sites like Amazon and CNET.com. Although companies risk getting a bad review, they usually gain more by harnessing the credible voices and authentic experiences of customers they have served. In this process they also gain invaluable feedback about what's working or not working for their customers. Using this input, they can retool their products or approach to better match what customers want and improve business over time.





Additionally, smart marketers know that when people take a public stance on a product or issue, they tend to become more committed to that position. Thus, customer relationship management can become a virtuous cycle. As customers have more exposure and positive interaction with a company and its products, they want to become more deeply engaged, and they are more likely to become vocal evangelists who share their opinions publicly. Customers become an active part of a marketing engine that generates new business and retains loyal customers for repeat business and increased customer lifetime value.

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1. "Definition: Customer Lifetime Value." Cambridge Dictionary. Accessed June 25, 2019. http://dictionary.cambridge.org/us/dictionary/english/customer-lifetime-value. ↵

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28.7: Influences on Consumer Decisions

Learning Objectives

- Explain the factors that influence customer decisions

What, Exactly, Influences a Purchasing Decision?

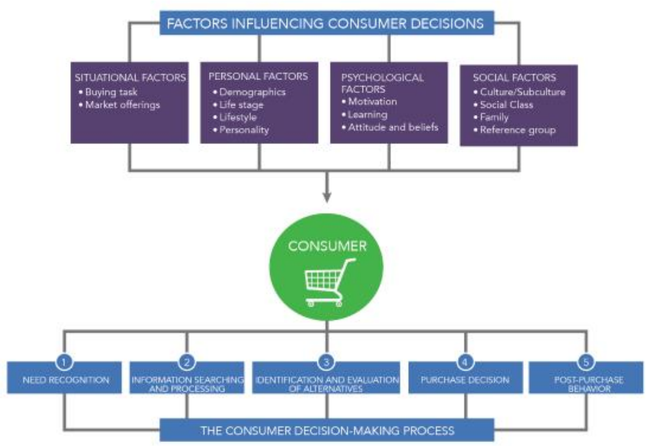
While a purchase decision-making process itself appears quite standardized, no two people make a decision in exactly the same way. People have many beliefs and behavioral tendencies—some controllable, some beyond our control. How all these factors interact with each other ensures that each of us is unique in our consumer actions and choices.

Although it isn't feasible for marketers to react to the complex, individual profiles of every single consumer, it is possible to identify factors that tend to influence most consumers in predictable ways.

The factors that influence the consumer purchasing process are many and complex. For example, as groups, men and women express very different needs and behaviors regarding personal-care products. Families with young children tend to make different dining-out choices than single and married people with no children. A consumer with much prior purchasing experience in a product category might approach the decision differently from someone with no experience. As marketers gain a better understanding of these influencing factors, they can draw more accurate conclusions about consumer behavior.

We can group these influencing factors into four sets, illustrated in the figure below:

- **Situational Factors** pertain to the consumer's level of involvement in a buying task and the market offerings that are available.
- **Personal Factors** are individual characteristics and traits such as age, life stage, economic situation, and personality.
- **Psychological Factors** relate to the consumer's motivation, learning, socialization, attitudes, and beliefs.
- **Social Factors** pertain to the influence of culture, social class, family, and reference groups.



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28.8: Buying-Process Stages

Learning Objectives

- Explain the consumer buying process

Figure 1, below, outlines the process a consumer goes through in making a purchase decision. Once the process is started, a potential buyer can withdraw at any stage before making the actual purchase. This six-stage process represents the steps people undergo when they make a conscious effort to learn about the options and select a product–the first time they purchase a product, for instance, or when buying high-priced, long-lasting items they don't purchase frequently. This is called *complexdecisionmaking*.

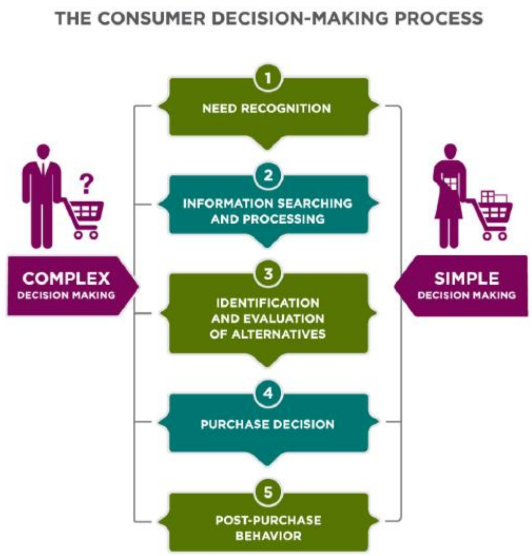

Figure 28.8.1

For many products, the purchasing behavior is routine: you notice a need and you satisfy that need according to your habit of repurchasing the same brand or the cheapest brand or the most convenient alternative, depending on your personal assessment of trade-offs and value. In these situations, you have learned from your past experiences what will best satisfy your need, so you can bypass the second and third stages of the process. This is called *simple decision making*. However, if something changes appreciably (price, product, availability, services), then you may re-enter the full decision process and consider alternative brands.

The following section discusses each step of the consumer decision-making process.

Need Recognition

The first step of the consumer decision process is recognizing that there is a problem–or unmet need–and that this need warrants some action. Whether we act to resolve a particular problem depends upon two factors: (1) the magnitude of the difference between what we have and what we need, and (2) the importance of the problem. A man may desire a new Lexus and own a five-year-old Ford Focus. The discrepancy may be fairly large but relatively unimportant compared to the other problems he faces. Conversely, a woman may own a two-year-old car that is running well, but for various reasons she considers it extremely important to purchase another car this year. Consumers do not move on to the next step until they have confirmed that their specific needs are important enough to act on.

Information Search

After recognizing a need, the prospective consumer may seek information to help identify and evaluate alternative products, services, experiences, and outlets that will meet that need. Information may come from any number of sources: family and friends, search engines, Yelp reviews, personal observation, *Consumer Reports*, salespeople, product samples, and so forth. Which sources are most important depends on the individual and the type of purchase he or she is considering.

The information-search process can also identify new needs. As a tire shopper looks for information, she may decide that the tires are not the real problem, but instead she needs a new car. At this point, her newly perceived need may trigger a new information search.

Evaluation of Alternatives

As a consumer finds and processes information about the problem she is trying to solve, she identifies the alternative products, services, and outlets that are viable options. The next step is to evaluate these alternatives and make a choice, assuming a choice is possible that meets the consumer's financial and psychological requirements. Evaluation criteria vary from consumer to consumer and from purchase to purchase, just as the needs and information sources vary. One consumer may consider price most important while another puts more weight on quality or convenience.

Consider a situation in which you are buying a new vacuum cleaner. During your information search process, you identified five leading models in online reviews, as well as a set of evaluation criteria that are most important to you: 1) price, 2) suction power, 3) warranty, 4) weight, 5) noise level, and 6) ease of using attachments. After visiting Best Buy and Home Depot to check out all the options in person, you're torn between two models you short-listed. Finally you make the agonizing choice, and the salesperson heads to the warehouse to get one for you. He returns with bad news: The vacuum cleaner is out of stock, but a new shipment is expected in three days. Strangely relieved, you take that as a sign to go for the other model, which happens to be in stock. Although convenience wasn't on your original list of selection criteria, you need the vacuum cleaner before the party you're having the next day. You pick the number-two choice and never look back.

The Purchase Decision

After much searching and evaluating (or perhaps very little), consumers at some point have to decide whether they are going to buy. Anything marketers can do to simplify purchasing will be attractive to buyers. For example, in advertising, marketers might suggest the best size of product for a particular use or the right wine to drink with a particular food. Sometimes several decision situations can be combined and marketed as one package. For example, travel agents often package travel tours, and stores that sell appliances try to sell them with add-on warranties.

Post-purchase Behavior

All the behavior determinants and the steps of the buying process up to this point take place before or during the time a purchase is made. However, a consumer's feelings and evaluations after the sale are also significant to a marketer, because they can influence repeat sales and what the customer tells others about the product or brand.

Marketing is all about keeping the customer happy at every stage of the decision-making process, including postpurchase. It is normal for consumers to experience some postpurchase anxiety after any significant or nonroutine purchase. This anxiety reflects a phenomenon called *cognitive dissonance*. According to this theory, people strive for consistency among their cognitions (knowledge, attitudes, beliefs, and values). When there are inconsistencies, dissonance arises, which people try to eliminate.

Marketers may take specific steps to reduce postpurchase dissonance. One obvious way is to help ensure delivery of a quality solution that will satisfy customers. Another step is to develop advertising and new-customer communications that stress the many positive attributes or confirm the popularity of the product. Providing personal reinforcement has proven effective with big-ticket items such as automobiles and major appliances. Salespeople in these areas may send cards or even make personal calls in order to reassure customers about their purchase.

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28.9: Introduction to Segmentation and Targeting

What you'll learn to do: explain the role of segmentation and targeting in marketing

Segmentation and targeting answer a basic question: *Who am I trying to reach?* In this section, first we will focus on why segmentation and targeting are so important. Then we will discuss how to conduct segmentation and targeting and use these tools to guide marketing activity.

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28.10: Defining Your Target Market

Learning Objectives

- Explain the concepts of segmentation and targeting

Whom Are You Trying to Reach?

Suppose you are selling automotive detailing products. Is your target "anyone with money to pay for your product?" Or are you focusing your efforts on a tightly defined market segment of people with an identified need for what you are selling? "Anyone with money" is such a broad audience that it's difficult to make any impact at all with your marketing efforts or convince very many people that they need your product. If you narrow and carefully define your target market, though, your efforts will be more fruitful because they're focused on people with a preexisting need or interest in what you offer.

Step 1: Identify the Customer Need You Address

To define your total market, start by stating the needs you will fulfill: Who are your products or services intended for? Who do you want to do business with? What is unique about your product? If you're selling products used in automotive detailing, your total market consists of vehicle owners—that is, all the people who could potentially buy your product. Your business will help them keep their vehicles clean and shiny.

Step 2: Segment Your Total Market

Next, break down this large market into smaller sections, using a process known as segmentation. You can use a variety of approaches to segment your total market into groups with common wants or needs. In this case, we can segment by vehicle ownership and related behavior. Specific segments might include the following:

- People who restore classic automobiles.
- People who drive old clunkers and run them through the car wash occasionally.
- People who own "status" cars.
- Truck drivers.
- Motorcycle owners.

Which of these subgroups are likely to be your most productive market segment(s)? You recognize that auto owners who don't care about keeping their cars clean and shiny probably won't be very interested in your products. Then there are those who care, but they lack the time and interest to do the work themselves. They take their vehicle to a shop. Others only worry about auto detailing only when it's time for a trade-in.

You reject these segments as unsuitable for your target market because they probably do not care enough about what you offer. After further consideration and research, you decide that your market segment will be automobile owners who have both the time and the interest to do their own detailing work—people who enjoy puttering with their vehicles, who have the time to spend, and who take pride in their vehicle's appearance.

You need to conduct research to confirm that there are enough potential customers in that group to support your business. You should also do competitive analysis to confirm that what you are offering is not readily available to them elsewhere. With this validation, you move to step three.

Step 3: Profile Your Target Customer Segment(s)

Next, develop profiles of your target customer(s) to get a true picture of the people you're trying to serve. Describe these potential customers as fully as you can. Who will actually buy your product? What do you know about them? Where do they live and what languages do they speak? How much do they spend on car detailing? Where do they shop? What is their annual income? What kinds of cars do they drive? If you're selling online, what methods do they prefer for online payment? What Web sites do they visit? How do they want their product delivered?

There are many different ways to profile your customers, as shown in the table and graphic below:

Table 28.10.1. Common Market Segmentation Approaches

Type of Approach	Segmentation Criteria
Geographic	nations, states, regions, cities, neighborhoods, zip codes, etc.
Demographic	age, gender, family size, income, occupation, education, religion, ethnicity, and nationality
Psychographic	lifestyle, personality, attitudes, and social class
Behavioral	user status, purchase occasion, loyalty, readiness to buy
Decision maker	decision-making role (purchaser, influencer, etc.)

Identify your customer profile before you conduct market planning, so that your planning is a good fit for your customers' behavior, interests, and needs.

? PRactice Question

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Step 4: Research and Validate Your Market Opportunity

Now that you have fully identified your target market, conduct research to verify that there will be enough business in this group to support your company in its growth. This process confirms that the need actually exists and that it's not just wishful thinking on your part.

Use both primary and secondary sources in your research. You might consult business directories, obtain statistics regarding automobile owners and their car-care practices, or locate newspaper articles and magazine stories written on the subject. You can also conduct your own market research using techniques such as surveys, focus groups, interviews, and so forth.

Your research should also determine the size of the market opportunity in terms of revenue as well as your potential market share.

You can use primary and secondary sources to find out how many potential customers there are in the geographic area you have defined and how many businesses are directly or indirectly competing with you. Your market share will be the number of customers likely to buy from you rather than from your competition.

Having defined and validated your target market, you are now better positioned to develop a marketing plan that will reach your potential customers. Perhaps your sales will take off right away—a great problem to have!

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28.11: The Importance of Marketing Information and Research

Learning Objectives

- Explain how segmentation and targeting relate to marketing strategy

Marketing Strategy Follows From the Segmentation and Targeting Process

Once your target market and customers have been identified, effective marketing moves to develop a strong knowledge base of those customers: the kind of knowledge that gives you unique insights into what they want and how to satisfy them better than the competition. The most reliable source of fresh customer insights is good **marketing information**. Useful marketing information may come from a variety of sources both inside and outside your organization. Marketing information is generated by a variety of different activities, including marketing research.

Marketing research is a systematic process for identifying marketing opportunities and solving marketing problems, using customer insights that come out of collecting and analyzing marketing information. The mechanics of marketing research must be controlled so that marketers uncover the relevant facts to answer the problem at hand. Control over this fact-finding process is the responsibility of the marketing research director, who must correctly design the research and carefully supervise its execution, to ensure it yields the customer insights the organization needs.

A marketing information system is a combination of people, technologies, and processes for managing marketing information, overseeing market research activities, and using customer insights to guide marketing decisions and broader management and strategy decisions.

Refining Knowledge of Target Market Segments and Customers Is Power Against the Competition

The business environment is increasingly competitive. With something as simple as a Google search, customers have unprecedented opportunities to explore alternatives to what any single company offers. Likewise, companies have ample opportunity to identify, track, and lure customers away from their less-vigilant competitors. A regular infusion of fresh customer insights can make all the difference between keeping customers and losing them. Marketing information and research are essential tools for marketers and the management team as they align marketing strategy with customer wants and needs.

Consider the following examples:

- Before introducing OnStar, the first-ever embedded wireless service in cars, GM used marketing research to understand what types of applications would make consumers most interested in subscribing to the service and how much they would pay for it. Of all the benefits OnStar could offer, the research helped GM prioritize how the initial service would provide value, focusing on driver assistance and security. Research also helped determine OnStar pricing to help the company build a large subscriber base quickly.[1]
- Enterprise systems provider PeopleSoft recruited a diverse set of universities as early-adopter "Beta" partners to provide input as it designed a new student information system for higher education. This marketing research helped PeopleSoft create a versatile system that could support the needs of a variety of colleges and universities, ultimately leading to strong receptivity and market share when the new system became widely available.[2]

What Characteristics of the Target Customer Should Marketers Investigate To Develop Marketing Strategies?

An easy—and truthful—answer to this question is "everything." There is no aspect of marketing to which information and research do not apply. Every marketing concept and every element involved in the marketing management process can be subjected to a great deal of careful marketing research and inquiry. Some important questions include:

- Who is the customer?
- What problems is the customer trying to solve with a given purchase?
- What does s/he desire in the way of satisfaction?
- How does the customer get information about available choices?
- Where does s/he choose to purchase?
- Why does s/he buy, or not buy?

- When does s/he purchase?
- How does s/he go about seeking satisfaction in the market?

Seeking answers to these questions yields insights into the customer's needs, perceptions, and behaviors. From here, appropriate marketing strategy and corresponding tactics can be developed for the business to act upon. Another area in which research is critical is profitability. Organizations need to forecast sales and related costs in order to understand how their operations will be profitable. They also need to plan competitive marketing programs that will produce the desired level of sales at an appropriate cost. The analysis of past sales and interpretation of cost information are important in evaluating performance and providing useful facts for future planning. All these activities rely on marketing information and a rigorous marketing research process to produce insights managers can trust and act on.

Ongoing Marketing Research Leads to More Successful Marketing Strategies

In most business situations, marketers and managers must choose among two or more courses of action. This is where fact-finding, marketing information, and research into the target market segment and target customer enter to help make the choice.

Marketing information and research address the need for quicker, yet more accurate, decision making by the marketer. These tools put marketers close to their customers to help them understand who they customers are, what they want, and what competitors are doing. When different stakeholders have very different views about a particular marketing-related decision, objective information and research can inform everyone about the issues in question and help the organization come to agreement about the path forward. Good research should help align marketing with the other areas of the business.

Marketers should always be tapping into regular sources of marketing information about their organization and industry in order to monitor what's happening generally. For example, at any given time marketers should understand how they are doing relative to sales goals and monitor developments in their industry or competitive set.

Beyond this general level of "tuning in," additional market research projects may also be justified. As a rule, if the research results can save the company more time, money, and/or risk than it costs to conduct the research, it is wise to proceed. Ultimately, successful marketing strategies are developed on the basis of focused and continued research of customers identified by disciplined segmentation and targeting.

? Practice Question

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1. Vincent P. Barabba, *Surviving Transformation: Lessons from GM's Surprising Turnaround*, pp 46–50, https://books.google.com/books?id=VvbDYad7cLoC&pg↵
2. Proquest, "First We Built, Now We Buy: A Sociological Case Study for Enterprise Systems in Higher Education," pp 292–203, books.google.com/books?id=rgIAaigKQBIC&pg↵

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28.12: The Marketing Research Process

Learning Objectives

- Explain the process and goal of market research
- Explain how market research helps marketers validate their target markets

Marketing research is a useful and necessary tool for helping marketers and an organization's executive leadership make wise decisions. Carrying out marketing research can involve highly specialized skills that go deeper than the information outlined in this module. However, it's important for any marketer to be familiar with the basic procedures and techniques of marketing research.

It's very likely that at some point a marketing professional will need to supervise an internal marketing research activity or to work with an outside marketing research firm to conduct a research project. Managers who understand the research function can do a better job of framing the problem and critically appraising the proposals made by research specialists. They are also in a better position to evaluate their findings and recommendations.

Periodically marketers themselves need to find solutions to marketing problems without the assistance of marketing research specialists inside or outside the company. If you are familiar with the basic procedures of marketing research, you can supervise and even conduct a reasonably satisfactory search for the information needed.

Figure 28.12.1: The Marketing Research Process

Step 1: Identify the Problem

The first step for any marketing research activity is to clearly identify and define the problem you are trying to solve. You start by stating the marketing or business problem you need to address and for which you need additional information to figure out a solution. Next, articulate the objectives for the research: What do you want to understand by the time the research project is completed? What specific information, guidance, or recommendations need to come out of the research in order to make it a worthwhile investment of the organization's time and money?

It's important to share the problem definition and research objectives with other team members to get their input and further refine your understanding of the problem and what is needed to solve it. At times, the problem you really need to solve is not the same problem that appears on the surface. Collaborating with other stakeholders helps refine your understanding of the problem, focus your thinking, and prioritize what you hope to learn from the research. Prioritizing your objectives is particularly helpful if you don't have the time or resources to investigate everything you want.

To flesh out your understanding of the problem, it's useful to begin brainstorming actual research questions you want to explore. What are the questions you need to answer in order to get to the research outcomes? What is the missing information that marketing research will help you find? The goal at this stage is to generate a set of preliminary, big-picture questions that will frame your research inquiry. You will revisit these research questions later in the process, but when you're getting started, this exercise helps clarify the scope of the project, whom you need to talk to, what information may already be available, and where to look for the information you don't yet have.

Marketing Research for Bookends

Your uncle Dan owns an independent bookstore called Bookends, and it's not doing very well. (That's you in the picture.) The store's sales are down, and the rent is going up. Dan has turned to you for help, since you know a thing or two about marketing.

You need a lot of information if you're going to help your uncle turn things around, so marketing research is a good idea. You begin by identifying the problem and then work to set down your research objectives and initial research questions:

Identifying Problems, Objectives, and Questions

Core business problem Dan needs to solve	How to get more people to spend more money at Bookends
Research objectives	1) Identify promising target audiences for Bookends; 2) Identify strategies for rapidly increasing revenue from these target audiences
Initial research questions	Who are Bookends' current customers? How much do they spend? Why do they come to Bookends? What do they wish Bookends offered? Who isn't coming to Bookends, and why?

Step 2: Develop a Research Plan

Once you have a problem definition, research objectives, and a preliminary set of research questions, the next step is to develop a research plan. Essential to this plan is identifying precisely what information you need to answer your questions and achieve your objectives. Do you need to understand customer opinions about something? Are you looking for a clearer picture of customer needs and related behaviors? Do you need sales, spending, or revenue data? Do you need information about competitors' products, or insight about what will make prospective customers notice you? When do need the information, and what's the time frame for getting it? What budget and resources are available?

Once you have clarified what kind of information you need and the timing and budget for your project, you can develop the research design. This details how you plan to collect and analyze the information you're after. Some types of information are readily available through *secondary research* and *secondary data* sources. Secondary research analyzes information that has already been collected for another purpose by a third party, such as a government agency, an industry association, or another company. Other types of information need to from talking directly to customers about your research questions. This is known as *primary research*, which collects *primary data* captured expressly for your research inquiry. Marketing research projects may include secondary research, primary research, or both.

Depending on your objectives and budget, sometimes a small-scale project will be enough to get the insight and direction you need. At other times, in order to reach the level of certainty or detail required, you may need larger-scale research involving participation from hundreds or even thousands of individual consumers. The research plan lays out the information your project will capture—both primary and secondary data—and describes what you will do with it to get the answers you need. (Note: You'll learn more about data collection methods and when to use them later in this module.)

Your data collection plan goes hand in hand with your analysis plan. Different types of analysis yield different types of results. The analysis plan should match the type of data you are collecting, as well as the outcomes your project is seeking and the resources at your disposal. Simpler research designs tend to require simpler analysis techniques. More complex research designs can yield powerful results, such as understanding causality and trade-offs in customer perceptions. However, these more sophisticated designs can require more time and money to execute effectively, both in terms of data collection and analytical expertise.

The research plan also specifies who will conduct the research activities, including data collection, analysis, interpretation, and reporting on results. At times a singlehanded marketing manager or research specialist runs the entire research project. At other times, a company may contract with a marketing research analyst or consulting firm to conduct the research. In this situation, the marketing manager provides supervisory oversight to ensure the research delivers on expectations.

Finally, the research plan indicates who will interpret the research findings and how the findings will be reported. This part of the research plan should consider the internal audience(s) for the research and what reporting format will be most helpful. Often, senior executives are primary stakeholders, and they're anxious for marketing research to inform and validate their choices. When this is the case, getting their buy-in on the research plan is recommended to make sure that they are comfortable with the approach and receptive to the potential findings.

✔ A Bookends Research Plan

You talk over the results of your problem identification work with Dan. He thinks you're on the right track and wants to know what's next. You explain that the next step is to put together a detailed plan for getting answers to the research questions.

Dan is enthusiastic, but he's also short on money. You realize that such a financial constraint will limit what's possible, but with Dan's help you can do something worthwhile. Below is the research plan you sketch out:

Identifying Data Types, Timing and Budget, Data Collection Methods, Analysis, and Interpretation

Types of data needed	1) Demographics and attitudes of current Bookends customers; 2) current customers' spending patterns; 3) metro area demographics (to determine types of people who aren't coming to the store)
Timing & budget	Complete project within 1 month; no out-of-pocket spending
Data collection methods	1) Current customer survey using free online survey tool, 2) store sales data mapped to customer survey results, 3) free U.S. census data on metro-area demographics, 4) 8–10 intercept ("man on the street") interviews with non-customers
Analysis plan	Use Excel or Google Sheets to tabulate data; Marina (statistician cousin) to assist in identifying data patterns that could become market segments
Interpretation and reporting	You and Dan will work together to comb through the data and see what insights it produces. You'll use PowerPoint to create a report that lays out significant results, key findings, and recommendations.

Step 3: Conduct the Research

Conducting research can be a fun and exciting part of the marketing research process. After struggling with the gaps in your knowledge of market dynamics—which led you to embark on a marketing research project in the first place—now things are about to change. Conducting research begins to generate information that helps answer your urgent marketing questions.

Typically data collection begins by reviewing any existing research and data that provide some information or insight about the problem. As a rule, this is secondary research. Prior research projects, internal data analyses, industry reports, customer-satisfaction survey results, and other information sources may be worthwhile to review. Even though these resources may not answer your research questions fully, they may further illuminate the problem you are trying to solve. Secondary research and data sources are nearly always cheaper than capturing new information on your own. Your marketing research project should benefit from prior work wherever possible.

After getting everything you can from secondary research, it's time to shift attention to primary research, if this is part of your research plan. Primary research involves asking questions and then listening to and/or observing the behavior of the target audience you are studying. In order to generate reliable, accurate results, it is important to use proper scientific methods for primary research data collection and analysis. This includes identifying the right individuals and number of people to talk to, using carefully worded surveys or interview scripts, and capturing data accurately.

Without proper techniques, you may inadvertently get bad data or discover bias in the responses that distorts the results and points you in the wrong direction. The module on Marketing Research Techniques discusses these issues in further detail, since the procedures for getting reliable data vary by research method.

Getting the Data on Bookends

Dan is on board with the research plan, and he's excited to dig into the project. You start with secondary data, getting a dump of Dan's sales data from the past two years, along with related information: customer name, zip code, frequency of purchase, gender, date of purchase, and discounts/promotions (if any).

You visit the U.S. Census Bureau Web site to download demographic data about your metro area. The data show all zip codes in the area, along with population size, gender breakdown, age ranges, income, and education levels.

The next part of the project is customer-survey data. You work with Dan to put together a short survey about customer attitudes toward Bookends, how often and why they come, where else they spend money on books and entertainment, and why they go other places besides Bookends. Dan comes up with the great idea of offering a 5 percent discount coupon to anyone who completes the survey. Although it eats into his profits, this scheme gets more people to complete the survey and buy books, so it's worth it.

Figure 28.12.1: Copy and Paste Caption here. (Copyright; author via source)

For a couple of days, you and Dan take turns doing "man on the street" interviews (you interview the guy in the red hat, for instance). You find people who say they've never been to Bookends and ask them a few questions about why they haven't visited the store, where else they buy books and other entertainment, and what might get them interested in visiting Bookends sometime. This is all a lot of work, but for a zero-budget project, it's coming together pretty well.

Step 4: Analyze and Report Findings

Analyzing the data obtained in a market survey involves transforming the primary and/or secondary data into useful information and insights that answer the research questions. This information is condensed into a format to be used by managers—usually a presentation or detailed report.

Analysis starts with formatting, cleaning, and editing the data to make sure that it's suitable for whatever analytical techniques are being used. Next, data are tabulated to show what's happening: What do customers actually think? What's happening with purchasing or other behaviors? How do revenue figures actually add up? Whatever the research questions, the analysis takes source data and applies analytical techniques to provide a clearer picture of what's going on. This process may involve simple or sophisticated techniques, depending on the research outcomes required. Common analytical techniques include regression analysis to determine correlations between factors; conjoint analysis to determine trade-offs and priorities; predictive modeling to anticipate patterns and causality; and analysis of unstructured data such as Internet search terms or social media posts to provide context and meaning around what people say and do.

Good analysis is important because the interpretation of research data—the "so what?" factor—depends on it. The analysis combs through data to paint a picture of what's going on. The interpretation goes further to explain what the research data mean and make recommendations about what managers need to know and do based on the research results. For example, what is the short list of key findings and takeaways that managers should remember from the research? What are the market segments you've identified, and which ones should you target? What are the primary reasons your customers choose your competitor's product over yours, and what does this mean for future improvements to your product?

Individuals with a good working knowledge of the business should be involved in interpreting the data because they are in the best position to identify significant insights and make recommendations from the research findings. Marketing research reports incorporate both analysis and interpretation of data to address the project objectives.

The final report for a marketing research project may be in written form or slide-presentation format, depending on organizational culture and management preferences. Often a slide presentation is the preferred format for initially sharing research results with internal stakeholders. Particularly for large, complex projects, a written report may be a better format for discussing detailed findings and nuances in the data, which managers can study and reference in the future.

✔ Analysis and Insights for Bookends: Target market validation

Getting the data was a bit of a hassle, but now you've got it, and you're excited to see what it reveals. Your statistician cousin, Marina, turns out to be a whiz with both the sales data and the census data. She identified several demographic profiles in the metro area that looked a lot like lifestyle segments. Then she mapped Bookends' sales data into those segments to show who is and isn't visiting Bookends. After matching customer-survey data to the sales data, she broke down the segments further based on their spending levels and reasons they visit Bookends.

Gradually a clearer picture of Bookends' customers is beginning to emerge: who they are, why they come, why they don't come, and what role Bookends plays in their lives. Right away, a couple of higher-priority segments—based on their spending levels, proximity, and loyalty to Bookends—stand out. The research has succeeded in segmenting the market into manageable targets. You and your uncle are definitely seeing some possibilities for making the bookstore a more prominent part of their lives. You capture these insights as "recommendations to be considered" while you evaluate the right marketing mix for each of the new segments you have now validated.

Step 5: Take Action

Once the report is complete, the presentation is delivered, and the recommendations are made, the marketing research project is over, right? Wrong.

What comes next is arguably the most important step of all: taking action based on your research results.

If your project has done a good job interpreting the findings and translating them into recommendations for the marketing team and other areas of the business, this step may seem relatively straightforward. When the research results validate a path the organization is already on, the "take action" step can galvanize the team to move further and faster in that same direction.

Things are not so simple when the research results indicate a new direction or a significant shift is advisable. In these cases, it's worthwhile to spend time helping managers understand the research, explain why it is wise to shift course, and explain how the business will benefit from the new path. As with any important business decision, managers must think deeply about the new approach and carefully map strategies, tactics, and available resources to plan effectively. By making the results available and accessible to managers and their execution teams, the marketing research project can serve as an ongoing guide and touchstone to help the organization plan, execute, and adjust course as it works toward desired goals and outcomes.

It is worth mentioning that many marketing research projects are never translated into management action. Sometimes this is because the report is too technical and difficult to understand. In other cases, the research conclusions fail to provide useful insights or solutions to the problem, or the report writer fails to offer specific suggestions for translating the research findings into management strategy. These pitfalls can be avoided by paying due attention to the research objectives throughout the project and allocating sufficient time and resources to do a good job interpreting research results for those who will need to act on them.

✔ Bookends' New Customer Campaign

Your research findings and recommendations identified three segments for Bookends to focus on. Based on the demographics, lifestyle, and spending patterns found during your marketing research, you're able to name them: 1) Bored Empty-Nesters, 2) Busy Families, and 3) Hipster Wannabes. Dan has a decent-sized clientele across all three groups, and they are pretty good spenders when they come in. But until now he hasn't done much to purposely attract any of them.

With newly identified segments in focus, you and Dan begin brainstorming about a marketing mix to target each group. What types of books and other products would appeal to each one? What activities or events would bring them into the store? Are there promotions or particular messages that would induce them to buy at Bookends instead of Amazon or another bookseller? How will Dan reach and communicate with each group? And what can you do to bring more new customers into the store within these target groups?

Even though Bookends is a real-life project with serious consequences for your uncle Dan, it's also a fun laboratory where you can test out some of the principles you're learning in your marketing class. You're figuring out quickly what it's like to be a marketer.

Well done, rookie!

? Practice Questions

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28.13: Introduction to Marketing Mix Introduction

What you'll learn to do: explain the marketing mix

The value proposition explains why a consumer should buy a product or use a service and how the product or service will add more value, or better solve a problem, than other similar offerings. Once you get the value proposition right, you still have to actually *deliver value* to your target customer. The marketing mix describes the tools that marketers use to create value for customers.

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28.14: Defining the Marketing Mix

Learning Objectives

- Define product
- Define promotion
- Define place
- Define price

Reaching Customers through the Marketing Mix

The value proposition is a simple, powerful statement of value, but it is only the tip of the iceberg. How do marketing professionals ensure that they are reaching and delivering value to the target customer?

Take yourself, as a "target customer." Think about your cell phone. What would make you want to buy a new one? How might the following issues affect your purchasing decision?

- Features: A company has just released a new phone with amazing features that appeal to you.
- Price: You're concerned about the price—is this phone a good deal? Too expensive? So cheap that you suspect there's a "catch"?
- Information: How did you find out about this phone? Did you see an ad? Hear about it from a friend? See pictures and comments about it online?
- Customer service: Is your cell service provider making it easier for you to buy this phone with a new plan or an upgrade?
- Convenience: Could you easily buy it online in a moment of indulgence?

You can see there are multiple factors that might influence your thinking and decision about what to buy—a *mix* of factors. Taken together, these factors are all part of the "marketing mix."

Organizations must find the right combination of factors that allow them to gain an advantage over their competitors. This combination—the marketing mix—is the combination of factors that a company controls to provide value to its target customers.

The following video illustrates how the marketing mix changes depending on the target customer:

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "Value Creation Through the Marketing Mix" (opens in new window).

Evolving Definitions of the Marketing Mix

There are a few different ways the marketing mix is presented. During the 1950s the components of the marketing mix were conceived as the "four Ps" and were defined as follows:

1. Product: the goods and services offered
2. Promotion: communication and information
3. Place: distribution or delivery
4. Price: ensuring fair value in the transaction[1]

Today, this categorization continues to be useful in understanding the basic activities associated with marketing. The marketing mix represents the way an organization's broad marketing strategies are translated into marketing programs for action.

PRactice Questions

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Over time, new categories of the marketing mix have been proposed. Most are more consumer oriented and attempt to better fit the movement toward a marketing orientation and a greater emphasis on customer value. One example is the four Cs, proposed by Robert F Lauterborn in 1990:

1. Customer solution: what the customer wants and needs
2. Communication: a two-way dialogue with the customer
3. Convenience: an easy process to act or buy
4. Cost: the customer's cost to satisfy that want or need[2]

The four Cs include a greater focus on the customer but align nicely with the older four Ps. They also enable one to think about the marketing mix for services, not just products. While it is difficult to think about hotel accommodations as a distinct *product*, it is much easier to think about a hotel creating a *customer solution*. You can see how the four Ps compare with the four Cs in the chart below:

The Four Ps and the Four Cs

Four Ps	Four Cs	Definition
Product	Consumer solution	A company will only sell what the consumer *specifically* wants to buy. So, marketers should study consumer wants and needs in order to attract them one by one with something he/she wants to purchase.
Promotion	Communication	Communications can include advertising, public relations, personal selling, viral advertising, and any form of communication between the organization and the consumer.

Place	Convenience	In the era of Internet, catalogs, credit cards, and smartphones, often people don't have to go to a particular place to satisfy a want or a need, nor are they limited to a few places to satisfy them. Marketers should know how the target market prefers to buy, how to be there and be ubiquitous, in order to provide *convenience of buying*. With the rise of Internet and hybrid models of purchasing, "place" is becoming less relevant. Convenience takes into account the ease of buying the product, finding the product, finding information about the product, and several other factors.
Price	Cost	Price is only a part of the total *cost to satisfy* a want or a need. For example, the total cost might be the *cost of time* in acquiring a good or a service, along with the *cost of conscience* in consuming it. It reflects the total cost of ownership. Many factors affect cost, including but not limited to the customer's cost to change or implement the new product or service and the customer's cost for not selecting a competitor's product or service.

Whether we reference the four Ps or the four Cs, it is important to recognize that marketing requires attention to a range of different approaches and variables that influence customer behavior. Getting the right mix of activities is essential for marketing success.

Competitors and the Marketing Mix

The challenge of getting the right marketing mix is magnified by the existence of competitors, who exert market pressures using strategies defined by their marketing mix alternatives. Remember, the purpose of the marketing mix is to find the right combination of product, price, promotion, and distribution (place) so that a company can gain and maintain advantage over competitors.

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1. McCarthy, Jerome E. (1964). *Basic Marketing. A Managerial Approach*. Homewood, IL: Irwin. ↵
2. Lauterborn, B. (1990). New Marketing Litany: *Four Ps Passé: C-Words Take Over*. Advertising Age, 61(41), 26. ↵

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28.15: Components of the Marketing Mix

Learning Objectives

- Define product
- Define promotion
- Define place
- Define price

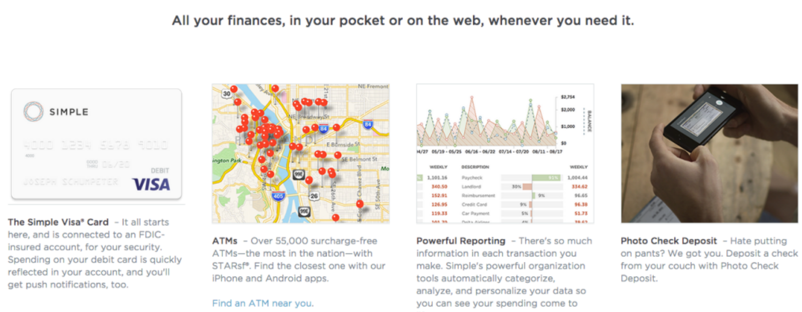
Product

Figure 28.15.1: Product

In the marketing mix, the term "product" means the solution that the customer wants and needs. In this context, we focus on the solution rather than only on the physical product. Examples of the product include:

- The Tesla Model S, a premium electric car
- A Stay at a Holiday Inn Express, a low-price national hotel chain
- Doritos Nachos Cheese, a snack food
- Simple, an online banking service

Each of these products has a unique set of features, design, name, and brand that are focused on a target customer. The characteristics of the products are different from competitors' products.



Source: https://www.simple.com/banking

Promotion

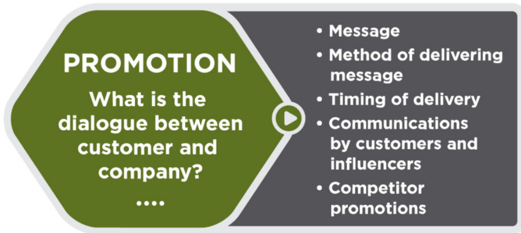


Figure 28.15.2: Promotion

In the marketing mix, the term "promotion" refers to the communications that occur between the company and the customer. Promotion includes both the messages sent by the company and messages that customers send to the public about their experience. Examples of promotion include:

- An advertisement in Cooking Light magazine
- A customer's review of the product on YouTube
- A newspaper article in the local paper quoting a company employee as an expert
- A text message sent to a list of customers or prospects

Marketing professionals have an increasingly difficult job influencing promotions that cannot be controlled by the company. The company's formal messages and advertising are only one part of promotions.

Figure 28.15.3: Marketers often run social media campaigns, rewarding customers who "Like" the company on Facebook.

Place

Figure 28.15.4: Place

In the marketing mix, the term "place" refers to the distribution of the product. Where does the customer buy the product? "Place" might be a traditional brick-and-mortar store, or it could be online. Examples include:

- Distribution through an online retailer such as Amazon.com
- Use of a direct sales force that sells directly to buyers
- Sales through the company's Web site, such as the shoe purchases at Nike.com
- Sales by a distributor or partner, such as the purchase of a Samsung phone from Best Buy or from a Verizon store

In today's world, the concept of "place" in the marketing mix rarely refers to a specific physical address. It takes into account the broad range of distribution channels that make it easy for the target customer to buy.

Price

Figure 28.15.5: Copy and Paste Caption here. (Copyright; author via source)

In the marketing mix, the term "price" refers to the cost to the customer. This requires the company to analyze the product's value for the target customer. Examples of price include:

- The price of a used college textbook in the campus bookstore
- Promotional pricing such as Sonic Drive-In's half-price cheeseburgers on Tuesdays
- Discounts to trade customers, such as furniture discounts for interior designers

Marketing professionals must analyze what buyers are willing to pay, what competitors are charging, and what the price means to the target customer when calculating the product's value. Determining price is almost always a complicated analysis that brings together many variables.

Figure 28.15.6: Sonic offers discounts on cheeseburgers on Tuesday, which is typically a low sales day of the week. Source: www.sonicdrivein.com

? Practice Questions

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28.16: Finding the Right Marketing Mix

Learning Objectives

- Give examples of the marketing mix

How does an organization determine the right marketing mix? The answer depends on the organization's goals. Think of the marketing mix as a recipe that can be adjusted—through small adjustments or dramatic changes—to support broader company goals.

Decisions about the marketing-mix variables are interrelated. Each of the marketing mix variables must be coordinated with the other elements of the marketing program.

Consider, for a moment, the simple selection of hair shampoo. Let's think about three different brands of shampoo and call them Discount, Upscale, and Premium. The table below shows some of the elements of the marketing mix that impact decisions by target customers.

Table 28.16.1. Comparing Discount, Upscale, and Premium Shampoo Using the Four Ps

4 Ps	Discount	Upscale	Premium
Product	Cleansing product, pleasant smell, low-cost packaging	Cleansing product, pleasant smell, attractive packaging	Cleansing product, pleasant smell created by named ingredients, premium packaging
Promotion	Few, if any, broad communications	National commercials show famous female "customers" with clean, bouncy hair	Differentiating features and ingredients highlighted (e.g., safe for colored hair), as well as an emphasis on the science behind the formula. Recommended by stylist in the salon.
Place	Distributed in grocery stores and drugstores	Distributed in grocery stores and drugstores	Distributed only in licensed salons
Price	Lowest price on the shelf	Highest price in the grocery store (8 times the prices of discount)	3 to 5 times the price of Upscale

A number of credible studies suggest that there is no difference in the effectiveness of Premium or Upscale shampoo compared with Discount shampoo, but the communication, distribution, and price are substantially different. Each product appeals to a very different target market. Do you buy your shampoo in a grocery store or a salon? Your answer is likely based on the marketing mix that has most influenced you.

An effective marketing mix centers on a target customer. Each element of the mix is evaluated and adjusted to provide unique value to the target customer. In our shampoo example, if the target market is affluent women who pay for expensive salon services, then reducing the price of a premium product might actually hurt sales, particularly if it leads stylists in salons to question the quality of the ingredients. Similarly, making the packaging more appealing for a discount product could have a negative impact if it increases the price even slightly *or* if it causes shoppers to visually confuse it with a more expensive product.

Practice Question

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The goal with the marketing mix is to align marketing activities with the needs of the target customer.

Tool Product Lines

Another example of an effective marketing mix comes from a tool company with both B2B and B2C customers, creating three distinct product lines—each with an appropriate marketing mix—to satisfy the needs of the three distinct target customers.

The first product line is an inexpensive set of basic tools for the home, available to purchase almost anywhere, that are advertised on TV. The second line is a moderately-priced set of better tools designed for the workshop enthusiast, distributed through big box home improvement stores that are promoted in DIY magazines. The third line is an expensive set of commercial-grade tools for the construction industry, sold directly at work sites and promoted in professional journals.

Table 28.16.2. Comparing Discount, Upscale, and Premium Tools Using the Four Ps

4 Ps	Discount	Upscale	Premium
Product	Simple, basic home tools	Better tools for workshop use	Commercial quality for construction use
Promotion	T.V. advertising to reach consumers	D.I.Y magazines and web sites	Professional journals
Place	Distributed to all mass market retailers	Distributed through big box home improvement stores	Distributed directly to construction job sites
Price	Inexpensive	Moderate	Expensive

Notice how the characteristics of each segment of the mix are geared for the target customer.

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28.17: Creating and Aligning the Marketing Strategy

Learning Objectives

- Evaluate how marketing strategies align with corporate strategies

Inputs That Inform Marketing Strategy

To a great extent, developing the marketing strategy follows the same sequence of activities used to define a corporate strategy. The chief difference is that the marketing strategy is directly affected by the overall corporate strategy; that is, the marketing strategy needs to work *with*—not apart from—the corporate strategy. As a result, the marketing strategy must always involve monitoring and reacting to changes in the corporate strategy and objectives.

In order to be effective, a marketing strategy must capitalize on the resources at its disposal *within* the company, but also take advantage of the market forces that are *outside* the company. One way to assess these different factors, or inputs, is by conducting a situation analysis (also called a SWOT analysis). As you recall, a SWOT analysis includes a review of the company's internal strengths and weaknesses and any external opportunities and threats that it faces.

Centering on the Target Customer

The **marketing strategy** defines how the marketing mix can best be used to achieve the corporate strategy and objectives. The centerpiece of the marketing strategy is the target customer. While the corporate strategy may have elements that focus on internal operations or seek to influence external forces, each component of the marketing strategy is focused on the target customer.

Recall the following steps of determining who your target customer is:

1. Identify the business need you will address, which will be driven by the corporate strategies and objectives;
2. Segment your total market, breaking down the market and identifying the subgroup you will target;
3. Profile your target customer, so that you understand how to provide unique value;
4. Research and validate your market opportunity.

Focusing the marketing strategy on the target customer seems like a no-brainer, but often organizations get wrapped up in their own strategies, initiatives, and products and forget to focus on the target customer. When this happens the customer loses faith in the product or the company and turns to alternative solutions.

Aligning Corporate and Marketing Strategies

Figure 28.17.1: Marketing Planning Process

How would good corporate-level objectives inform the marketing strategy and objectives? Consider the following examples:Objectives can create alignment between corporate and marketing strategies. If the corporate objectives are clearly defined and communicated, they can guide and reinforce each step of the marketing planning process.

1. Imagine completing a market segmentation process. You find a target market that will find unique value in your offering. The decision to pursue that target market will depend on whether that segment is large enough to support the corporate objectives for market growth.
2. How many new products should the company launch this year? The answer should be informed by the corporate objectives for growth and profitability.
3. The marketing function has identified a customer relationship management campaign that would create greater customer loyalty. Does the cost of the campaign and its expected returns align with the company objectives?

As you can see, company objectives provide important guidance to the marketing planning process. Likewise, marketing objectives ensure that the goals of the marketing strategy are defined, communicated, and measured.

? PRactice Question

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28.18: Putting It Together- Marketing Function

Synthesis

On February 1, 2015, a notable event occurred in the history of television: 114.5 million Americans watched a football game on TV, making it the most watched television program in U.S. history. Are there really 114.5 million football fans in the United States? Probably not. Why did so many people watch? Answer: the commercials!

Advertisers paid $4.5 million for 30 seconds of commercial airtime during this event. That works out to $150,000 per second. What were those companies doing when they made the decision to spend so much money? Marketing!

This is of course an extreme example of marketing in action, but if you begin to look closely at the world around you, you'll find that companies' marketing efforts are everywhere. Why do you shop where you shop? Are you a Coke or a Pepsi drinker? Do you only purchase items when they are on sale? Is your keychain (real or virtual) full of customer-loyalty cards? Marketing efforts are at work practically every time a customer perceives the value of a product or service and decides to swap some hard-earned money for it. Such marketing triumphs are just not the happy result of arbitrary circumstances, though—they're the product of strategic planning and research. Understanding how marketing efforts are created and conducted can help you be a better-informed consumer of products, goods, services, and information.

Summary

This module covered the marketing function and its contributions to business success. Below is a summary of the topics covered in this module.

Role of Customers

All marketing centers on creating, delivering, and communicating value to the customer. A value proposition is a clear and succinct statement to the customer of the value being offered by a company's products or services.

Segmentation and Targeting

One of the first steps in effective marketing is identifying and reaching the right customers. Marketers use segmentation and targeting to do this. Market segmentation is the process of splitting buyers into distinct, measurable groups that share similar wants and needs. Common segmentation approaches include geographic, demographic, psychographic, and behavioral criteria. Once different segments are identified, marketers determine which target segments to focus on to support corporate strategy and growth.

Marketing Mix Introduction

There are multiple factors that can influence someone's thinking and decision about what to buy—a *mix* of factors. Taken together, these factors are all part of the "marketing mix." The marketing mix, also known as the four Ps, is represented by the four main factors below:

1. Product: the goods and services offered
2. Promotion: communication and information
3. Place: distribution or delivery
4. Price: ensuring fair value in the transaction

The major objective of marketing is getting the marketing mix right for the target customer in alignment with corporate goals.

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28.19: Discussion- Customer Value Perception

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda has been fortunate that her dog treats have sold so well, but she has been reading about small business marketing and is concerned that as her business continues to grow, she may not get the highest return possible from her marketing dollars. Of primary concern is whether she has really identified her customers. In other words, if she doesn't know who her customers are, how can she be certain that they see the value in doing business with Salty Pawz?

Your Task

You will write a value statement that Wanda can include on her company Web site. In order to craft an appropriate statement, you must consider Wanda's business, the products she sells, her current and potential customers and markets.

For Discussion

1. Begin your post with a summary describing Salty Pawz's customers and the market segment that they represent. Be specific in your description, including demographic information about her customers.
2. Present the value statement you have written for Salty Pawz. Remember that a value statement is a business or marketing statement that summarizes why a consumer should buy a product or use a service. This statement should convince a potential consumer that one particular product or service will add more value or better solve a problem than other similar offerings.
3. Finally, briefly explain how your value statement helps Wanda
   - **identify** a want or need the prospective customers who possess this want or need,
   - **satisfy** these customers by delivering a product or service that addresses these needs at the time customers want it,
   - **retain** customers by creating new opportunities to win customer loyalty and business.

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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28.20: Discussion- Black Friday and Cyber Monday

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

What started as a promotional strategy among several large U.S. retailers has grown into an annual, nationwide shopping event held the day after Thanksgiving: Black Friday. Every year, Black Friday sales get larger, the stores open earlier, the prices get lower, and, unfortunately, the even often includes angry crowds of shoppers, desperate to be the first ones to get a good deal. Black Friday has also given rise Cyber Monday, its online counterpart. There are even businesses that use an anti–Black Friday position as a marketing strategy! Black Friday has spread to Britain, and since 2015, citizens across the United Kingdom have also been able to share in the madness of this pseudo holiday.

For Discussion

From a marketing perspective, you need to make a decision about whether participating in Black Friday madness makes sense, given your target market and customers.

1. Given this perspective, do you believe that ignoring Black Friday is a viable marketing decision? Why or why not?
2. What segment of the market do Black Friday and Cyber Monday target? Discuss whether you believe that the targeted market segments are the same for all businesses.
3. Finally, are *you* a Black Friday shopper? Why or why not?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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28.21: Assignment- Customers and Marketing at Salty Pawz

Scenario

Wanda has been fortunate that her dog treats have sold so well, but she has been reading about small-business marketing and is concerned that as her business continues to grow, she may not get the highest return possible from her marketing dollars. One of the things she repeatedly encounters in her reading is that the "role of marketing is to *identify, satisfy, and retain customers*." Has she really identified her customers? Are they satisfied? And, more important, how can she retain those customers she does have? In other words, do her customers or potential customers see the value in doing business with Salty Pawz?

Your Task

Consider Wanda's business, the products she sells, her customers, and markets.

1. Write a value statement for Salty Pawz. Remember that a value statement is a business or marketing statement that summarizes why a consumer should buy a product or use a service. This statement should convince a potential consumer that one particular product or service will add more value or better solve a problem than other similar offerings.
2. Explain how the value statement you have written reflects the role that marketing will play at Salty Pawz with regard to the following:
    1. **Identifies** a want or need of prospective customers,
    2. **Satisfies** those customers by delivering a product or service that addresses their needs,
    3. **Retains** customers by creating new opportunities to win their loyalty and business.

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Value statement summarizes the value of doing business with Salty Pawz.	0 points	11 points	16 points	20 points	20%
Explanation of how marketing will help Salty Pawz identify a want or need for prospective customers.	0 points	11 points	16 points	20 points	20%
Explanation of how marketing will help Salty Pawz satisfy customers by delivering a product or service that addresses their needs.	0 points	11 points	16 points	20 points	20%
Explanation of how marketing will help Salty Pawz create new opportunities to win their loyalty and business.	0 points	11 points	16 points	20 points	20%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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28.22: Assignment- Hit Your Target

Preparation

Before a business can effectively create and implement a marketing plan, it must first determine its target market. No matter how amazing the product, good, or service may be, not everyone is a potential customer! In this assignment you will consider a new product and then define the market you would target with your marketing efforts.

Your Task

1. Select one of the following products, goods, or services as the basis for your written assignment:

- An energy drink that uses all natural ingredients to boost energy levels and metabolism. This drink eliminates all of the harmful side effects that competitors' products have.
- An "intelligent" home system that monitors the residents' movements through the house and sends information to family members, caregivers, and medical providers. For example, handrails on the stairs contain heart rate monitors.
- A wireless virtual-reality headset that allows the user to experience 3D virtual reality programs including travel and games.
- A "smart bed" that monitors each partner individually and makes adjustments on its own to keep people sleeping soundly. As sleeping positions change throughout the night, the bed self-adjusts to optimize the sleep surface and comfort level.
- A chain of luxury hotels that offer luxury on-site pet accommodations for their guests' dogs and cats. Pets can receive massages, pedicures, chef-prepared gourmet meals, and outings to local parks, beaches, and lakes.

2. For the product or service you chose, prepare a Target Market Report that includes the following information:

- Identify the customer need(s) that the product/service addresses. This should include who the product/service is designed for, the unique features of the product/service, and who would you want your customers to be.
- Separate the large market you identified into smaller segments. After creating these smaller subgroups, determine which ones you believe would be the most profitable or productive to target.
- Create a profile of your target segments as described in your text.
- Now that you have identified a market segment to target, is it large enough to sustain the product/service in both the long and short term? You may want to look at demographic information from your state or federal databases, such as the United States Census Bureau.

Your submission must follow the written assignment guidelines for the course.

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28.23: Assignment- Marketing Mix Examples

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 the learning outcomes of Introduction to Business 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 Objectives

- Give examples of the marketing mix

In the Marketing Function module, we cover the 4Ps: Products, Promotion, Place, and Price. Even if you haven't had experience with marketing, you have a lot of experience as a customer. What is the marketing mix of one of your favorite brand? Think of the marketing mix as a recipe that can be adjusted—through small adjustments or dramatic changes—to support broader company goals.

Using your cell phone or any other recording device, create a short video about the 4Ps of one of your favorite products. 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.

Do an internet search for a product of your choice. Research for areas of their website where they mention details about their products, promotions, places, and price. Think of your audience as fellow students who are interested to learn about these ideas because they want to learn important marketing concepts. In your video, you can address the following:

- What are some interesting points on the website about the product?
- What are their promotions? What's the price? Where can you find the product?
- If you have had experience with the company of your choice, and you feel comfortable sharing your experience, tell your audience what worked or didn't work for you about their marketing. What can they improve?

A Note To Teachers: For this assignment, the first term students will be creating the videos, and then the next term's students can respond to the videos. After you have two terms of examples, use the best three from the batch as examples and start the process over again. Using the videos as starting points for OL discussion boards may work as well. If you are using the Salty Paws Case Study, you could refer back to that assignment as guidance for your students who may be learning these concepts for the first time.

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SECTION OVERVIEW

28.24: Module 12- Marketing

28.24.1: Reading- Introduction to Product Pricing

Price, the Only Revenue Generator

Price is the only marketing mix variable or part of the offering that generates revenue. Buyers relate the price to value. They must feel they are getting value for the price paid. Pricing decisions are extremely important. So how do organizations decide how to price their goods and services?

New Product Pricing

With a totally new product, competition does not exist or is minimal. Two general strategies are most common for setting prices: penetration pricing and skimming

Penetration Pricing

In the introductory stage of a new product's life cycle means accepting a lower profit margin and to price relatively low. Such a strategy should generate greater sales and establish the new product in the market more quickly. Penetration pricing is the pricing technique of setting a relatively low initial entry price, often lower than the eventual market price, to attract new customers. The strategy works on the expectation that customers will switch to the new brand because of the lower price. Penetration pricing is most commonly associated with a marketing objective of increasing market share or sales volume, rather than to make profit in the short term.

The advantages of penetration pricing to the firm are the following:

- It can result in fast diffusion and adoption. This can achieve high market penetration rates quickly. This can take the competitors by surprise, not giving them time to react.
- It can create goodwill among the early adopters segment. This can create more trade through word of mouth.
- It creates cost control and cost reduction pressures from the start, leading to greater efficiency.
- It discourages the entry of competitors. Low prices act as a barrier to entry.
- It can create high stock turnover throughout the distribution channel. This can create critically important enthusiasm and support in the channel.
- It can be based on marginal cost pricing, which is economically efficient.
- A penetration strategy would generally be supported by the following conditions: price-sensitive consumers, opportunity to keep costs low, the anticipation of quick market entry by competitors, a high likelihood for rapid acceptance by potential buyers, and an adequate resource base for the firm to meet the new demand and sales.

Skimming

Skimming involves goods being sold at higher prices so that fewer sales are needed to break even. Selling a product at a high price and sacrificing high sales to gain a high profit is therefore "skimming" the market. Skimming is usually employed to reimburse the cost of investment of the original research into the product. It is commonly used in electronic markets when a new range, such as DVD players, are firstly dispatched into the market at a high price. This strategy is often used to target "early adopters" of a product or service. Early adopters generally have a relatively lower price sensitivity and this can be attributed to their need for the product outweighing their need to economize, a greater understanding of the product's value, or simply having a higher disposable income.

This strategy is employed only for a limited duration to recover most of the investment made to build the product. To gain further market share, a seller must use other pricing tactics such as economy or penetration. This method can have some setbacks as it could leave the product at a high price against the competition. A skimming strategy would generally be supported by the following conditions:

- Having a premium product. In this case, "premium" does not just denote high cost of production and materials—it also suggests that the product may be rare or that the demand is unusually high. An example would be a USD 500 ticket for the World Series or an USD 80,000 price tag for a limited-production sports car.
- Having legal protection via a patent or copyright may also allow for an excessively high price. Intel and their Pentium chip possessed this advantage for a long time. In most cases, the initial high price is gradually reduced to match new competition and allow new customers access to the product.

Psychological Pricing

Psychological pricing is a marketing practice based on the theory that certain prices have meaning to many buyers.

As with other elements in the marketing mix, price conveys meanings beyond the dollar amount it denotes. One such meaning is referred to as the psychological aspect of pricing. Associating quality with price is a common example of this psychological dimension. For instance, a buyer may assume that a suit priced at $500 is of higher quality than one priced at $300.

Products and services frequently have customary prices in the minds of consumers. A customary price is one that customers identify with particular items. For example, for many decades a five-stick package of chewing gum cost five cents, and a six-ounce bottle of Coca-Cola also cost five cents. Candy bars now cost 60 cents or more, which is the customary price for a standard-sized bar. Manufacturers tend to adjust their wholesale prices to permit retailers to use customary pricing.

Odd Pricing

Another manifestation of the psychological aspects of pricing is the use of odd prices. We call prices that end in digits like 5, 7, 8, and 9 "odd prices. " Examples of odd prices include: $2.95, $15.98, or $299.99. Odd prices are intended to drive demand higher than would be expected if consumers were perfectly rational.

Psychological pricing is one cause of price points. For a long time, marketers have attempted to explain why odd prices are used. It seemed to make little difference whether one paid $29.95 or $30.00 for an item. Perhaps one of the most often heard explanations concerns the psychological impact of odd prices on customers. The explanation is that customers perceive even prices such as $5.00 or $10.00 as regular prices. Odd prices, on the other hand, appear to represent bargains or savings and therefore encourage buying. There seems to be some movement toward even pricing; however, odd pricing is still very common. A somewhat related pricing strategy is combination pricing, such as two-for-one or buy-one-get-one-free. Consumers tend to react very positively to these pricing techniques.

The psychological pricing theory is based on one or more of the following hypotheses:

- Consumers ignore the least significant digits rather than do the proper rounding. Even though the cents are seen and not totally ignored, they may subconsciously be partially ignored.
- Fractional prices suggest to consumers that goods are marked at the lowest possible price.
- When items are listed in a way that is segregated into price bands (such as an online real estate search), the price ending is used to keep an item in a lower band, to be seen by more potential purchasers.

Everyday Low Pricing

Everyday low price (EDLP) is a pricing strategy promising consumers a low price without the need to wait for sale-price events or comparison shopping.

EDLP saves retail stores the effort and expense needed to mark down prices in the store during sale events, as well as to market these events. EDLP is believed to generate shopper loyalty. It was noted in 1994 that the Wal-Mart retail chain in America, which follows an EDLP strategy, would buy "feature advertisements" in newspapers on a monthly basis, while its competitors would advertise 52 weeks per year.

Procter & Gamble, Wal-Mart, Food Lion, Gordmans, and Winn-Dixie are firms that have implemented or championed EDLP. One 1992 study stated that 26% of American supermarket retailers pursued some form of EDLP, meaning the other 74% were Hi-Lo promotion-oriented operators.

One 1994 study of an 86-store supermarket grocery chain in the United States concluded that a 10% EDLP price decrease in a category increased sales volume by 3%, while a 10% Hi-Low price increase led to a 3% sales decrease; but that because consumer demand at the supermarket did not respond much to changes in everyday price, an EDLP policy reduced profits by 18%, while Hi-Lo pricing increased profits by 15%.

An example of a successful brand (other than the infamous Wal-Mart) that uses the EDLP strategy is Trader Joe's . Trader Joe's is a private-brand label that conducts a Niche marketing strategy describing itself as the "neighborhood store. " The firm has been growing at a steady pace, offering a wide variety of organic and natural food items that are hard to find, enabling the business to enjoy a distinctive competitive advantage.

Everyday Low Pricing at Trader Joe's

Trader Joe's is not an ordinary store. It's unique because of its commitment to quality and lower prices, which it makes available to everyone—no membership required. The company states that "every penny we save is every penny our customer saves" (Trader Joe's 2010). Trader Joe's has worked hard to manage this economic image of value for its products, which competitors, even giant retail stores, are unable to meet.

High/Low Pricing

High-low pricing is a method of pricing for an organization where the goods or services offered by the organization are regularly priced higher than competitors. However, through promotions, advertisements, and or coupons, lower prices are offered on other key items consumers would want to purchase. The lower promotional prices are designed to bring customers to the organization where the customer is offered the promotional product as well as the regular higher priced products.

High-low pricing is a type of pricing strategy adopted by companies, usually small and medium sized retail firms. The basic type of customers for the firms adopting high-low price will not have a clear idea about what a product's price would typically be or have a strong belief that "discount sales = low price. " Customers for firms adopting this type of strategy also have strong preference in purchasing the products sold in this type or by this certain firm. They are loyal to a specific brand.

Many big firms use this type of pricing strategy (e.g., Reebok, Nike, Adidas). The way competition prevails in the shoe industry is through high-low price. High-low pricing is also used extensively in the fashion industry by department stores (ex: Macy's and Nordstrom) This pricing strategy is not only in the shoe and fashion industry but also in many other industries. However, in these industries one or two firms will not provide discounts and works on fixed rate of earnings. Those firms will follow everyday low price strategy in order to compete in the market.

One pricing strategy does not fit all, thus adapting various pricing strategies to new scenarios is necessary for a firm to stay viable.

Other Pricing Strategies

Pricing strategies for products or services encompass three main ways to improve profits. The business owner can cut costs, sell more, or find more profit with a better pricing strategy. When costs are already at their lowest and sales are hard to find, adopting a better pricing strategy is a key option to stay viable. There are many different pricing strategies that can be utilized for different selling scenarios:

Cost-Plus Pricing

Cost-plus pricing is the simplest pricing method. The firm calculates the cost of producing the product and adds on a percentage (profit) to that price to give the selling price. This method although simple has two flaws: it takes no account of demand, and there is no way of determining if potential customers will purchase the product at the calculated price.

Limit Pricing

A limit price is the price set by a monopolist to discourage economic entry into a market, and is illegal in many countries. The limit price is the price that the entrant would face upon entering as long as the incumbent firm did not decrease output. The limit price is often lower than the average cost of production or just low enough to make entering not profitable. The quantity produced by the incumbent firm to act as a deterrent to entry is usually larger than would be optimal for a monopolist, but might still produce higher economic profits than would be earned under perfect competition.

Dynamic Pricing

A flexible pricing mechanism made possible by advances in information technology, and employed mostly by Internet based companies. By responding to market fluctuations or large amounts of data gathered from customers – ranging from where they live to what they buy to how much they have spent on past purchases – dynamic pricing allows online companies to adjust the prices of identical goods to correspond to a customer's willingness to pay. The airline industry is often cited as a success story . In fact, it employs the technique so artfully that most of the passengers on any given airplane have paid different ticket prices for the same flight.

Non-Price Competition

Non-price competition means that organizations use strategies other than price to attract customers. Advertising, credit, delivery, displays, private brands, and convenience are all examples of tools used in non-price competition. Business people prefer to use non-price competition rather than price competition, because it is more difficult to match non-price characteristics.

Pricing Above Competitors

Pricing above competitors can be rewarding to organizations, provided that the objectives of the policy are clearly understood and that the marketing mix is used to develop a strategy to enable management to implement the policy successfully. Pricing above competition generally requires a clear advantage on some non-price element of the marketing mix. In some cases, it is possible due to a high price-quality association on the part of potential buyers. Such an assumption is increasingly dangerous in today's information-rich environment. Consumer Reports and other similar publications make objective product comparisons much simpler for the consumer. There are also hundreds of dot.com companies that provide objective price comparisons. The key is to prove to customers that your product justifies a premium price.

Pricing Below Competitors

While some firms are positioned to price above competition, others wish to carve out a market niche by pricing below competitors. The goal of such a policy is to realize a large sales volume through a lower price and profit margins. By controlling costs and reducing services, these firms are able to earn an acceptable profit, even though profit per unit is usually less. Such a strategy can be effective if a significant segment of the market is price-sensitive and/or the organization's cost structure is lower than competitors. Costs can be reduced by increased efficiency, economies of scale, or by reducing or eliminating such things as credit, delivery, and advertising. For example, if a firm could replace its field sales force with telemarketing or online access, this function might be performed at lower cost. Such reductions often involve some loss in effectiveness, so the trade off must be considered carefully.

In summary, the price that we pay for any given product, good or service is the result of a series of thoughtful, well planned out strategies by the business.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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28.24.2: Reading- The Promotion Mix- The Fourth P

Factors Influencing the Promotion Mix

Promotion is the art and science of communicating about and promoting a product. The "promotion mix" is the set of activities and media channels marketers use to communicate about and promote a product.

A marketing manager from one company might decide to focus on social media, whereas a marketing manager from another company might decide to focus her company's efforts on television commercials. A third marketing manager might use both methods. Why do companies select different types of media for what may be perceived as similar messages? As Figure 1 shows, a number of factors affect the choice of promotion mix elements.

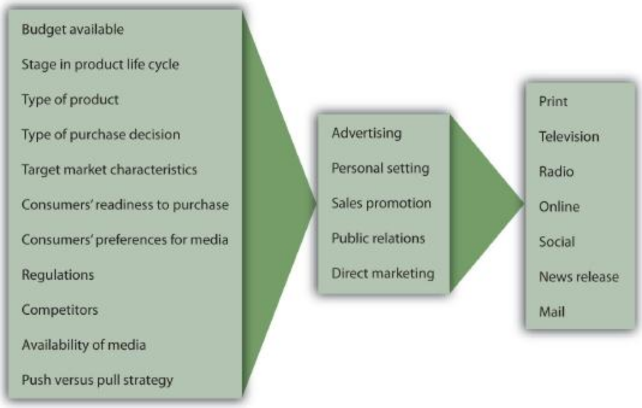

Figure 28.24.2.1: Factors That Influence Selection of Promotion Mix

For many companies, the budget available to market a product determines what elements of the promotion mix are utilized. The budget affects a promotion's reach (number of people exposed to the message) and frequency (how often people are exposed). For example, many smaller companies may lack the money to create and run commercials on top-rated television shows or during the Super Bowl. As a result, they may not get the exposure they need to be successful. Other firms such as McDonald's may come up with creative ways to reach different target markets. For example, McDonald's targeted college students with a special promotion that it filmed live in a Boston University lecture.

Stage in the Product Life Cycle

The stage in the product life cycle also affects the type and amount of promotion used. Products in the introductory stages typically need a lot more promotional dollars to create awareness in the marketplace. Consumers and businesses won't buy a product if they do not know about it. More communication is needed in the beginning of the product life cycle to build awareness and trial.

Type of Product and Type of Purchase Decision

Different products also require different types of promotion. Very technical products and very expensive products (high involvement) often need professional selling so the customer understands how the product operates and its different features. By contrast, advertising is often relied upon to sell convenience goods and products purchased routinely (low involvement) since customers are familiar with the products and they spend relatively little time making purchase decisions.

Target Market Characteristics and Consumers' Readiness to Purchase

In order to select the best methods to reach different target markets, organizations need to know what types of media different targets use, how often they make purchases, where they make purchases, and what their readiness to purchase is as well as characteristics such as age, gender, and lifestyle. Some people are early adopters and want to try new things as soon as they are available, and other groups wait until products have been on the market for a while. Some consumers might not have the money to purchase different products, although they will need the product later. For example, are most college freshmen ready to purchase new cars?

Consumers' Preferences for Various Media

We've already explained that different types of consumers prefer different types of media. In terms of target markets, college-aged students may prefer online, cell phone, mobile marketing, and social media more than older consumers do. Media preferences have been researched extensively by academics, marketing research companies, and companies to find out how consumers want to be reached.

Regulations, Competitors, and Environmental Factors

Regulations can affect the type of promotion used. For example, laws in the United States prohibit tobacco products from being advertised on television. In some Asian countries, controversial products such as alcohol cannot be advertised during Golden (prime) time on television. The hope is that by advertising late at night, young children do not see the advertisements. The strength of the economy can have an impact as well. In a weak economy, some organizations use more sales promotions such as coupons to get consumers into their stores. The risk is that consumers may begin to expect coupons and not want to buy items without a special promotion.

Availability of Media

Organizations must also plan their promotions based on availability of media. The top-rated television shows and Super Bowl ad slots, for example, often sell out quickly. Magazines tend to have a longer lead time, so companies must plan far in advance for some magazines. By contrast, because of the number of radio stations and the nature of the medium, organizations can often place radio commercials the same day they want them to be aired. Social media and online media may be immediate, but users must be careful about what they post and their privacy. Uncontrollable events can affect a company's promotions, too. For example, when a disaster occurs, TV stations often cut advertisements to make way for continuous news coverage. If there is a crisis or disaster and your company is in the middle of a promotion being advertised on TV, you will likely have to scramble to reach consumers via another medium.

The Communication Process

The goal of the communication process is to effectively reach the consumers you are targeting and convey your desired message. Achieving this is easier said than done.

Do you use TiVo or a digital video recorder (DVR) to record movies or television shows so you can watch them when you want without television commercials? Do you ever use the remote to skip the commercials or zap (change channels) to look at different shows? Think about which television shows you choose to watch, which magazines you read, which radio stations you select. The perceptual process is how a person decides what to pay attention to and how to interpret and remember different things, including information in advertising. By selecting a magazine, a television show, or even an elective class in school, you're selecting what you're exposed to and deciding what gets your attention. However, your selection does not insure you'll either pay attention or remember or correctly interpret what you see or hear.

Think about what else you are doing when you watch television, when you are studying, or when you are listening to the radio. It's a hot day in July and you're enjoying a day at the beach. Your friends brought a radio and the volume is turned up so you can hear all the music. If you're listening to the music or talking to a friend at the beach while you're listening to the radio, do you hear or pay attention to the commercials? Do you remember which products were advertised? If you're with a friend and hear someone else say your name, do you pay more attention to the person talking about you than to your friend?

The same thing happens when you are watching a television show, reading a magazine, or studying for a test. The phone rings or your friends show up and your attention shifts to them. With so many different types of distractions and technology (such as recording devices), imagine how difficult it is for an advertiser to get you to pay attention much less remember the message. Do you remember the terms you memorized for a test a day later? Do you know your friends' phone numbers and e-mail addresses or do you just find their names on your contact list? To increase retention, advertisers may repeat the same message multiple times in different places, but they must be careful that consumers don't get so tired of the message that there is a negative effect.

The communication process illustrates how messages are sent and received, as shown in Figure 2 below. The source (or sender) encodes, or translates, a message so that it's appropriate for the message channel—say, for a print advertisement, TV commercial, or store display—and shows the benefits and value of the offering. The receiver (customer or consumer) then decodes, or interprets, the message. For effective communication to occur, the receiver must 1) hear the message, and 2) interpret the message as the sender intended.

Feedback is the additional step in effective communication. Purchasing a product provides the sender with feedback. It tells the seller that a consumer saw information and wanted to try the product. If the consumer used any coupons or promotions when buying a product, the advertiser knows which vehicle was used to get the information. Market research and warranty registration also provide feedback.

Message Problems

Communicating a clear message – and having it heard – are key to a successful promotional mix.

Suppose you’re ready to go home on a Friday afternoon and you hear someone mention an upcoming event on Saturday. However, you did not listen to all the details and assume the event is the next day, not the following Saturday. Since you already made other plans for the next day, you don’t even consider showing up the following Saturday. Has this ever happened to you? If you do not hear someone correctly, misread information, or if they fail to communicate clearly, you might think a product or service provides different benefits or is easier or harder to use than it really is.

Clear, relevant messaging is critical for effective communication. Marketing messages that try to pack in too much information or else don’t say enough leave people wondering what is the point. We tend to purchase products and remember information that has some relevance to our personal situation or beliefs. If you have no need for a product or service, you might not pay attention to or remember the messages used to market it. Advertisers want you to remember their brands so that you’ll think of their products and services when you need to make a purchase.

Interference, or noise, can distort marketing messages. Factors such as poor reception, poor print quality, problems with a server, or a low battery can interfere with your getting messages. Interference includes any distractions receivers and senders face during the transmission of a message. Think about what it’s like to study for an exam while you’re talking on the phone. The conversation interferes with remembering what you’re reading. Likewise, if you miss class and borrow someone else’s notes, do you understand what they mean? Not only must advertisers try to present consistent messages, they must also try to ensure that you interpret the message as they intended.

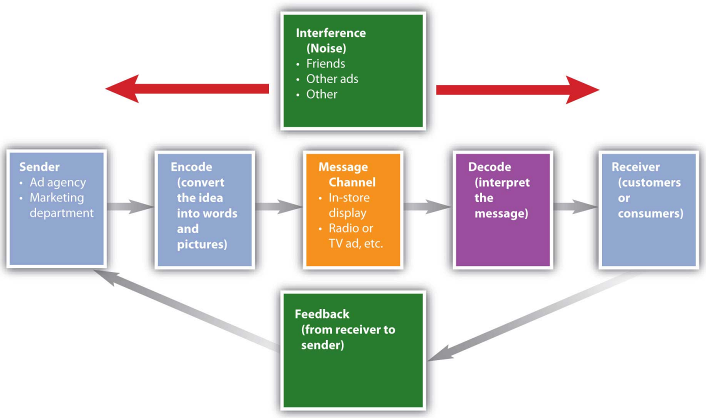

Figure 28.24.2.2: The Communication Process

The Promotion Mix

Although the money organizations spend promoting their offerings may go to different media channels, a company still wants to send its customers and potential consumers a consistent message The different types of marketing communications an organization uses compose its promotion or communication mix, which consists of advertising, sales promotions, direct marketing, public relations and publicity, sponsorships (events and experiences), social media and interactive marketing, and professional selling. The importance of integrated marketing communications (IMC) will be demonstrated throughout the discussion of traditional media as well as newer, more targeted, and often interactive online media.

Advertising involves paying to disseminate a message that identifies a brand (product or service) or an organization being promoted to many people at one time. The typical media that organizations utilize for advertising of course include television, magazines, newspapers, the Internet, direct mail, and radio. Businesses also advertise on mobile devices and social media such as Facebook, blogs, and Twitter.

Consumer sales promotions consist of short-term incentives such as coupons, contests, games, rebates, and mail-in offers that supplement the advertising and sales efforts. Sales promotions include promotions that are not part of another component of the communication mix and are often developed to get customers and potential customers to take action quickly, make larger purchases, and/or make repeat purchases.

In business-to-business marketing, sales promotions are typically called trade promotions because they are targeted to channel members who conduct business or trade with consumers. Trade promotions include trade shows and special incentives given to retailers to market particular products and services, such as extra money, in-store displays, and prizes.

Direct marketing involves the delivery of personalized and often interactive promotional materials to individual consumers via channels such as mail, catalogs, Internet, e-mail, telephone, and direct-response advertising. By targeting consumers individually, organizations hope to get consumers to take action.

Professional selling is an interactive, paid approach to marketing that involves a buyer and a seller. The interaction between the two parties can occur in person, by telephone, or via another technology. Whatever medium is used, developing a relationship with the buyer is usually something the seller desires.

When you interview for internships or full-time positions and try to convince potential employers to hire you, you are engaging in professional selling. The interview is very similar to a buyer-seller situation. Both the buyer and seller have objectives they hope to achieve. Business-to-business marketers generally utilize professional selling more often than most business-to-consumer marketers. If you have ever attended a Pampered Chef party or purchased something from an Amway or Mary Kay representative, you've been exposed to professional selling.

Public relations (PR) involves communication designed to help improve and promote an organization's image and products. PR is often perceived as more neutral and objective than other forms of promotion because much of the information is tailored to sound as if it has been created by an organization independent of the seller. Public relations materials include press releases, publicity, and news conferences. While other techniques such as product placement and sponsorships, especially of events and experiences, tend to generate a lot of PR, the growth of expenditures and importance of sponsorships are so critical for so many companies that it is often considered a separate component in the communication mix. Many companies have internal PR departments or hire PR firms to find and create public relations opportunities for them. As such, PR is part of a company's promotion budget and their integrated marketing communications.

Sponsorships typically refer to financial support for events, venues, or experiences and provide the opportunity to target specific groups. Sponsorships enhance a company's image and usually generate public relations. With an increasing amount of money being spent on sponsorships, they have become an important component of the promotion mix.

Sales promotions are activities that supplement a company's advertising, public relations, and professional selling efforts. They create incentives for customers to buy products more quickly and make larger purchases. Sales promotions are often temporary, but when the economy is weak, sales promotions become even more popular for consumers and are used more frequently by organizations.

Consumer Sales Promotions

Samples, coupons, premiums, contests, and rebates are examples of consumer sales promotions. Do you like free samples? Most people do. A free sample allows consumers to try a small amount of a product so that hopefully they will purchase it. The strategy encourages trial and builds awareness. You have probably purchased a product that included a small free sample with it—for example, a small amount of conditioner packaged with your shampoo. Have you ever gone to a store that provided free samples of different food items? Although sampling is an expensive strategy, it is usually very effective for food products. People try the product, and the person providing the sample tells them about the product and mentions any special prices for it.

In many retail grocery stores, coupons are given to consumers with the samples. Coupons provide an immediate price reduction off an item. The amount of the coupon is later reimbursed to the retailer by the manufacturer. The retailer gets a handling fee for accepting coupons. When the economy is weak, more consumers cut out coupons and look for special bargains such as double coupons and buy-one-get-one-free (BOGO) coupons. They may also buy more store brands.

While many consumers cut coupons from the inserts in Sunday newspapers, other consumers find coupons online or on their cell phones. Point-of-purchase displays, including coupon machines placed next to products in stores, encourage consumers to buy a brand or product immediately. When a consumer sees a special display or can get a coupon instantly, manufacturers hope the sales promotion increases sales. Stores may also provide coupons for customers with loyalty cards to encourage them to select particular brands and products.

Mobile marketing and the Internet provide consumers in international markets access to coupons and other promotions. In India, the majority of coupons used are digital, while paper coupons have the largest share in the United States. Over 80 percent of diapers are purchased with coupons; imagine how much easier and less wasteful digital coupons scanned from a mobile phone are for both organizations and consumers.

Other sales promotions may be conducted online and include incentives such as free items, free shipping, coupons, and sweepstakes. For example, many online merchants such as Shoe Station and Zappos offer free shipping and free return shipping to encourage consumers to shop online. Some firms have found that the response they get to their online sales promotions is better than response they get to traditional sales promotions.

Another very popular sales promotion for consumers is a premium. A premium is something you get either for free or for a small shipping and handling charge with your proof of purchase (sales receipt or part of package). Remember wanting your favorite cereal because there was a toy in the box? The toy is an example of a premium. Sometimes you might have to mail in a certain number of proofs of purchase to get a premium. The purpose of a premium is to motivate you to buy a product multiple times. What many people don't realize is that when they pay the shipping and handling charges, they may also be paying for the premium.

Contests or sweepstakes also attract a lot of people. Contests are sales promotions people enter or participate in to have a chance to win a prize. The Publisher's Clearing House Sweepstakes and the Monopoly Game at McDonald's are both examples. The organization that conducts the sweepstakes or contest hopes you will not only enter its contest but buy some magazines (or more food) when you do.

Loyalty programs are sales promotions designed to get repeat business. Loyalty programs include things such as frequent flier programs, hotel programs, and shopping cards for grocery stores, drugstores, and restaurants. Sometimes point systems are used in conjunction with loyalty programs. After you accumulate so many miles or points, an organization might provide you with a special incentive such as a free flight, free hotel room, or free sandwich. Many loyalty programs, especially hotels and airlines, have partners to give consumers more ways to accumulate and use miles and points.

Rebates are popular with both consumers and the manufacturers that provide them. When you get a rebate, you are refunded part (or all) of the purchase price of a product back after completing a form and sending it to the manufacturer with your proof of purchase. The trick is completing the paperwork on time. Although different types of sales promotions work best for different organizations, rebates are very profitable for companies because many consumers forget or wait too long to send in their rebate forms. Consequently, they do not get any money back. Rebates sound great to consumers until they forget to send it back.

Trade Promotions

In business-to-business (B2B) marketing, sales promotions are typically called trade promotions because they are targeted to channel members who conduct business or "trade" with consumers. Trade promotions include trade shows, conventions, event marketing, trade allowances, training, and special incentives given to retailers to market particular products and services, such as extra money, in-store displays, and prizes.

Trade shows are one of the most common types of sales promotions in B2B markets. A trade show is an event in which firms in a particular industry display and demonstrate their offerings to other organizations they hope will buy them. There are typically many different trade shows in which one organization can participate. Using displays, brochures, and other materials, representatives at trade shows can identify potential customers (prospects), inform customers about new and existing products, and show them products and materials. Representatives can also get feedback from prospects about their company's products and materials and perhaps about competitors.

Companies also gather competitive information at trade shows because they can see the products other firms are exhibiting and how they are selling them. While approximately 75 percent of representatives attending trade shows actually buy the product(s) they see, 93 percent of attendees are influenced by what they see at the trade shows. However, only 20 percent of organizations follow up on leads obtained at trade shows and only 17 percent of buyers are called upon after they express interest in a particular company's products. (John F. Tanner, Jr., and Dennis Pitta, "Identifying and Creating Customer Value." Special session presentation, Summer Educators' Conference, Chicago, 2009). Trade shows can be very successful, although the companies that participate in them need to follow-up on the leads generated at the shows. With changing technology, webinars are being used to reach businesses that may not be able to attend trade shows. Follow-up after a Webinar is also essential.

Conventions, or meetings, with groups of professionals also provide a way for sellers to show potential customers different products. For example, a medical convention might be a good opportunity to display a new type of medical device. Sales representatives and managers often attend conventions to market their products.

Sales contests, which are often held by manufacturers or vendors, provide incentives for salespeople to increase their sales. Often, the contests focus on selling higher-profit or slow-moving products. The sales representative with the most sales of the product wins a prize such as a free vacation, company recognition, or cash.
Trade allowances give channel partners—for example, a manufacturer's wholesalers, distributors, retailers, and so forth—different incentives to push a product. One type of trade allowance is anadvertising allowance (money) to advertise a seller's products in local newspapers. An advertising allowance benefits both the manufacturer and the retailer. Typically, the retailer can get a lower rate than manufacturers on advertising in local outlets, saving the manufacturer money. The retailer benefits by getting an allowance from the manufacturer.

Another sales promotion that manufacturers, such as those in the tool or high tech industries, offer businesses is training to help their salespeople understand how the manufacturers' products work and how consumers can be enticed to buy them. Many manufacturers also provide in-store product demonstrations to show a channel partner's customers how products work and answer any questions they might have. Demonstrations of new video game systems and computers are extremely popular and successful in generating sales.

Free merchandise, such as a tool, television, or other product produced by the manufacturer, can also be used to get retailers to sell products to consumers. In other words, a manufacturer of televisions might offer the manager of a retail electronics store a television to push its products. If a certain number of televisions are sold, the manager gets the television. Have you ever been to an electronics store or a furniture store and felt like the salesperson was pushing one particular television or one particular mattress? Perhaps the salesperson was getting push money, or a cash incentive from the manufacturer to push a particular item. The push to sell the item might be because there is a large amount of inventory of it, it is being replaced by a new model, or the product is not selling well. Figure 28.24.2.3 "Examples of Sales Promotions," below recaps the different types of sales promotions designed for both consumers and businesses.

Consumer Sales Promotions	Business-to-Business Sales Promotions
Coupons	Trade shows and conventions
Sweepstakes or contests	Sales contests
Premiums	Trade and advertising allowances
Rebates	Product demonstrations
Samples	Training
Loyalty programs	Free merchandise
Point-of-purchase displays	Push money

Figure 28.24.2.3: Examples of Sales Promotions

Push vs. Pull Strategy

Businesses must also decide whether to use a push strategy, a pull strategy, or both push and pull strategies. A push strategy involves promoting a product to businesses (middlemen), such as wholesalers and retailers, who then push the product through the channel promoting it to final consumers. Manufacturers may set up displays in retail outlets for new products or provide incentives such as price discounts to the retailer so the retailer can promote or push the product to consumers.

Companies use a pull strategy when they target final consumers with promotions. In other words, a company promotes its products and services to final consumers to pull consumers into the stores or get the consumers asking for the product. If a company sends coupons to the consumers, hopefully the consumers will take the coupons (sales promotion) to the store and buy the product. A manufacturer promotes its new product on television to consumers and places coupons in the newspaper inserts, hoping consumers will demand the product. Their pull causes wholesalers and retailers to buy the product to try to meet the demand.

Many manufacturers use both a push strategy and a pull strategy, promoting their products and services to both final consumers and their trade partners (e.g., retailers and wholesalers). Figure 28.24.2.4 below shows how a push strategy differs from a pull strategy.

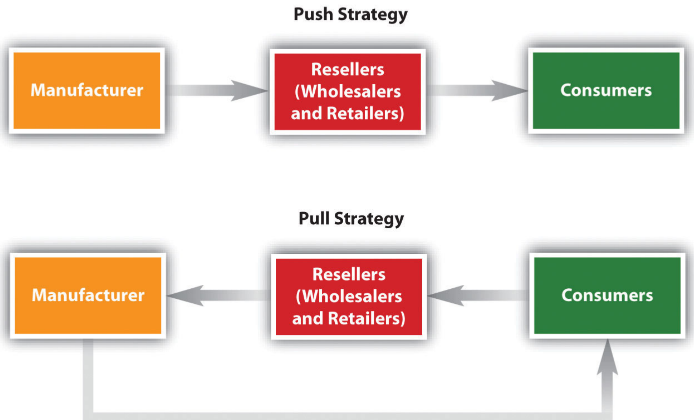

Figure 28.24.2.4: A Push vs. a Pull Strategy

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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28.24.3: Reading- Introduction to Social Media Marketing

Introduction to Social Media Marketing

The internet has completely transformed the role of media in everyday life.

In the past, dominant media channels were television, radio, magazines and newspapers. All were well-suited to broadcasting out one-way communications from a central source. Media outlets *distributed* information and messages. People *received* information and messages.

Today, the internet and mobile technologies have made it simple for virtually anyone to not only receive but also publish and distribute information (also known as “content”). Access is simple and typically free. Social media channels have evolved to capitalize on this new, interactive relationship with information. The realm of social media is about collaborating, generating content, sharing, and most of all, connecting.

Social media use technology and mobility to provide an interactive means of communication among people, organizations, and communities who are interconnected and interdependent. Many channels and vehicles are available for social media just as there are many different television shows and magazines. With changing technology, new social media tools are continually available. The parade of popular and influential sites includes Facebook, Twitter, Instagram, LinkedIn, Pinterest, Flickr, Google+ and Vine, among many others.

Media Designed for Sharing

What’s different about social media? Most simply put, social media are media (including written, visual, audio, multimedia, and everything in between) that are designed to be shared. Sharing typically means that it is easy to create, publish, interact with, send and comment on these media creations, and there are no high costs associated with viewing the media. Because of the connected nature of the internet, it means that sharing, commenting, and viewing can all be tracked and measured.

Table $28.24.3.1$: The Differences between Traditional and Social Media

Traditional Media	Social Media
Fixed, unchangable	Instantly updatable
Commentary limited and not real time	Unlimited real-time commentary
Limited, time-delayed bestseller list	Instant popularity gauge
Archive poorly accessible	Archives accessible
Limited media mix	All media can be mixed
Committee publishers	Individual publishers
Finite	Infinite
Sharing not encouraged	Sharing and participation encouraged
Control	Freedom

With more than half of all Americans participating in social networks, people and organizations who don’t participate may be at a disadvantage with some groups in society. Not only does the majority of the population in the United States have a profile on a social network, but at least one-third of those people access the sites multiple times a day. Social media are popular for keeping in touch with friends,. Not surprisingly, companies tap into these same networks to promote their brands and as a tool for recruiting and hiring. People follow companies and brands on social media, especially on Facebook, whereas LinkedIn generates millions of job referrals. Just as companies are allocating more of their promotion budget to social media, they are also increasing their expenditures on social recruiting.

Social Media Zones

Social media are complex and rapidly changing. While there is some overlap between uses of social media for personal and business purposes, one way to improve the understanding of social media is to think about social media zones. Social media zones include social communities, social publishing, social entertainment, and social commerce. Think about the different ways you use social media and which zones you utilize. You probably use all of the zones.

Social communities are channels that focus on activities and relationships and include social networking sites (online hosts such as Facebook and LinkedIn), forums, wikis, and message boards, channels where you may already participate. Think about your profile. Whatever you type becomes a digital version of you. In social communities, you communicate and socialize with others. While you may share information with others, you must be careful how much and which information you choose to post.

Social publishing helps distribute information to different audiences and includes channels such as blogs (web log sites with content that is updated regularly) and media sharing sites with searchable content featuring videos (YouTube), photos (Flickr), and music and podcasts (iTunes). Think about videos you may have posted. When companies pay to have product reviews posted or to promote contests or their brands, they may use social publishers to write blogs and generate word of mouth buzz. Many companies post their own commercials and other content on YouTube.

Opportunities for games and entertainment are part of the **social entertainment** zone. Social games like FarmVille, entertainment networks, action games, puzzle games, and reality games have increased revenues in the social gaming industry. Social gaming appears to be growing in popularity.

Social commerce is e-commerce territory where people buy and sell products on the Internet. Social commerce provides a means for interactive shopping, including reviews, ratings, and social shopping websites where you can chat with merchant personnel or with friends while you are shopping. Think about the questions you may ask a customer service person in a chat room versus what you may ask at a store in a mall.

Using Social Media for Marketing

As more and more people around the planet become more and more connected through social media, the influence of these channels continues to grow. In response, organizations are allocating more of their promotion budgets to social media. This makes sense when social media strategies align with broader marketing strategy in support of corporate objectives.

What are the advantages of social media in marketing? When used effectively, they can generating a lot of buzz without a lot of expense. There are still costs associated with content creation, but the proliferation of online content creators and hungry media outlets means that on social media, content tends to be cheap.

The 24×7 cycle of global social media requires eyes, brains and analytical tools to stay on top of everything happening, but never before has it been so easy to tap into, listen and learn from individuals and communities interacting with your product or brand. It is undoubtedly exciting for your brand to become a trending topic among these networks, but it is important to remember social media attention can easily veer into positive or negative territory. Absolute control of the message is virtually impossible with social media. Managing consumer perceptions in a fickle 24×7 media cycle requires attention and perseverance.

Because many people share immense amounts of information about themselves through social media, increasingly marketers can use this information to delivery highly targeted messages and offers. Navigational click-stream data from social media and other websites is another source of valuable information about consumer behavior, what makes them tick, and how they do or don't choose to engage with your brand. At the same time, firms must be prepared to address increasingly complex challenges associated with cybersecurity and data privacy.

Reflection Questions

- How do you use social media for personal purposes, and how do you use it for business and professional purposes?
- How would social media allow you to target particular types of consumers for marketing or recruiting purposes?

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28.24.4: Reading- Defining Marketing

Defining Marketing

Marketing is defined by the American Marketing Association in the following way:

The activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

If you read the definition closely, you see that there are four activities, or components, of marketing:

1. **Creating.** The process of collaborating with suppliers and customers to create offerings that have value.
2. **Communicating**. Broadly, describing those offerings, as well as learning from customers.
3. **Delivering**. Getting those offerings to the consumer in a way that optimizes value.
4. **Exchanging.** Trading value for those offerings.

Let’s look more closely at some of the components that make up this definition.

Value

Value is at the center of everything that marketing does (Figure $28.24.4.1$). What does value mean?

Figure $28.24.4.1$: Creating value

Marketing is composed of four activities centered on customer value: creating, communicating, delivering, and exchanging value.

When we use the term *value*, we mean the benefits buyers receive that meet their needs. In other words, value is what the customer gets by purchasing and consuming a company’s offering. So, although the offering is created by the company, the value is determined by the customer.

Furthermore, our goal as marketers is to create a profitable exchange for consumers. By profitable, we mean that the consumer’s personal value equation is positive. The personal value equation is value = benefits received – [price + hassle]

Hassle is the time and effort the consumer puts into the shopping process. The equation is a personal one because how each consumer judges the benefits of a product will vary, as will the time and effort he or she puts into shopping. Value, then, varies for each consumer.

One way to think of value is to think of a meal in a restaurant. If you and three friends go to a restaurant and order the same dish, each of you will like it more or less depending on your own personal tastes. Yet the dish was exactly the same, priced the same, and served exactly the same way. Because your tastes varied, the benefits you received varied. Therefore the value varied for each of you. That’s why we call it a *personal* value equation.

Value varies from customer to customer based on each customer’s needs. The marketing concept, a philosophy underlying all that marketers do, requires that marketers seek to satisfy customer wants and needs. Firms operating with that philosophy are said to be market oriented. At the same time, market-oriented firms recognize that exchange must be profitable for the company to be successful. A marketing orientation is not an excuse to fail to make profit.

Firms don’t always embrace the marketing concept and a market orientation. Beginning with the Industrial Revolution in the late 1800s, companies were production orientation. They believed that the best way to compete was by reducing production costs. In other words, companies thought that good products would sell themselves. Perhaps the best example of such a product was Henry Ford’s Model A automobile, the first product of his production line innovation. Ford’s production line made the automobile cheap and affordable for just about everyone. The production era lasted until the 1920s, when production-capacity growth began to outpace demand growth and new strategies were called for. There are, however, companies that still focus on production as the way to compete.

From the 1920s until after World War II, companies tended to be selling orientation, meaning they believed it was necessary to push their products by heavily emphasizing advertising and selling. Consumers during the Great Depression and World War II did not have as much money, so the competition for their available dollars was stiff. The result was this push approach during the selling era. Companies like the Fuller Brush Company and Hoover Vacuum began selling door-to-door and the vacuum-cleaner salesman (they were always men) was created. Just as with production, some companies still operate with a push focus.

In the post–World War II environment, demand for goods increased as the economy soared. Some products, limited in supply during World War II, were now plentiful to the point of surplus. Companies believed that a way to compete was to create products different from the competition, so many focused on product innovation. This focus on product innovation is called the product orientation. Companies like Procter & Gamble created many products that served the same basic function but with a slight twist or difference in order to appeal to a different consumer, and as a result products proliferated. But as consumers had many choices available to them, companies had to find new ways to compete. Which products were best to create? Why create them? The answer was to create what customers wanted, leading to the development of the marketing concept. During this time, the marketing concept was developed, and from about 1950 to 1990, businesses operated in the marketing era.

So what era would you say we’re in now? Some call it the value era: a time when companies emphasize creating value for customers. Is that really different from the marketing era, in which the emphasis was on fulfilling the marketing concept? Maybe not. Others call today’s business environment the one-to-one era, meaning that the way to compete is to build relationships with customers one at a time and seek to serve each customer’s needs individually. For example, the longer you are customer of Amazon, the more detail they gain in your purchasing habits and the better they can target you with offers of new products. With the advent of social media and the empowerment of consumers through ubiquitous information that includes consumer reviews, there is clearly greater emphasis on meeting customer needs. Yet is that substantially different from the marketing concept?

Still others argue that this is the time of service-dominant logic and that we are in the service-dominant logic era. Service-dominant logic is an approach to business that recognizes that consumers want value no matter how it is delivered, whether it’s via a product, a service, or a combination of the two. Although there is merit in this belief, there is also merit to the value approach and the one-to-one approach. As you will see throughout this book, all three are intertwined. Perhaps, then, the name for this era has yet to be devised.

Whatever era we’re in now, most historians would agree that defining and labeling it is difficult. Value and one-to-one are both natural extensions of the marketing concept, so we may still be in the marketing era. To make matters more confusing, not all companies adopt the philosophy of the era. For example, in the 1800s Singer and National Cash Register adopted strategies rooted in sales, so they operated in the selling era forty years before it existed. Some companies are still in the selling era. Recently, many considered automobile manufacturers to be in the trouble they were in because they work too hard to sell or push product and not hard enough on delivering value.

Creating Offerings That Have Value

Marketing creates those goods and services that the company offers at a price to its customers or clients. That entire bundle consisting of the tangible good, the intangible service, and the price is the company’s offering. When you compare one car to another, for example, you can evaluate each of these dimensions—the tangible, the intangible, and the price—separately. However, you can’t buy one manufacturer’s car, another manufacturer’s service, and a third manufacturer’s price when you actually make a choice. Together, the three make up a single firm’s offer.

Marketing people do not create the offering alone. For example, when the iPad was created, Apple’s engineers were also involved in its design. Apple’s financial personnel had to review the costs of producing the offering and provide input on how it should be priced. Apple’s operations group needed to evaluate the manufacturing requirements the iPad would need. The company’s logistics managers had to evaluate the cost and timing of getting the offering to retailers and consumers. Apple's dealers also likely provided input regarding the iPad's service policies and warranty structure. Marketing, however, has the biggest responsibility because it is marketing's responsibility to ensure that the new product delivers value.

Communicating Offerings

Communicating is a broad term in marketing that means describing the offering and its value to your potential and current customers, as well as learning from customers what it is they want and like. Sometimes communicating means educating potential customers about the value of an offering, and sometimes it means simply making customers aware of where they can find a product. Communicating also means that customers get a chance to tell the company what they think. Today companies are finding that to be successful, they need a more interactive dialogue with their customers. For example, Comcast customer service representatives monitor Twitter. When they observe consumers tweeting problems with Comcast, the customer service reps will post resolutions to their problems. Similarly, JCPenney has created consumer groups that talk among themselves on JCPenney-monitored Web sites. The company might post questions, send samples, or engage in other activities designed to solicit feedback from customers.

Mobile devices, like iPads and Droid smartphones, make mobile marketing possible too. For example, if consumers check-in at a shopping mall on Foursquare or Facebook, stores in the mall can send coupons and other offers directly to their phones and pad computers.

Figure 28.24.4.2: A BMW X5 costs much more than a Honda CRV, but why is it worth more? What makes up the complete offering that creates such value? (Source: Wikimedia Commons)

Companies use many forms of communication, including advertising on the Web or television, on billboards or in magazines, through product placements in movies, and through salespeople. Other forms of communication include attempting to have news media cover the company's actions (part of public relations [PR]), participating in special events such as the annual International Consumer Electronics Show in which Apple and other companies introduce their newest gadgets, and sponsoring special events like the Susan G. Komen Race for the Cure.

Delivering Offerings

Marketing can't just promise value, it also has to deliver value. Delivering an offering that has value is much more than simply getting the product into the hands of the user; it is also making sure that the user understands how to get the most out of the product and is taken care of if he or she requires service later. Value is delivered in part through a company's supply chain. The supply chain includes a number of organizations and functions that mine, make, assemble, or deliver materials and products from a manufacturer to consumers. The actual group of organizations can vary greatly from industry to industry, and include wholesalers, transportation companies, and retailers. Logistics, or the actual transportation and storage of materials and products, is the primary component of supply chain management, but there are other aspects of supply chain management that we will discuss later.

Exchanging Offerings

In addition to creating an offering, communicating its benefits to consumers, and delivering the offering, there is the actual transaction, or exchange, that has to occur. In most instances, we consider the exchange to be cash for products and services. However, if you were to fly to Louisville, Kentucky, for the Kentucky Derby, you could "pay" for your airline tickets using frequent-flier miles. You could also use Hilton Honors points to "pay" for your hotel, and cash back points on your Discover card to pay for meals. None of these transactions would actually require cash. Other exchanges, such as information about your preferences gathered through surveys, might not involve cash.

When consumers acquire, consume (use), and dispose of products and services, exchange occurs, including during the consumption phase. For example, via Apple's "One-to-One" program, you can pay a yearly fee in exchange for additional periodic product training sessions with an Apple professional. So each time a training session occurs, another transaction takes place. A transaction also occurs when you are finished with a product. For example, you might sell your old iPhone to a friend, trade in a car, or ask the Salvation Army to pick up your old refrigerator.

Disposing of products has become an important ecological issue. Batteries and other components of cell phones, computers, and high-tech appliances can be very harmful to the environment, and many consumers don't know how to dispose of these products properly. Some companies, such as Office Depot, have created recycling centers to which customers can take their old electronics.

Apple has a Web page where consumers can fill out a form, print it, and ship it along with their old cell phones and MP3 players to Apple. Apple then pulls out the materials that are recyclable and properly disposes of those that aren't. By lessening the hassle associated with disposing of products, Office Depot and Apple add value to their product offerings.

KEY TAKEAWAYS

The focus of marketing has changed from emphasizing the product, price, place, and promotion mix to one that emphasizes creating, communicating, delivering, and exchanging value. Value consists of the benefits an individual receives minus the price the consumer paid and the time and effort they expended making the purchase.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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28.24.5: Reading- The Four Ps of Marketing

The Four Ps of Marketing

The traditional way of viewing the components of marketing is in terms of the four Ps:

1. **Product**. Goods and services (creating offerings).
2. **Promotion**. Communication.
3. **Place**. Getting the product to a point at which the customer can purchase it (delivering).
4. **Price.** The monetary amount charged for the product (exchanging).

Introduced in the early 1950s, the four Ps were called the marketing mix, and a typical marketing plan would include a mix of these four components. Getting the four Ps right for any given marketing effort depends first on identifying your target customer – who are you trying to sell to, and how will you provide value to them? Once you know who you're targeting, you can refine decisions around product, promotion, place and price to ensure you are delivering something of value.

Recall the American Marketing Association's current definition of marketing, which emphasizes the four activities of **creating**, **communicating**, **delivering**, and **exchanging**. You might be wondering why this definition shifts away from the four Ps. The answer is that they are *not* exactly the same. Product, price, place, and promotion are *nouns*. As such, these words fail to capture all the *activities* of marketing. For example, exchanging requires mechanisms for a transaction, which consist of more than simply a price or place. Exchanging requires, among other things, the transfer of ownership. For example, when you buy a car, you sign documents that transfer the car's title from the seller to you. That's part of the exchange process.

Even the term *product*, which seems pretty obvious, is limited. Does the product include services that come with your new car purchase (such as free maintenance for a certain period of time on some models)? Or does the product mean only the car itself? The following video expands upon the concept of the four Ps and explains its more dynamic use today.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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28.24.6: Reading- The Marketing Environment

The Marketing Environment

By and large, managers can control the four Ps of the marketing mix: they can decide which products to offer, what prices to charge for them, how to distribute them, and how to reach target audiences. Unfortunately, there are other forces at work in the marketing world—forces over which marketers have much less control. These forces make up a company's external marketing environment, which, as you can see in Figure 1, "The Marketing Environment," can be divided into five sets of factors:

1. Political and regulatory
2. Economic
3. Competitive
4. Technological
5. Social and cultural

Figure 1. The Marketing Environment

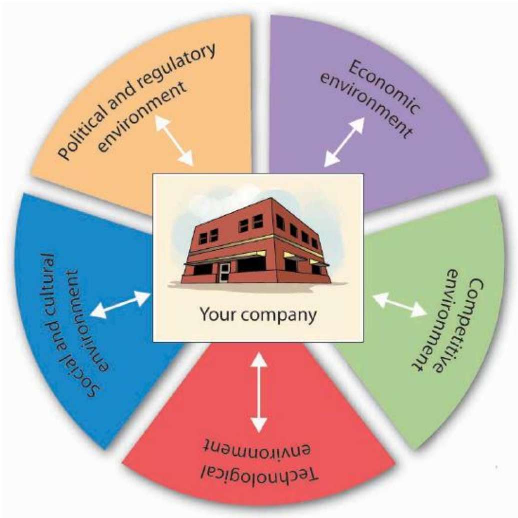

Figure 28.24.6.1: The Marketing Environment

These factors—and changes in them—present both threats and opportunities that require shifts in marketing plans. To spot trends and other signals that conditions may be in flux, marketers must continually monitor the environment in which their companies operate. To get a better idea of how they affect a firm's marketing activities, let's look at each of the five areas of the external environment.

The Political and Regulatory Environment

Federal, state, and local bodies can set rules or restrictions on the conduct of businesses. The purpose of regulation is to protect both consumers and businesses. Businesses favor some regulations (such as patent laws) while chafing under others (such as restrictions on advertising). The tobacco industry, for example, has had to learn to live with a federal ban on TV and radio advertising. More recently, many companies in the food industry have expressed unhappiness over regulations requiring the labeling of trans-fat content. The broadcasting industry is increasingly concerned about fines being imposed by the Federal Communications Commission for offenses against "standards of decency." The loudest outcry probably came from telemarketers in response to the establishment of "do-not-call" registries. All these actions occasioned changes in the marketing strategies of affected companies. Tobacco companies rerouted advertising dollars from TV to print media. Food companies reduced trans-fat levels and began targeting health-conscious consumers. Talent coordinators posted red flags next to the names of Janet Jackson (of the now-famous malfunctioning costume) and other performers. The telemarketing industry fired workers and scrambled to reinvent its entire business model.

The Economic Environment

Every day, marketing managers face a barrage of economic news. They must digest it, assess its impact, and alter marketing plans accordingly. Sometimes (but not recently), the news is cause for optimism—the economy's improving, unemployment's declining, consumer confidence is up. At other times (like today), the news makes them nervous—our economy is weak, industrial production is down, jobless claims are rising, consumer confidence has plummeted, credit is hard to get. Naturally, business thrives when the economy is growing, employment is full, and prices are stable. Marketing products is easier because consumers are willing to buy. On the other hand, when the economy is slowing (or stalled) and unemployment is rising, people have less money to spend, and the marketer's job is harder. Then there's inflation, which pushes interest rates upward. If you're trying to sell cars, you know that people facing higher interest rates aren't so anxious to take out car loans. Sales will slip, and to counteract the anticipated slowdown, you might have to add generous rebates to your promotional plans. Moreover, if you operate in foreign markets, you can't focus on solely domestic economic conditions: you have to monitor the economy in every region where you do business. For example, if you're the marketing director for a U.S. company whose goods are manufactured in China and sold in Brazil, you'll need to know as much as you can about the economies in three countries: the United States, China, and Brazil. For one thing, you'll have to pay particular attention to fluctuations in exchange rates, because changes will affect both your sales and your profits.

The Competitive Environment

Imagine playing tennis without watching what your opponent was doing. Marketers who don't pay attention to their competitors are playing a losing game. In particular, they need to monitor the activities of two groups of competitors: the makers of competing brands and the makers of substitute products. Coke and Pepsi, for instance, are brand competitors who have engaged in the so-called cola wars for decades. Each tries to capture market share by convincing people that its soft drinks are better. Because neither wants to lose share to the other, they tend to resort to similar tactics. In summer 2004, both companies came out with nearly identical new colas boasting half the sugar, half the calories, and half the carbohydrates of regular colas. Coke called its product Coke C2, while Pepsi named its competing brand PepsiEdge. Both companies targeted cola drinkers who want the flavor of a regular soda but fewer calories. (By the way, both products failed and were taken off the market.) Meanwhile, Coke and Pepsi have to watch Nantucket Nectars, whose fruit drinks are substitute products. What if Nantucket Nectars managed to get its drinks into the soda machines at more fast-food restaurants? How would Coke and Pepsi respond? What if Nantucket Nectars, which markets an ice tea with caffeine, introduced an ice tea drink with mega amounts of caffeine? Would marketers at Coke and Pepsi take action? What if Nantucket Nectars launched a marketing campaign promoting the health benefits of fruit drinks over soda? Would Coke and Pepsi reply with campaigns of their own? Would they respond by introducing new non-cola products?

The Technological Environment

When's the last time you rented a DVD of a new movie? And do you even remember ever renting a videotape? Technology evolves rapidly and these days, videotapes are long since past. While DVDs are still common, Blu-ray, digital downloads and on-demand services are the more forward-looking formats for people who want to watch movies at home. Hopefully one-time videotape makers monitored technological trends in the industry and took steps to keep up or otherwise protect themselves from losses (maybe even getting out of the market). In addition to making old products obsolete, technological advances create new products. Where would we be without the cell phone, digital cameras, text messaging, LASIK surgery, and global positioning systems? New technologies also transform the marketing mix in another important way: they alter the way companies market their products. Consider the revolutionary changes brought about by the Internet, which offers marketers a new medium for promoting and selling a vast range of goods and services. Marketers must keep abreast of technological advances and adapt their strategies, both to take advantage of the opportunities and to ward off threats.

The Social and Cultural Environment

Marketers also have to stay tuned to social and cultural factors that can affect sales. The values and attitudes of American consumers are in a state of almost constant flux; what's cool one year is out of style the next. Think about the clothes you wore five years ago: would you wear them today? A lot of people wouldn't—they're the wrong style, the wrong fit, the wrong material, the wrong color, or just plain wrong. Now put yourself in the place of a marketer for a clothing company that targets teenagers and young adults. You wouldn't survive if you tried to sell the same styles every year. As we said at the outset of this chapter, the key to successful marketing is meeting the needs of customers. This means knowing what they want right now, not last year. Here's another illustration. The last few decades have witnessed monumental shifts in the makeup of the American workforce. The number of women at all levels has increased significantly, the workforce has become more diverse, and telecommuting is more common. More people place more importance on balancing their work lives with the rest of their lives, and fewer people are willing to sacrifice their health to the demands of hectic work schedules. With these changes have come new marketing opportunities. As women spend more time at work, the traditional duties of the "homemaker" have shifted to day-care centers, nannies, house-cleaning services, and (for those who can afford them) child chauffeurs, birthday-party coordinators, and even family-photo assemblers.[1] The number of gyms has mushroomed, the selection of home office furniture has expanded, and McDonald's has bowed to the wishes of the health-conscious by eliminating its "super-size" option.

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1. Sandra Tsing Loh, "Nannyhood and Apple Pie," *The Atlantic*, October 1, 2003, 122–23. ↵

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28.24.7: Reading- Generation Effects and Consumer Behavior

Generation Gaps

Clothiers who target teens and young adults (such as Gap and Abercrombie & Fitch) must estimate the size of both current and future audiences. So must companies that specialize in products aimed at customers in other age brackets—say, young children or retirees. Marketers pay particular attention to population shifts because they can have dramatic effects on a consumer base, either increasing or decreasing the number of potential customers. Marketers tend to assign most Americans born in the last sixty years to one of three groups: the *baby-boom generation* (those born between 1946 and 1964), *Generation* X (1965 to 1975), and *Generation* Y—also known as "echo baby boomers" or "millennials" (1976 to 2001). In addition to age, members of each group tend to share common experiences, values, and attitudes that stay with them as they mature. These values and attitudes have a profound effect on both the products they want and the marketing efforts designed to sell products to them. Let's look a little more closely at some of the defining characteristics of each group.

Baby Boomers

The huge wave of baby boomers began arriving in 1946, following World War II, and marketers have been catering to them ever since. What are they like? Sociologists have attributed to them such characteristics as "individuality, tolerance, and self-absorption." There are seventy million of them, and as they marched through life over the course of five decades, marketers crowded the roadside to supply them with toys, clothes, cars, homes, and appliances—whatever they needed at the time. They're still a major marketing force, but their needs have changed: they're now the target market for Botox, pharmaceutical products, knee surgery, financial investments, cruises, vacation homes, and retirement communities.

Generation X

Because birth rates had declined by the time the "Gen X" babies first arrived in 1965, this group had just one decade to grow its numbers. Thus, it's considerably smaller (seventeen million) than the baby-boomer group, and it has also borne the brunt of rising divorce rates and the arrival of AIDS. Experts say, however, that they're diverse, savvy, and pragmatic and point out that even though they were once thought of as "slackers," they actually tend to be self-reliant and successful. At this point in their lives, most are at their peak earning power and affluent enough to make marketers stand up and take notice.

Generation Y

When they became parents, baby boomers delivered a group to rival their own. Born between 1976 and 2001, their sixty million children are sometimes called "echo boomers" (because their population boom is a reverberation of the baby boom). They're still evolving, but they've already been assigned some attributes: they're committed to integrity and honesty, they're family oriented and close to parents, ethnically diverse and accepting of differences, upbeat and optimistic about the future (although the troubled economy is lessening their optimism), education focused, independent, and goal oriented. They also seem to be coping fairly well: among today's teens, arrests, drug use, drunk driving, and school dropout rates are all down. Generation Ys are being courted by carmakers. Global car manufacturers have launched a number of 2012 cars designed to cater to the members of Generation Y. Advertisers are also busy trying to find innovative ways to reach this group, but they're finding that it's not easy. Generation Ys grew up with computers and other modes of high technology, and they're used to doing several things at once—simultaneously watching TV, texting, and playing games on the computer. As a result, they're quite adept at tuning out ads. Try to reach them through TV ads and they'll channel-surf right past them or hit their TiVo remotes. You can't get to them over the Internet because they know all about pop-up blockers. In one desperate attempt to get their attention, an advertiser paid college students fifty cents to view thirty-second ads on their computers. Advertisers keep trying, because Generation Y is big enough to wreck a brand by giving it a cold shoulder.

Consumer Behavior

Why did you buy an Apple computer when your friend bought a Dell PC? What information did you collect before making the decision? What factors did you consider when evaluating alternatives? How did you make your final choice? Were you happy with your decision? To design effective strategies, marketers need to find the answers that consumers give to questions such as these. In other words, they try to improve their understanding of consumer behavior—the decision process that individuals go through when purchasing or using products. Later we'll look at the process that buyers go through in choosing one product over another. Then, we'll explore some factors that influence consumers' behavior.

The Buying Process

Generally speaking, buyers run through a series of steps in deciding whether to purchase a particular product. Some purchases are made without much thought. You probably don't think much, for example, about the brand of gasoline you put in your car; you just stop at the most convenient place. Other purchases, however, require considerable thought. For example, you probably spent a lot of time deciding which college to attend. Let's revisit that decision as a means of examining the five steps that are involved in the consumer buying process and that are summarized in Figure 28.24.7.1: *need recognition*, *information search*, *evaluation*, *purchase*, and *post-purchase evaluation*.

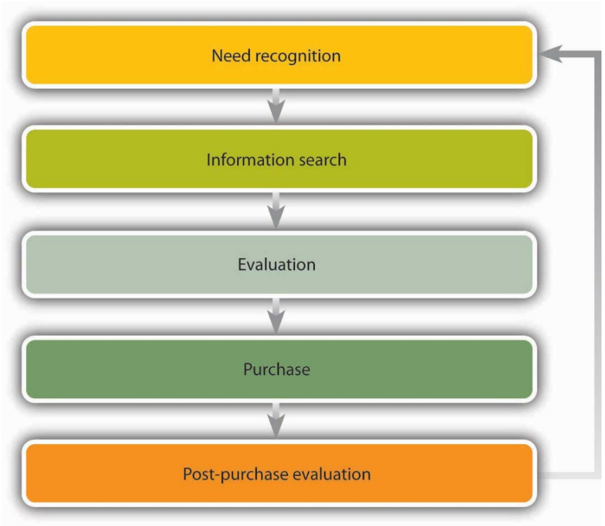

Figure 28.24.7.1: The Buying Process

1. *Need recognition*. The process began when you recognized a need to go to college. Perhaps you wanted to prepare for a particular career, to become better educated, or to postpone going to work full time. Maybe your parents insisted.
2. *Information search*. Once you recognized the need to go to college, you probably started gathering information about colleges. You may have gone online and studied the Web sites posted by a few schools. Perhaps you attended college fairs or spoke with your high school guidance counselor. You probably talked with friends about your options. Once you let colleges know that you were interested, admissions departments likely sent you tons of information.
3. *Evaluation*. At this point, you studied the information you'd gathered. First, you probably decided what you wanted from a college. Perhaps price was your number-one criterion, or maybe distance from home. Maybe size was important, or reputation or available majors. Maybe it was the quality of the football team or the male-to-female ratio.
4. *Purchase*. Ultimately you made a "purchase" decision. In so doing, you focused on what was most important to you. Naturally, you could choose only among schools that had accepted you.
5. *Postpurchase evaluation*. The buying process didn't end when you selected a school. It continues today, while you're using the "product" you purchased. How many times have you rethought your decision? Are you happy with it? Would you make the same choice again?

Understanding the buying process of potential students is crucial to college administrators in developing marketing strategies to attract qualified "buyers." They'd certainly like to know what information you found useful, which factors most influenced your decision, and how you made your final choice. They'll also want to know whether you're happy with your choice. This is the kind of information that colleges are seeking when they solicit feedback, both from students who chose their schools and from those who didn't.

Influences on Buying Behavior

Did you ever buy something you knew you shouldn't buy but just couldn't help yourself—something you simply wanted? Maybe it was a spring-break trip to the Bahamas that you really couldn't afford. Objectively, you may have made a bad decision, but not all decisions are made on a purely objective basis. *Psychological* and *social influences* come into play. Let's take a closer look at each of these factors.

Psychological Influences

Under this category, we can identify at least the following five variables:

1. *Motivation*. The internal process that causes you to seek certain goals.
2. *Perception*. The way you select, organize, and interpret information.
3. *Learning*. Knowledge gained through experience and study.
4. *Attitudes*. Your predisposition to respond in particular ways because of learned values and beliefs.
5. *Personality*. The collection of attributes that characterize an individual.

Social Influences

Here, we find the following four factors:

1. *Family*.
2. *Reference groups*. Friends or other people with whom you identify.
3. *Economic or social status*.
4. *Culture*. Your set of accepted values.

It shouldn't be surprising that marketers are keenly interested in the effect of all these influences on your buying decisions. For instance, suppose the travel agency that sold you your spring-break getaway found that you bought the package because you viewed it as a reward for studying hard and doing well academically. In that case, it might promote student summer-travel programs as rewards for a hard year's work at school.

KEY TAKEAWAYS

- A number of forces over which it has little or no control affect a company's marketing activities.
- Taken together, they make up its **external marketing environment**, which includes regulatory and political activity, economic conditions, competitive forces, changes in technology, and social and cultural influences.
- Successful marketing often hinges on understanding **consumer behavior**—the decision process that individuals go through when purchasing or using products.
- Several psychological and social variables influence buyers' decisions. They go through a series of steps in reaching the decision to buy a product: *need recognition*, *information search*, *evaluation*, *purchase*, and *postpurchase evaluation*.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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28.24.8: Reading- Using Market Research to Understand Consumers

What Is a Consumer?

A consumer is a person (or group) who pays to consume the goods and/or services produced by a seller (i.e., company, organization).

Figure 28.24.8.1: Copy and Paste Caption here. (Copyright; author via source)

Using Market Research to Understand Consumers

The ultimate goal of consumer research is to serve as the voice of the consumer. This type of research focuses on understanding the consumer as a person by learning more about his or her attitudes, needs, motivations, and behavior as they relate to a product or service. More broadly, consumer research helps provide a company with relevant, reliable, valid, and current information about their target buyer.

In the field of marketing, consumer market research can generally be defined as the systematic collection and evaluation of data regarding customers' preferences for actual and potential products and services. It is also important to note that consumer market research is not the exactly the same as marketing research. Marketing research is actually comprised of both consumer and business-to-business research and examines all aspects of a business environment.

Consumer market research can serve a variety of purposes, including the following:

- Help companies make better business decisions and gain advantages over the competition
- Help marketing managers or executives make numerous strategic and tactical decisions in the process of identifying and satisfying customer needs
- Remove some of the uncertainty by providing relevant information about the marketing variables, environment, and consumers. In the absence of relevant information, the consumer response to marketing programs cannot be predicted reliably or accurately
- Provide insights that help guide the creation of a business plan, launch a new product or service, optimize existing products and services, and guide expansion into new markets
- Determine which portion of the population will be most likely to purchase a product or service, based on variables such as age, gender, location, and income level
- Reveal characteristics of a target market
- Understand how consumers talk about the products in the market
- Identify which consumer needs are important and whether the needs are being met by current products

For instance, a consumer goods company that wants to develop a new cheese product for the growing Hispanic demographic can use market research. If the consumer market research demonstrates that consumers do in fact have an unsatisfied need for a cheese that could replace the product they are currently consuming in Latin America, the company could go ahead and develop the cheese product.

Quantitative and Qualitative Models to Explain Patterns of Behavior

Both quantitative and qualitative models provide important information about consumers, but it is important to understand the benefits and shortcomings of each.

What Is Quantitative Research?

Quantitative research is defined as the systematic empirical investigation of social phenomena via statistical, mathematical, or computational techniques. It requires collection of enough data points to conduct valid statistical or mathematical analyses.

Its objective is to develop and employ mathematical models, theories, and/or hypotheses about phenomena. At its core, quantitative research is used to identify patterns and predict behavior. This type of research is used in business, marketing, and in social sciences such as psychology, economics, sociology, and political science, and, less frequently, in anthropology and history.

What Is Qualitative Research?

Qualitative research uses examination, analysis, and interpretation to discover underlying meanings and patterns of relationships in a manner that does not involve mathematical models.

Qualitative researchers aim to gather an in-depth understanding of human behavior and the reasons that govern it. The qualitative method investigates the *why* and *how* of consumer behavior, not just *what*, *where*, *when*. Two of the main tools used to conduct qualitative research are the focus group and the in-depth interview. In a focus group, participants are asked about their perceptions, opinions, beliefs, and attitudes toward a specific product, service, concept, advertisement, etc. Usually this takes place in an interactive group setting where participants are free to talk with one another. In an in-depth interview, researchers conduct a one-on-one discussion with the participant to explore their perceptions in detail.

Regardless of what type of research marketing managers conduct, their ultimate goal is to understand and predict consumer behavior.

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28.24.9: Reading- The Market Research Process

The Market Research Process

Marketing research identifies opportunities, generates informed marketing actions, monitors marketing performance, and improves understanding of the marketing process.

There are three types of objectives that can be deployed in marketing research: exploratory research, descriptive research, and causal research.

Exploratory Research

- Used to better define a problem or scout opportunities.
- In-depth interviews and discussions groups are commonly used.

Descriptive Research

- Used to assess a situation in the marketplace (i.e., potential for a specific product or consumer attitudes).
- Methods include personal interviews and surveys.

Causal Research

- Used for testing cause-and-effect relationships, typically through estimation.

The Marketing Research Process

The marketing research process involves the following six steps:

1. Problem definition
2. Development of an approach to the problem
3. Research design formulation
4. Data collection
5. Data preparation and analysis
6. Report preparation and presentation

Step 1: Problem Definition

The first step in any marketing research study is to define the problem, while taking into account the purpose of the study, the relevant background information, what information is needed, and how it will be used in decision making. This stage involves discussion with the decision makers, interviews with industry experts, analysis of secondary data, and, perhaps, some qualitative research, such as focus groups.

Step 2: Development of an Approach to the Problem

Step two includes formulating an objective or theoretical framework, analytical models, research questions, hypotheses, and identifying characteristics or factors that can influence the research design. This process is guided by discussions with management and industry experts , case studies and simulations, analysis of secondary data, qualitative research, and pragmatic considerations.

Four workers standing around schedules on the wall. They appear to be planning and discussing with one another.

Step 3: Research Design Formulation

A research design is a framework or blueprint for conducting the marketing research project. It details the procedures necessary for obtaining the required information, and its purpose is to design a study that will test the hypotheses of interest, determine possible answers to the research questions, and provide the information needed for decision making. Decisions are also made regarding what data should be obtained from the respondents (e.g., by conducting a survey or an experiment). A questionnaire and sampling plan also are designed in order to select the most appropriate respondents for the study. The following steps are involved in formulating a research design:

- Secondary data analysis (based on secondary research)
- Qualitative research
- Methods of collecting quantitative data (survey, observation, and experimentation)
- Definition of the information needed

- Measurement and scaling procedures
- Questionnaire design
- Sampling process and sample size
- Plan of data analysis

Two students in a library looking at a book together.

The research plan outlines sources of existing data and spells out the specific research approaches, contact methods, sampling plans, and instruments that researchers will use to gather data. This plan includes a written proposal that outlines the management problem, research objectives, information required, how the results will help management decisions, and the budget allocated for the research.

Step 4: Data Collection

Data collection is a crucial step in the research process because it provides the basis for decisions that will influence the marketing strategy.

Fieldwork, or data collection, involves a field force or staff that operates either in the field, as in the case of personal interviewing (focus group, in-home, mall intercept, or computer-assisted personal interviewing), from an office by telephone (telephone or computer-assisted telephone interviewing/CATI), or through mail (traditional mail and mail panel surveys with pre-recruited households). Proper selection, training, supervision, and evaluation of the field force helps minimize data-collection errors.

An example of data collection is when a consumer goods company hires a market research company to conduct in-home ethnographies and in-store shop-alongs.

Systematic planning is required at all stages of the marketing research process, especially in the data collection step. The procedures followed at each stage are methodologically sound, well documented, and, as much as possible, planned in advance.

Marketing research aims to provide accurate information that reflects a true state of affairs; therefore it’s important for research to be conducted as impartially as possible. While it is impossible to eliminate bias entirely, the researcher should make every effort to keep personal and political views out of the data collection process.

Primary vs. Secondary Research

There are many sources of information a marketer can use when collecting data. The Nielson Ratings is an audience measurement system that provides data on audience size and the composition of television markets in the United States. The Gallup Polls conduct public opinion polls with its results published daily in the form of data driven news. The U.S. Census Bureau, directed by the U.S. Government, is the principal agency responsible for producing data about American people and the economy. Population, housing, and demographic characteristics are gathered to help plan and define transportation systems, police and fire precincts, election districts, and schools.

Step 5: Data Preparation and Analysis

Data Analysis is an important step in the Marketing Research process where data is organized, reviewed, verified, and interpreted.

During this phase of the research process, data is carefully edited, coded, transcribed, and verified in order for it to be properly analyzed. Statistical market research tools are used. The validity of the results is also assessed to confirm how well the data measures what it is supposed to measure. Oftentimes, the research team will arrange a debriefing session with the client to review highlights from the data and brainstorm potential ideas on how the findings can be implemented . This typically happens when a client hires a market research company and they want to remain thoroughly involved in the research process.

Analysis of data is a process of inspecting, cleaning, transforming, and modeling data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making. Data analysis has multiple facets and approaches, encompassing diverse techniques under a variety of names in different business, science, and social science domains. Data mining is a particular data analysis technique that focuses on modeling and knowledge discovery for predictive rather than purely descriptive purposes. Marketers use databases to extract applicable information that identifies customer patterns, characteristics and behaviors.

Business intelligence covers data analysis that relies heavily on aggregation and focusing on business information. In statistical applications, some people divide data analysis into descriptive statistics, exploratory data analysis (EDA), and confirmatory data analysis (CDA). EDA focuses on discovering new features in the data and CDA focuses on confirming or falsifying existing hypotheses. Predictive analytics focuses on application of statistical or structural models for predictive forecasting or classification. Text analytics applies statistical, linguistic, and structural techniques to extract and classify information from textual sources, a species of unstructured data. All are varieties of data analysis.

Step 6: Report Preparation and Presentation

During the Report Preparation & Presentation step, the entire project should be documented in a written report that addresses the specific research questions identified; describes the approach, the research design, data collection, and data analysis procedures adopted; and presents the results and the major findings. This permanent document is also helpful because it can be easily referenced by others who may not have been part of the research.

The findings should be presented in a comprehensible format so that they can be readily used in the decision making process. In addition, an oral presentation should be made to management using tables, figures, and graphs to enhance clarity and impact.

A successful presentation may include the following elements:

- Charts, graphs, and visual elements that help showcase important facts and make the presentation easily digestible and memorable
- Recommendations about how to apply the research
- Final conclusions (based on the insights gathered from data collected) that effectively meet the initial objectives of the research

A formal research report presentation typically includes the following:

- Table of Contents
- Executive Summary
- Background
- Research Objectives
- Research Methodology
- Highlights of Data Collected
- Findings/Insights
- Recommendations/Implications and Action Plan
- Appendix (including Respondent Screening Instrument and Questionnaire)

As you can tell, a great deal of thought and effort goes into determining opportunities and managing the marketing process both before and after the product, good or service ever reaches the consumer.

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28.24.10: Reading- Developing Organizational Objectives and Formulating Strategies

Developing Objectives

Objectives are what organizations want to accomplish—the end results they want to achieve—in a given time frame. In addition to being accomplished within a certain time frame, objectives should be realistic (achievable) and be measurable, if possible. “To increase sales by 2 percent by the end of the year” is an example of an objective an organization might develop. You have probably set objectives for yourself that you want to achieve in a given time frame. For example, your objectives might be to maintain a certain grade point average and get work experience or an internship before you graduate.

Objectives help guide and motivate a company’s employees and give its managers reference points for evaluating the firm’s marketing actions. Although many organizations publish their mission statements, most for-profit companies do not publish their objectives. Accomplishments at each level of the organization have helped PepsiCo meet its corporate objectives over the course of the past few years. PepsiCo’s business units (divisions) have increased the number of their facilities to grow their brands and enter new markets. PepsiCo’s beverage and snack units have gained market share by developing healthier products and products that are more convenient to use.

A firm’s marketing objectives should be consistent with the company’s objectives at other levels, such as the corporate level and business level. An example of a marketing objective for PepsiCo might be “to increase by 4 percent the market share of Gatorade by the end of the year.” The way firms analyze their different divisions or businesses will be discussed later in the chapter.

Formulating Strategies

Firms formulate strategies to help them achieve their objectives. Strategies are the means to the ends, the game plan, or what a firm is going to do to achieve its objectives. Successful strategies help organizations establish and maintain a competitive advantage that competitors cannot imitate easily.

Firms then use a variety of tactics to execute their strategies. Tactics include specific actions, such as coupons, television commercials, banner ads, and so on, taken to execute the strategy. PepsiCo attempts to sustain its competitive advantage by constantly developing new products and innovations, including “mega brands,” which include nineteen individual brands that generate over $1 billion in sales each. The tactics may consist of specific actions (digital media campaigns, Super Bowl commercials; coupons; buy one get one free offers; etc.) to promote products and brands.

Firms often use multiple strategies to accomplish their objectives and capitalize on marketing opportunities. For example, in addition to pursuing a low cost strategy (selling products inexpensively), Walmart has simultaneously pursued a strategy of opening new stores rapidly around the world. Many companies develop marketing strategies as part of their general, overall business plans. Other companies prepare separate marketing plans.

A marketing plan is a strategic plan at the functional level that provides a firm’s marketing group with direction. It is a road map that improves the firm’s understanding of its competitive situation. The marketing plan also helps the firm allocate resources and divvy up the tasks that employees need to do for the company to meet its objectives. Let’s take a look at the different types of basic market strategies firms pursue before they develop their marketing plans.

Figure 28.24.10.1: The different types of product and market entry strategies a firm can pursue in order to meet their objectives.

The different types of product and market entry strategies a firm can pursue in order to meet their objectives.

Market penetration strategies focus on increasing a firm's sales of its existing products to its existing customers. Companies often offer consumers special promotions or low prices to increase their usage and encourage them to buy products. When Frito-Lay distributes money-saving coupons to customers or offers discounts to buy multiple packages of snacks, the company is utilizing a penetration strategy. The Campbell Soup Company gets consumers to buy more soup by providing easy recipes using their soup as an ingredient for cooking quick meals.

Product development strategies involve creating new products for existing customers. A new product can be a totally new innovation, an improved product, or a product with enhanced value, such as one with a new feature. Cars that parallel park themselves, offer rear-view cameras or wifi are examples of a product with enhanced value. A new product can also be one that comes in different variations, such as new flavors, colors, and sizes. Mountain Dew Voltage, introduced by PepsiCo Americas Beverages in 2009, is an example. Keep in mind, however, that what works for one company might not work for another. For example, just after Starbucks announced it was cutting back on the number of its lunch offerings, Dunkin' Donuts announced it was adding items to its lunch menu.

Diversification strategies aim to enter a new industry or market by developing a new product to give the firm a foothold in that new market. By broadening – or "diversifying" – its offerings, a firm can reduce its risk of exposure to the ups and downs of operating only in one industry. Diversification is generally considered a riskier strategy, but when it succeeds, it can result in strong, multi-industry, powerhouse companies. A great example is Disney, which has diversified over time from animated films into markets for toys, apparel, theme parks, resorts and cruise vacations, among other product categories.

Market development strategies focus on entering new markets with existing products. For example, during the recent economic downturn, manufacturers of high-end coffee makers began targeting customers who go to coffee shops. The manufacturers are hoping to develop the market for their products by making sure consumers know they can brew a great cup of coffee at home for a fraction of what they spend at Starbucks.

New markets can include any new groups of customers such as different age groups, new geographic areas, or international markets. Many companies, including PepsiCo and Hyundai, have entered—and been successful in—rapidly emerging markets such as Russia, China, and India. Decisions to enter foreign markets are based on a company's resources as well as the complexity of factors such as the political environmental, economic conditions, competition, customer knowledge, and probability of success in the desired market. As the figure below, "Market Entry Methods," shows, there are different ways, or strategies, by which firms can enter international markets. The strategies vary in the amount of risk, control, and investment that firms face. Firms can simply export, or sell their products to buyers abroad, which is the least risky and least expensive method but also offers the least amount of control. Many small firms export their products to foreign markets.

Firms can also license, or sell the right to use some aspect of their production processes, trademarks, or patents to individuals or firms in foreign markets. Licensing is a popular strategy, but firms must figure out how to protect their interests if the licensee decides to open its own business and void the license agreement. The French luggage and handbag maker Louis Vuitton faced this problem when it entered China. Competitors started illegally putting the Louis Vuitton logo on different products, which cut into Louis Vuitton's profits.

Figure 28.24.10.2: The front of a KFC franchise in Asia may be much larger than KFC stores in the United States. Selling franchises is a popular way for firms to enter foreign markets. Source: Wikimedia Commons.

Franchising is a longer-term (and thus riskier) form of licensing that is extremely popular with service firms, such as restaurants like McDonald's and Subway, hotels like Holiday Inn Express, and cleaning companies like Stanley Steamer. Franchisees pay a fee for the franchise and must adhere to certain standards; however, they benefit from the advertising and brand recognition the franchising company provides.

Contract manufacturing allows companies to hire manufacturers to produce their products in another country. The manufacturers are provided specifications for the products, which are then manufactured and sold on behalf of the company that contracted the manufacturing. Contract manufacturing may provide tax incentives and may be more profitable than manufacturing the products in the home country. Examples of products in which contract manufacturing is often used include cell phones, computers, and printers.

Joint ventures combine the expertise and investments of two companies and help companies enter foreign markets. The firms in each country share the risks as well as the investments. Some countries such as China often require companies to form a joint venture with a domestic firm in order to enter the market. After entering the market in a partnership with a domestic firm and becoming established in the market, some firms may decide to separate from their partner and become their own business. Fuji Xerox Co., Ltd. is an example of a joint venture between the Japanese Fuji Photo Film Co. and the American document management company Xerox. Another example of a joint venture is Sony Ericsson. The venture combined the Japanese company Sony's electronic expertise with the Swedish company Ericsson's telecommunication expertise. With investment by both companies, joint ventures are riskier than exporting, licensing, franchising, and contract manufacturing but also provide more control to each partner.

Direct investment (owning a company or facility overseas) is another way to enter a foreign market, providing the most control but also having the most risk. For example, In Bev, the Dutch maker of Beck's beer, was able to capture market share in the United States by purchasing St. Louis-based Anheuser-Busch. A direct investment strategy involves the most risk and investment but offers the most control. Other companies such as advertising agencies may want to invest and develop their own businesses directly in international markets rather than trying to do so via other companies.

Market Entry Methods

Figure 28.24.10.3: Copy and Paste Caption here. (Copyright; author via source)

Diversification strategies involve entering new markets with new products or doing something outside a firm's current businesses. Firms that have little experience with different markets or different products often diversify their product lines by acquiring other companies. Diversification can be profitable, but it can also be risky if a company does not have the expertise or resources it needs to successfully implement the strategy. Warner Music Group's purchase of the concert promoter Bulldog Entertainment is an example of a diversification attempt that failed.

KEY TAKEAWAYS

The strategic planning process includes a company's objectives (end results desired) and strategies (means). A firm's objectives should be realistic (achievable) and measurable. The different product market strategies firms pursue include market penetration, product development, market development, and diversification.

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28.24.11: Reading- Overview of the Marketing Plan

The Role of Marketing in the Organization

We previously discussed marketing as a set of activities that anyone can do. Marketing is also a functional area in companies, just like operations and accounting are. Within a company, marketing might be the title of a department, but some marketing functions, such as sales, might be handled by another department. Marketing activities do not occur separately from the rest of the company, however.

As we have explained, pricing an offering, for example, will involve a company's finance and accounting departments in addition to the marketing department. Similarly, a marketing strategy is not created solely by a firm's marketing personnel. Instead, it flows from the company's overall strategy.

Everything Starts with Customers

Most organizations start with an idea of how to serve customers better. Apple's engineers began working on the iPod by looking at the available technology and thinking about how customers would like to have their music more available, as well as more affordable, through downloading.

Many companies think about potential markets and customers when they start. John Deere, for example, founded his company on the principle of serving customers. When admonished for making constant improvements to his products even though farmers would take whatever they could get, Deere reportedly replied, "They haven't got to take what we make and somebody else will beat us, and we will lose our trade." He recognized that if his company failed to meet customers' needs, someone else would. As a result, their company mission statement changed to the following:

We aspire to distinctively serve customers—those linked to the land—through a great business, a business as great as our products. To achieve this aspiration, our strategy is:

- Exceptional operating performance
- Disciplined SVA growth
- Aligned high-performance teamwork.

Here are a few mission statements from other companies. Note that they all refer to their customers, either directly or by making references to relationships with them. Note also how these are written to inspire employees and others who interact with the company and may read the mission statement.

IBM

IBM will be driven by these values:

- Dedication to every client's success.
- Innovation that matters, for our company and for the world.
- Trust and personal responsibility in all relationships.

Coca-Cola

Everything we do is inspired by our enduring mission:

- To refresh the world…in body, mind, and spirit.
- To inspire moments of optimism…through our brands and our actions.
- To create value and make a difference…everywhere we engage.

McDonald's

- To be our customers' favorite place and way to eat.

Merck

- To provide innovative and distinctive products and services that save and improve lives and satisfy customer needs, to be recognized as a great place to work, and to provide investors with a superior rate of return.

Not all companies create mission statements that reflect a marketing orientation. Note Apple's mission statement: "Apple ignited the personal computer revolution in the 1970s with the Apple II and reinvented the personal computer in the 1980s with the

Macintosh. Today, Apple continues to lead the industry in innovation with its award-winning computers, OS X operating system and iLife and professional applications. Apple is also spearheading the digital media revolution with its iPod portable music and video players and iTunes online store, and has entered the mobile phone market with its revolutionary iPhone."

This mission statement reflects a product orientation, or an operating philosophy based on the premise that Apple's success is due to great products and that simply supplying them will lead to demand for them. The challenge, of course, is how to create a "great" product without thinking too much about the customer's wants and needs. Apple, and for that matter, many other companies, have fallen prey to thinking that they knew what a great product was without asking their customers. In fact, Apple's first attempt at a graphic user interface (GUI) was the LISA, a dismal failure.

The Marketing Plan

The marketing plan is the strategy for implementing the components of marketing: creating, communicating, delivering, and exchanging value. Once a company has decided what business it is in and expressed that in a mission statement, the firm then develops a corporate strategy. Marketing strategists subsequently use the corporate strategy and mission and combine that with an understanding of the market to develop the company's marketing plan.

Step 1: Customer Focus. Customer focus is also an essential part of the marketing plan. Understanding who you are targeting, what are the customer's wants and needs; how the customer wants to acquire, consume, and dispose of the offering; and what makes up their personal value equation are three important goals. Marketers need to know their customers—who they are and what they like to do—so as to uncover this information. Generally, this requires marketing researchers to collect sales and other related customer data and analyze it.

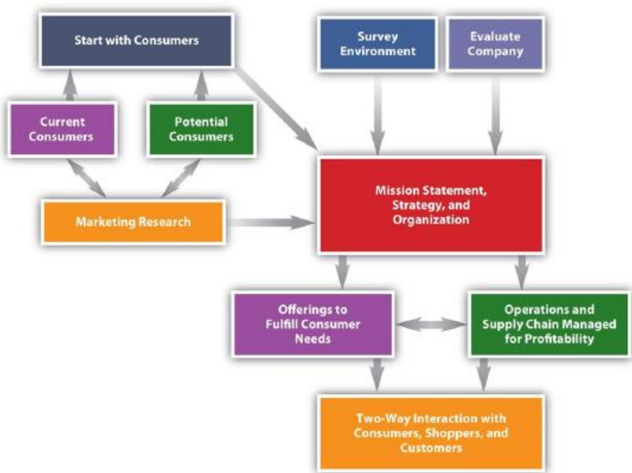

Figure 28.24.11.1: Customer Focus

Step 2: Product Development. Once the firm understands who they are targeting and how to satisfy customer needs, the planners can then work to create the right offering. Products and services are developed, bundled together at a price, and then tested in the market. Decisions have to be made as to when to alter the offerings, add new ones, or drop old ones.

Step 3: Value Chain. Building on decisions about product offerings, planners must address questions and opportunities associated with building the value chain. Once an offering is designed, the company has to be able to make it and get it to the market. The marketing plan may address stakeholder relationships across the value chain including distribution, in order to deliver value to customers.

Step 4: Communicating Value. A key function of the marketing plan is to effectively communicate with the stakeholders who are essential to the success of the plan. How will various teams within the company align to support the company's success? What compelling offer will the firm make to consumers? How does the firm make them aware of the value it has to offer? What steps should consumers take to realize this value? How does the firm help them recognize that value and decide that they should purchase products?

Step 5: The Exchange. Once a consumer has decided that her personal value equation is likely to be positive, she will decide to purchase the product. That decision still has to be acted on, however, which is the exchange. Customers should have a positive experience with the exchange, and marketing plans may address improvements to this experience.

Step 6: Evaluating Performance. As exchanges occur, marketing planners refine their plans based on data captured throughout the consumer decision process, the feedback they receive from their customers, what their competitors are doing, and how market conditions are changing.

The Changing Marketing Environment

At the beginning of this chapter, we mentioned that the view of marketing has changed from a static set of four Ps to a dynamic set of processes that involve marketing professionals as well as many other employees in an organization. The way business is being conducted today is changing, too, and marketing is changing along with it. Worth noting are several themes, or important trends, that may shape company strategies and in turn marketing strategies and planning.

- **Ethics and social responsibility.** Businesses exist only because society allows them to. When businesses begin to fail society, society will punish them or revoke their license. The crackdown on companies in the subprime mortgage-lending industry is one example. These companies created and sold loans (products) that could only be paid back under ideal circumstances, and when consumers couldn't pay these loans back, the entire economy suffered greatly. Scandals such as these illustrate how society responds to unethical business practices. However, whereas ethics require that you only do no harm, the concept of social responsibility requires that you must actively seek to improve the lot of others. Today, people are demanding businesses take a proactive stance in terms of social responsibility, and they are being held to ever-higher standards of conduct.
- **Sustainability.** Sustainability is an example of social responsibility and involves engaging in practices that do not diminish the earth's resources. Coca-Cola, for example, is working with governments in Africa to ensure clean water availability, not just for manufacturing Coke products but for all consumers in that region. Further, the company seeks to engage American consumers in participating by offering opportunities to contribute to clean water programs. Right now, companies do not *have* to engage in these practices, but because firms really represent the people behind them (their owners and employees), forward-thinking executives are seeking ways to reduce the impact their companies are having on the planet.
- **Service-dominant logic.** You might have noticed that we use the word *offering* a lot instead of the term *product*. That's because of service-dominant logic, the approach to business that recognizes that consumers want value no matter how it is delivered—whether through a tangible product or through intangible services. That emphasis on value is what drives the functional approach to value that we've taken—that is, creating, communicating, delivering, and exchanging value.
- **Metrics.** Technology has increased the amount of information available to decision makers. As such, the amount and quality of data for evaluating a firm's performance is increasing. Earlier in our discussion of the marketing plan, we explained that customers communicate via transactions. Although this sounds both simple and obvious, better information technology has given us a much more complete picture of each exchange. Cabela's, for example, combines data from Web browsing activity with purchase history in order to determine what the next best offer is likely to be. Using data from many sources, we can build more effective metrics that can then be used to create better offerings, better communication plans, and so forth.
- **A global environment.** Every business is influenced by global issues. The price of oil, for example, is a global concern that affects everyone's prices and even the availability of some offerings. We already mentioned Coke's concern for clean water. But Coke also has to be concerned with distribution systems in areas with poor or nonexistent roads, myriads of government policies and regulations, workforce availability, and so many different issues in trying to sell and deliver Coke around the world. Even companies with smaller markets source some or all their offerings from companies in other countries or else face some sort of direct competition from companies based in other countries. Every business professional, whether marketing or otherwise, has to have some understanding of the global environment in which companies operate.

KEY TAKEAWAYS

A company's marketing plan flows from its strategic plan. Both begin with a focus on customers. The essential components of the plan are understanding customers, creating an offering that delivers value, communicating the value to the customer, exchanging with the customer, and evaluating the firm's performance. A marketing plan is influenced by environmental trends such as social responsibility, sustainability, service-dominant logic, the increased availability of data and effective metrics, and the global nature of the business environment.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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28.24.12: Reading- Branding

Defining a Brand

Before you begin reading about branding and the strategies companies can adopt when placing their mark on a product, take a few minutes to watch the following video about Starbucks, a truly global brand:

A brand is a promise: the promise of what a company or product will provide to the people who interact with it. 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 we have about this brand. Brand encompasses visual design elements (i.e., logo, color, typography, images, tagline, etc.), distinctive product features (i.e. quality, design sensibility, etc.), and intangible aspects of customers' experience with a product or company (i.e. reputation, customer experience, etc.). Branding may take place at multiple levels: the company as a whole, individual products or product lines. Other entities that work to build consumer loyalty can also be considered brands, such as celebrities (e.g. Lady Gaga), events (e.g. Susan G. Komen Race for the Cure) and places (e.g. Las Vegas).

History

The word "brand" is derived from the Old Norse "brand" meaning "to burn," which refers to the practice of producers burning their mark (or brand) onto their products. Italians are considered among the first to use brands in the form of watermarks on paper in the 1200s. However, in mass-marketing, this concept originated in the nineteenth century with the introduction of packaged goods.

During the Industrial Revolution, the production of many household items, such as soap, was moved from local communities to centralized factories to be mass-produced and sold to the wider markets. When shipping their items, factories branded their logo or insignia on the barrels used. Eventually these "brands" became trademarks, or recognized symbols of a company or product that are established by use. These new brand marks enabled packaged-goods manufacturers to communicate that their products are distinctive and should be trusted as much as (or more than) local competitors. Campbell Soup, Coca-Cola , Juicy Fruit gum, Aunt Jemima, and Quaker Oats were among the first products to be "branded. "

Figure 28.24.12.1: The Coca-Cola logo is an example of a widely recognized trademark and global brand.

Connotations

A successful brand is much more than just a name or logo. 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, as follows:

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.
3. **Values:** company values and operational principles. The Mercedes brand evokes company values around excellence and high performance.
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 suggests 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.

Figure 28.24.12.2: As an automobile brand, the Mercedes-Benz logo suggests high prestige.

What Is the Purpose of Branding and Why Is It So Important?

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 attention and investment in communicating about and delivering the unique value embodied in a company's "brand," but this effort reaps long-term profitability.

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 as a new brand extension or product line builds on consumers' positive perceptions of the established brand.

Benefits of Branding for the Consumer

Brands help simplify consumer choices. 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 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.

Figure 28.24.12.3: 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.

Benefits of Branding for the Manufacturer

Branding helps create loyalty. It decreases the risk of losing market share to the competition by establishing a differential advantage. 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. 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.

Figure 28.24.12.4: The Starbucks brand is associated with premium, high-priced coffee.

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

Benefits of Branding for the Retailer

Branding enables the retailer to benefit from brand marketing support by helping to attract more customers (ideally ones who normally don't frequent the 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.

Brand Loyalty

In marketing, brand loyalty refers to a consumer's commitment to repurchase or otherwise continue using a particular brand by repeatedly buying a product or service.

The American Marketing Association defines brand loyalty in the following ways:

1. The situation in which a consumer generally buys the same manufacturer-originated product or service repeatedly over time rather than buying from multiple suppliers within the category (sales promotion definition)
2. The degree to which a consumer consistently purchases the same brand within a product class (consumer behavior definition)

Aside from a consumer's ability to repurchase a brand, true brand loyalty exists when the customer is committed to the brand, and the customers have a high relative attitude toward the brand, which is then exhibited through repurchase behavior. For example, if Joe has brand loyalty to Company A, he will purchase Company A's products even if Company B's products are cheaper and/or of a higher quality.

Brand loyalty is viewed as a multidimensional construct, determined by several distinct psychological processes, such as the customers' perception of value, brand trust, satisfaction, repeat-purchase behavior, and commitment. Commitment and repeated-purchase behavior are considered necessary conditions for brand loyalty, followed by perceived value, satisfaction, and brand trust.

Philip Kotler identifies the following four customer types that exhibit similar patterns of behavior:

1. Hardcore Loyals, who buy the brand all the time
2. Split Loyals, loyal to two or three brands
3. Shifting Loyals, moving from one brand to another
4. Switchers, with no loyalty (possibly “deal-prone,” constantly looking for bargains, or “vanity prone,” looking for something different)

Benefits of Brand Loyalty

The benefits of brand loyalty are longer tenure (or staying a customer for longer), and lower sensitivity to price. Recent research found evidence that longer-term customers were indeed less sensitive to price increases.

According to Andrew Ehrenberg, consumers buy “portfolios of brands. ” They switch regularly between brands, often because they simply want a change. Thus, “brand penetration” or “brand share” reflects only a statistical chance that the majority of customers will buy that brand next time as part of a portfolio of brands. It does not guarantee that they will stay loyal.

By creating promotions and loyalty programs that encourage the consumer to take some sort of action, companies are building brand loyalty by offering more than just an advertisement. Offering incentives like big prizes creates an environment in which customers see the advertiser as more than just the advertiser. Individuals are far more likely to come back to a company that uses interesting promotions or loyalty programs than a company with a static message of “buy our brand because we’re the best.”

Popular Loyalty Programs

Below are some of the most popular customer loyalty programs in use today by major companies as a means of engaging their customers beyond traditional advertising:

- Sweepstakes and Advergames
- Branded digital games that engage consumers with prize incentives
- Contests
- Skill tests and user-generated promotions such as video and photo contests
- Social media applications and management
- Social media promotions and offers
- Customer rewards programs (e.g. pay lower prices using a frequent buyer card)
- Points-based loyalty programs, awarding prizes for incremental purchase behavior (e.g., frequent flyer programs)
- Coupons (hard copy and/or digital)
- Promotional auctions—bid for prizes with points earned from incremental purchase behavior
- Email clubs
- Subscription databases—national and/or segmented by market
- SMS Promotions
- iPhone apps
- Branded web apps

Brand Equity

In marketing, brand equity refers to the value of a brand that is well-known and conjures positive mental and emotional associations. For any given product, service, or company, brand equity is considered a key asset because it helps the brand remain relevant and competitive. Brand equity can manifest itself in consumer recognition of logos or other visual elements, brand language associations made by consumers’ perception of quality, and value among other relevant brand attributes.

When consumers trust a brand and find it relevant, they may select the offerings associated with that brand over those of competitors even at a premium price. For example, Starbucks can sell its coffee at a higher price than solid market competitors because consumers associate the brand with quality and value. This is why brand equity often correlates directly with a brand’s profitability.

Measuring Brand Equity

Brand equity is strategically important, but also difficult to quantify. As a result, many experts have developed tools or metrics to analyze this asset, although there is no universally accepted way to measure it. For example, while it can be measured quantitatively using numerical values such as profit margins and market share, this approach fails to capture qualitative elements such as prestige and mental and emotional associations.

According to David Aaker, a marketing professor and brand consultant, the following are ten attributes of a brand that can be used to assess its strength:

1. Differentiation
2. Satisfaction or loyalty
3. Perceived quality
4. Leadership or popularity
5. Perceived value
6. Brand personality
7. Organizational associations
8. Brand awareness
9. Market share
10. Market price and distribution coverage

Brand Asset Valuator

Young & Rubicam, a marketing communications agency, has developed the brand asset valuator, a tool to diagnose the power and value of a brand. The agency uses this tool to survey and measure consumers' perspectives along the following four dimensions:

- **Differentiation**: The defining characteristics of the brand and its distinctiveness relative to competitors
- **Relevance**: The appropriateness and connection of the brand to a given consumer
- **Esteem**: Consumers' respect for and attraction to the brand
- **Knowledge**: Consumers' awareness of the brand and understanding of what it represents

Below are other ways that brand equity can be measured. These can be used individually or in combination:

- **At the firm level**: Brand equity can be studied as a financial asset by making a calculation of a brand's worth as an intangible asset. For example, a company can estimate brand value on the basis of projected profits discounted to a present value. In turn, the present value can be used to calculate the risk profile, market leadership, stability, and global reach.
- **At the product level**: The price of an equivalent well-known brand can be compared to that of a competing, no-name or private label product.
- **At the consumer level**: This measure seeks to map the mind of the consumer to uncover associations with the given brand. For example, projective techniques can be used to identify tangible and intangible attributes, attitudes, and various perceptions about the brand. Under this approach, the brands with the highest levels of awareness and most favorable and unique associations are considered high equity brands.

Types of Brands

As alluded to earlier, different types of brands include: individual products, product ranges, services, organizations, individual persons, groups, events, geographic places, private label brands, media, and e-brands.

Individual Brands. The most common type of brand is a tangible, individual product, such as a car or drink. This can be very specific, such as the Kleenex brand of tissues, or can comprise a wide range of products. Product brands can also be associated with a range, such as the Mercedes S-class cars or all varieties of Colgate toothpaste.

Service Brands. A service brand develops as companies move from manufacturing products to delivering complete solutions and intangible services. Service brands are characterized by the need to maintain a consistently high level of service delivery. This category comprises the following:

- Classic service brands (such as airlines, hotels, car rentals, and banks).
- Pure service providers (such as member associations).
- Professional service brands (such as advisors of all kinds – accountancy, management consultancy).
- Agents (such as travel agents and estate agents).
- Retail brands (such as supermarkets, fashion stores, and restaurants).

Organization Brands. Organization brands are companies and other entities that deliver products and services. Mercedes and the US Senate each possess strong organization brands, and each has qualities associated with them that constitute their brand.

Organizations can also be linked closely with the brand of an individual. For example, the U.S. Democratic party is closely linked with President Barack Obama.

Personal Brands. A person can be considered a brand. It can be comprised of one, as in the case of Oprah Winfrey, or a few individuals, where the branding is associated with different personalities, such as with the American Democratic Party.

Group Brands. Group branding happens when there is a small group of branded entities that have overlapping, interconnected brand equity. For example, the OWN brand of the Oprah Winfrey Network and the brand of its known members (Oprah and her team) are strongly connected. The OWN group brand is closely linked to Oprah Winfrey herself.

Figure 28.24.12.5: OWN: The Oprah Winfrey Network

Event Brands. Events can become brands when they strive to deliver a consistent experience that attracts consumer loyalty. Examples include conferences the TED series; music festivals like Coachella or SXSW; sporting events like the Olympics or NASCAR; touring Broadway musicals like Wicked. The strength of these brands depends on the experience of people attending the event. Savvy brand managers from product, service and other types of brands realize the power of event brands and seek to have their brands associated with the event brands through sponsorships. Event sponsorship is now a thriving big business.

Geographic Place Brands. Many places or areas of the world seek to brand themselves to build awareness of the essential qualities they offer. Branded places can range from countries and states to cities, streets and even buildings. Those who govern or represent these geographies work hard to develop the brand. Geographic branding is used frequently to attract commerce and economic investment, tourism, new residents, and so forth.

Private Label Brands. Private label brands, also called own brands, or store brands, exist among retailers that possess a particularly strong identity (such as Save-A-Lot). Interestingly, private labels may denote superior, “select” quality or lower cost for a quality product.

Media Brands. Media brands include newspapers, magazines, and television channels such as CNN.

Figure 28.24.12.6: CNN Logo

CNN Logo

E-Brands. E-Brands exist only in the virtual world. Many e-brands, such as Amazon.com have a central focus on providing an online front end for delivering physical products or services. Others provide information and intangible services to benefit consumers. Typically a common denominator for e~brands is a focus on delivering a valued service or experience in the virtual environment.

Brand Ownership

Brand ownership is about building, developing and sustaining a brand that reflects your principles and values and which effectively persuades consumers to believe in and purchase your product/service.

In order to really own your brand, you must have a clear understanding of where your brand stands in the marketplace today, and a concrete strategy that outlines how you wish to manage and grow your brand moving forward in support of company strategy and objectives. Equally important is understanding what makes your brand different. You must also create clear and persuasive messaging communication targeting your end consumer. You should also develop a plan to reach your goals in a realistic and organized fashion.

When you truly own your brand, your money is spent wisely on marketing that is targeted, sharp and effective because you have a sophisticated understanding of the marketplace, your product/service, your consumer base and your strategy. This will translate into disciplined and effective brand management that will enable you to remain relevant in a rapidly-changing [and oftentimes saturated] marketplace.

Brand ownership should also be considered the responsibility of its management and employees. Steve Jobs, for example, was considered a leader in shaping the identity of Apple, which has helped fuel a very high stock price for the company. As a result, the brand image and reputation has attracted some of the world's best talent which, in turn, has yielded an variety of innovative mobile products that will undoubtedly be marked in the history of popular consumer culture.

A brand owner may seek to protect proprietary rights in relation to a brand by registering the trademark such that it becomes a "Registered Trademark. " Also, a firm or licensor can also grant the right to use their brand name, patents or sales knowledge in exchange for some form of payment.

Figure 28.24.12.7: The Registered Trademark symbol

A brand identifies a commercial product or service as distinct from those of other sellers, and therefore it is made up of all the things that create this distinction. A brand's name is an essential part of this package. A brand name may be a product name, or it may be the name under which the entire organization operates. Because the name is so integral to identity, naming a brand is crucial to its reputation, development, and future success – and to the brand owner's ability to differentiate the brand from its competitors.

Naming a Brand

Selecting a brand name is one of the most important product decisions a seller makes. A brand name reflects the overall product image, positioning and, ideally, its benefits. A successful brand name can enable a product to: be meaningfully advertised and distinguished from competitors, be tracked down by consumers, and be given legal protection. At its best, a brand can provide a carryover effect when customers are able to associate quality products with an established brand name.

Attention to naming also helps customers associate products within the same brand family. For example, Apple names its mobile products with a lowercase *i*—for example, iPad, iPod, iPhone. Starbucks names its coffee sizes in Italian.

Naming a brand is a systematic effort. It starts with defining the personality and distinctive attributes of the company or product to be named. A scan of the competitive landscape identifies brand names already active in the category, in order to avoid selecting a name that would easily be confused with competitors. Next, the naming team generates potential brand names, screens them to make sure they are available to use legally (no trademark conflicts) and perceptually (no mindshare conflicts with other known brands). It is always wise to conduct market research to test short-listed names among consumers. Ultimately the naming team selects the name with the most potential for creating a strong brand, combined with the least risk from a trademark ownership perspective. Brand names are mandatory if the manufacturer or distributor plans to produce mass advertising for their product.

But before this process even begins, a basic branding strategy must be employed where a company or seller must select from among the following three viable options:

1. A strict manufacturer's branding policy under which a producer can only manufacture merchandise under his own brand
2. An exclusive distributor's brand policy where a producer does not have a brand of his own but agrees to sell his products only to a particular distributor and carry his brand name (typically employed by private brands)
3. A mixed brand policy, which allows elements of both extremes (options 1. and 2.) and leads to the production of manufacturer's as well as distributor's brands

Figure 28.24.12.8: Apple's iPad—iPad is one of Apple's mobile products named with the distinctive "i."

Brand Lines

What is a Brand Line? Brand line is a marketing term used to describe all the products sold under a single brand name.

Brand line is a marketing term used to describe all the products sold under a single brand name. New flavors, package sizes, nutritional content, or products containing special additives are included in this definition. More than half of all new products introduced each year are brand line extensions. For example, when a coffee manufacturer adds decaffeinated coffee to the same brand line of coffee products already on the market (such as regular coffee and instant coffee), a line extension has been made. Line extensions do not compete with each other, since each answers different needs and thus appeals to a different market.

Another form of brand extension is a licensed brand extension. In this scenario, the brand-owner works with a partner (sometimes a competitor), who takes on the responsibility of manufacturing and sales of the new products, paying a royalty every time a product is sold.

A company introduces a brand line extension (also referred to as product line extension) by using an established product's brand name to launch a new or slightly different item which may or may not be in the same product category. For example, Diet Coke™ is a line extension of the parent brand Coke ™. While the products have distinct differences, they are in the same product category. The new product is oftentimes referred to as a spin-off.

Figure 28.24.12.9: Diet Coke is a brand line extension of the Coca Cola Brand.

What Is the Purpose of a Brand Line or Brand Extension?

Organizations use this strategy to increase and leverage brand equity. An example of a brand extension is Jell-O gelatin creating Jello pudding pops. It increases awareness of the brand name and increases profitability from offerings in more than one product category.

Brand line extensions are crucial because they reduce financial risk associated with new product development by leveraging the parent brand name to enhance consumers' perception as a result of its core brand equity. Due to the established success of the parent brand, consumers will have instant recognition of the product name and will be more likely to try the new line extension.

Also, launching a new product is time consuming and requires a generous budget to create awareness and to promote a product's benefits. As a result, promotional costs are much lower for a line extension than for a completely new product. More products expand the company's shelf space presence, thereby enhancing brand recognition. For example, consider Campbell's Soups™ – the strength of the Campbell's™ brand lowers costs of launching a new flavor of soup, such as Creamy Chicken Noodle™, due to the established brand name and package design. Consumers who have enjoyed Campbell's Chicken Noodle Soup™ are likely to try Campbell's Creamy Chicken Noodle Soup™ , even with minimal impact from advertisements and promotions.

Overall, the main benefits of a brand line extension are:

- Expand company shelf space presence.
- Gain more potential customers.
- Offer customers more variety.
- Greater marketing efficiency.
- Greater production efficiency.
- Lower promotional costs.
- Increased profits.

Brand Line Extensions Can Also Represent Risk

While there can be significant benefits in brand extension strategies, there can also be significant risks, resulting in a diluted or severely damaged brand image. Poor choices for brand extension may dilute and deteriorate the core brand and damage the brand equity. Most of the literature focuses on the consumer evaluation and positive impact on a parent brand. In practical cases, the failures of brand extension are at a higher rate than the successes. Some studies show that negative impact may dilute brand image and equity. In spite of the positive impact of brand extension, negative association and wrong communication strategy can do harm to the parent brand and even the brand family.

Brand line extensions do present two potential main threats. If the new line extension fails to satisfy, consumers' attitudes toward other products carrying the same brand name may be damaged. Additionally, there is potential for intra-firm competition between the parent product and the line extension or between two or more line extensions. The key to avoiding intra-firm competition is to clearly differentiate between products. Although similar, the products must be different enough that they will not compete with one another as much as they will with the brands of rival companies.

Branding Strategies

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

"House Brand" Strategy

A "House Brand" strategy uses a 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 in the United States). 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

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 against 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.

Competitive Multi-Brand Strategy

In a very saturated market, a supplier can deliberately launch totally new brands in apparent competition with its own existing strong brand (and often with identical product characteristics) to soak up some of the share of the market. The rationale is that having 3 out of 12 brands in such a market will give a greater overall share than having 1 out of 10. Procter & Gamble is a leading exponent of this philosophy, running as many as ten detergent brands in the U.S. market. In the hotel business, Marriott uses the name Fairfield Inns for its budget chain.

Cannibalization is a particular problem of a multi-brands strategy approach, in which the new brand takes business away from an established one which the organization also owns. This may be acceptable (indeed to be expected) if there is a net gain overall.

Attitude Branding and Iconic Brands

Attitude branding is the choice to represent a larger feeling a brand comes to represent, which transcends the specific products being consumed. Examples of companies that use this approach effectively include:

- Nike – "Just do it"
- Apple – "Think different"
- Harley Davidson – "Live to Ride"
- Starbucks – "Daily Inspiration"

Effective attitude branding can transform strong brands into iconic, "lifestyle" brands that contribute to the consumer's self-expression and personal identity.

Component Brands

Some suppliers of key components may wish to guarantee its own position by promoting that component as a brand in its own right. For example, Intel, positions itself in the PC market with the slogan (and sticker) "Intel Inside."

Private Labels

Also called own brands, or store brands, these have become increasingly popular. Where the retailer has a particularly strong identity this "own brand" may be able to compete against even the strongest brand leaders, and may outperform those products that are not otherwise strongly branded.

"No-brand" Branding

Recently a number of companies have successfully pursued "no-brand" strategies by creating packaging that imitates generic brand simplicity. "No brand" branding may be construed as a type of branding as the product is made conspicuous through 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 simply recognized by the color of the cap of this cleaning products company.

Individual and Organizational Brands

These are types of branding that treat individuals and organizations as the products to be branded. Personal branding treats persons and their careers as brands. Faith branding treats religious figures and organizations as brands.

Crowdsourced Branding

These are brands that are created by the people for the business, which is opposite to the traditional method where the business creates a brand. This type of method minimizes the risk of brand failure, since the people that might reject the brand in the traditional method are the ones who are participating in the branding process. However, the business itself typically cannot fully control these brands because they are the product of crowdsourcing.

One interesting example is the Timbers Army, the independent fan organization of the Portland Timbers Major League Soccer (MLS) Team. The Timbers Army was created by fans, and it operates independently from the MLS team and the Portland Timbers management. Although the organizations coordinate in many areas, ultimately the fan organization asserts its own brand identity.

Nation Branding

Nation branding is a field of theory and practice which aims to measure, build, and manage the reputation of countries. Typically aimed at attracting investment, commerce and/or tourism, it is closely related to geographic place branding, discussed above.

Brand Extension and Brand Dilution

The existing strong brand name can be used as a vehicle for new or modified products. For example, many fashion and designer companies extended brands into fragrances, shoes and accessories, furniture, and hotels. Frequently, the product is no different than what is already on the market, except it has a brand name marking. The risk of over-extension is brand dilution, which is when the brand loses its brand associations with a market segment, product area, or quality, price, or cachet.

KEY TAKEAWAYS

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, and so forth. Branding is the set of activities designed to create a brand and position it relative to competing brands in the minds of consumers. Effective branding requires a sophisticated understanding of customers targeted, what they want from a brand, and how the brand delivers those benefits in ways that distinguish it from the competition. Brand is the ultimate touchstone to guide choices around messaging, visual design, packaging, marketing, communications and product strategy.

Naming is an important decision companies must make about how to market a new brand. A brand extension involves utilizing an existing brand name or brand mark for a new product or category (line) of products. Cannibalization occurs when a company's new offering eats into the sales of one of its older offerings. It is something to be avoided in most cases, but it can also be a sign of progress because it means a company is developing new and better products.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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CHAPTER OVERVIEW

29: Module 14- Marketing Mix

29.1: Why It Matters- Marketing Mix

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

You can view the transcript for “Felix Baumgartner’s supersonic freefall from 128k’ – Mission Highlights” (opens in new window).

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 spot 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 section.

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29.2: Introduction to 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.

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29.3: Consumer Product Categories

Learning Objectives

- Describe common 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.

Speciality 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.

Figure 29.3.1: 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.

? Practice Question

https://assessments.lumenlearning.co...essments/14491

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1. American Marketing Association. "Product." Dictionary. Accessed June 10, 2019. www.ama.org/resources/Pages/Dictionary.aspx?dLetter=P#product. ↩
2. Business Dictionary. "Industrial Goods." Accessed June 10, 2019. www.businessdictionary.com/definition/industrial-goods.html↩

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29.4: Elements and Benefits of Branding

Learning Objectives

- Explain the 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."

You can view the transcript for "Coca Cola" (opens in new window).

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 (e.g., Las Vegas).

Brands Create Market Perceptions

A successful brand is much more than just a name or logo. As suggested in one of the definitions above, a 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.

Figure 29.4.1: As an automobile brand, the Mercedes-Benz logo suggests high prestige.

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

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

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

Value of Branding for the Consumer

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.

Figure 29.4.2: 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 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

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.

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

Figure 29.4.3: The Starbucks brand is associated with premium, high-priced coffee.

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 CVS store 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 available at this particular retailer.

? Practice Question

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29.5: Common Branding Strategies

Learning Objectives

- Describe 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

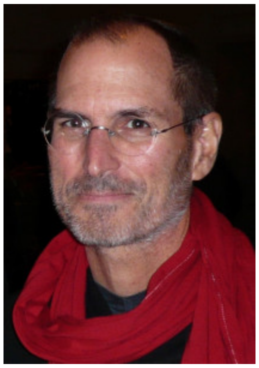

Figure 29.5.1: Steve Jobs, co-founder and long-time CEO of Apple

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.

Figure 29.5.2: Modern Kool-Aid Man

House of Brands Strategy

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.[1]

“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.

Figure \(\PageIndex{3}\): Sierra Club

Personal or Organization 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.

You can view the transcript for “What Happens Here, Stays Here” (opens in new window) or the text alternative for “What Happens Here, Stays Here” (opens in new window).

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.

Figure 29.5.4: Copy and Paste Caption here. (Copyright; author via source)

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

Figure 29.5.5: 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.

Figure 29.5.6: 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.

? Practice Question

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1. "Our Brands." Safeway. Accessed June 25, 2019. http://www.safeway.com/ShopStores/Brands/Our-Brands.page. ↵

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29.6: Stages of the Product Life Cycle

Learning Objectives

- Describe 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 maturity, withdrawal and eventual decline. This progression is shown in the graph, below.

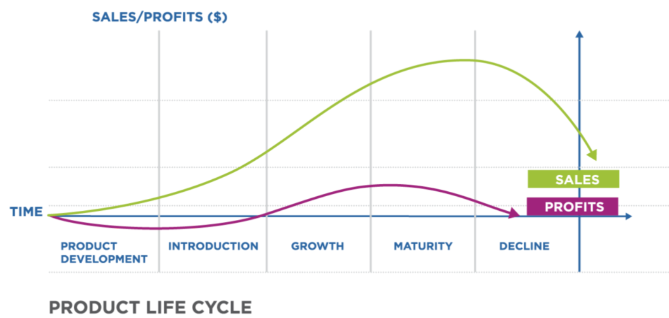

Figure 29.6.1: Product life cycle

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.

Product Life Cycle Stages and Common Characteristics

Stage 1: Product Development	1. investment is made 2. sales have not begun 3. new product ideas are generated, operationalized, and tested
Stage 2: Market Introduction	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
Stage 3: Growth	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

Stage 4: Maturity	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
Stage 4: Decline	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

? Practice Question

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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.[1]

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 characteristics that apply to a given product as it moves through the various stages.

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1. Mullor-Sebastian, Alicia. “The Product Life Cycle Theory: Empirical Evidence.” Journal of International Business Studies 14.3 (1983): 95–105. ↵

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- Chapter 7: Introducing and Managing the Product, from Introducing Marketing. **Authored by**: John Burnett. **Provided by**: Global text. **Located at**: solr.bccampus.ca:8001/bcc/file/ddbe3343-9796-4801-a0cb-7af7b02e3191/1/Core%20Concepts%20of%20Marketing.pdf.. **License**: *CC BY: Attribution*

29.7: Marketing through the Product Cycle

Learning Objectives

- Explain marketing considerations through the product life 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 social media campaign, print or broadcast advertising, a press release and press 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.

Figure 29.7.1: 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 itself. 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." In 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 minimizing costs. Marketing spend is reduced for 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 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."

Practice Question

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29.8: The New-Product Development Process

Learning Objectives

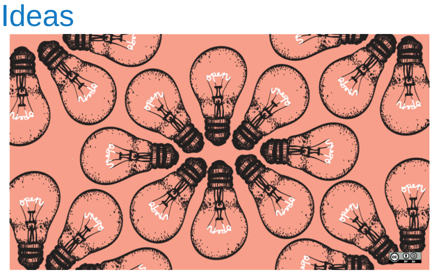
- Explain the stages of the new-product development process

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.

New-Product Development Process: Phases and Stages

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 8: Evaluation

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.

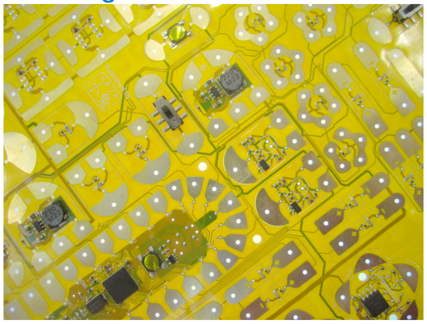
The key to the idea generation stage is to explore possibilities, knowing that most will not result in products that go to market.

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 overall 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 leveraging technology for 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, 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.

? Practice Question

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29.9: Introduction to Promotion

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

The information in this section cover seven different marketing communication methods 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.

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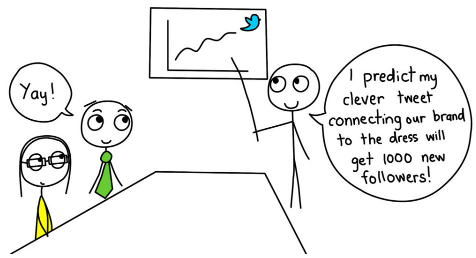
29.10: Integrated Marketing Communication (IMC) Definition

Learning Objectives

- Explain integrated marketing communication (IMC)
- Explain the promotion mix

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. A business that follows strict environmental practices says much about the organization.

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 marketing activity more efficient and effective because it relies on multiple communication methods and customer touch points to deliver a consistent message in multiple means and in more compelling ways.

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.

Figure 29.10.1: The promotion mix

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 retailers. 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.

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 re-convince 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.

? Practice Questions

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29.11: Common Marketing Communication Methods

Learning Objectives

- Describe common marketing communication methods, including their advantages and disadvantages

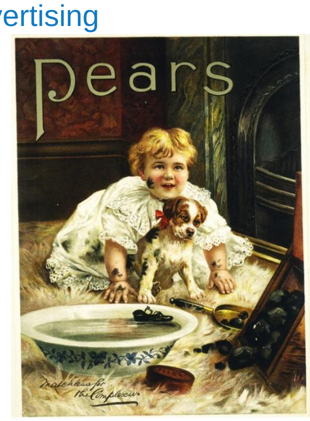
In a successfully operated campaign, all activities will be well-coordinated to build on one another to increase the overall impact. For example, a single campaign might include:

- **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 and training for customer sales representatives about the campaign to equip them to explain and demonstrate the product benefits stressed in advertising.
- **Sales promotion:** 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).

What is 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.

What is 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 stumping 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.

What is 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 messaging 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.

What are 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 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, 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 renew 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.

What is Digital Marketing?

Digital marketing is an umbrella term for using 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 brick-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 it does 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 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 promote the brand.

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. 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.

What are 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.")

A link to an interactive elements can be found at the bottom of this page.

You can view the transcript for "Tyson Foods Meals That Matter – Moore, Okla., June 2013" (opens in new window).

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.

? Practice Question

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1. Merchant, Paul. "Strategic Selling Techniques." Small Business. October 26, 2016. Accessed June 25, 2019. http://smallbusiness.chron.com/strategic-selling-techniques-15747.html. ↵
2. "How to Establish a Promotional Mix." Edward Lowe Foundation. Accessed June 25, 2019. http://edwardlowe.org/digital-library/how-to-establish-a-promotional-mix/. ↵

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29.12: Using IMC to Support Marketing Strategies

Learning Objectives

- Explain how organizations use IMC to support their 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.

The Walt Disney Company (Disney) was a pioneer and "wrote the book" on IMC techniques. For example, when Disney released a new movie property they would unleash a marketing juggernaut across their business empire. Ads and trailers for the new movie would be run on Disney T.V. channels and Disney movies currently in theaters. Posters and merchandise would populate Disney theme parks- even new rides would be constructed with the new property theme. Videos would be run in Disney retail stores with posters and merchandise available for purchase. Disney licensees would partner with large national retailers to coordinate the movie release with in-store promotions and displays. Utilizing T.V., movies, retail stores, theme parks, and national retail promotion, it is easy to see why the Walt Disney Company has been so successful with its marketing efforts.

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."

The IMC approach takes a central theme and pushes that message through appropriate communication channels. LinkedIn recently staged a campaign using "In it together" as their theme. The company produced a number of black and white, documentary-style videos featuring highly-motivated individuals demonstrating their inspiration for their hard work. The company used outdoor ads, social media, and their web site to leverage the inspirational videos and their message.

? Practice Question

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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.[1] These mosaics, two of which are below, appeared on the Web and on the streets of Switzerland. You can visit a higher-resolution version of the Clear Channel mosaic that reveals all the brands that make up the mosaics.

Some of the billboards appeared in animated form, as below. (Note that the video has no narration. Access audio description by using the widget below the video.)

Access the text alternative for "Clear Channel: Where Brands Meet People" (opens in new window).

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. "Clear Channel: Where Brands Meet People." Charis Tsevis. Accessed June 10, 2019. https://tsevis.com/clear-channel-where-brands-meet-people. ↵

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29.13: Introduction to 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.

29.14: Channels of Distribution

> **Learning Objectives**
>
> - List the characteristics and flows of a distribution channel

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

? Practice Question

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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.

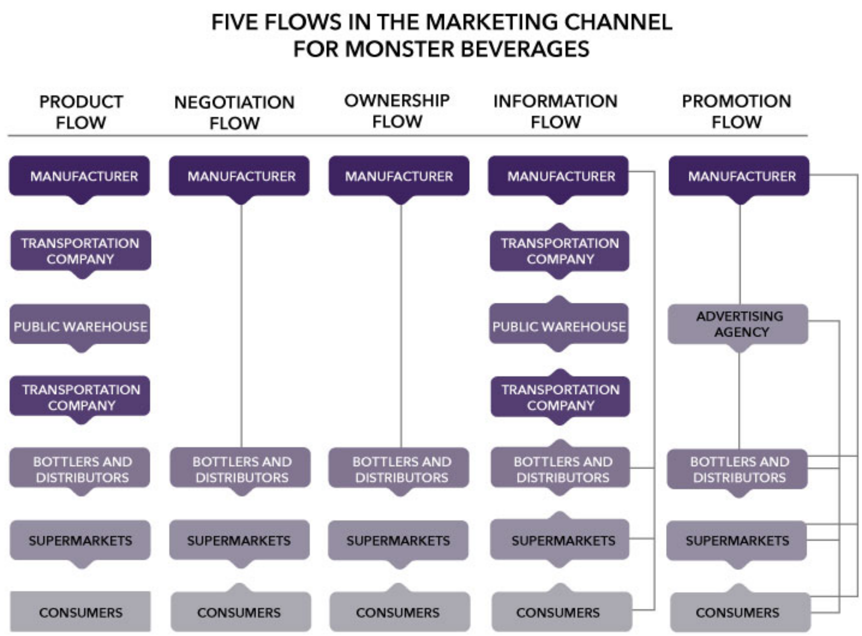

Figure 29.14.1: Flows for the Monster Energy drink (and many other energy drink brands)

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.

- Product flow: the bottlers receive and process the bases and syrups
- Negotiation flow: the bottlers buy concentrate, sell product and collect revenue from customers
- Ownership flow: distributors acquire the title of the syrups and own the product until it's sold to supermarkets
- 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

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1. "The Coca-Cola System." The Coca-Cola Company. Accessed June 25, 2019. http://www.coca-colacompany.com/our-company/the-coca-cola-system/. ↵

Contributors and Attributions

29.15: Channel Partners

> **Learning Objectives**
>
> - Describe the channel partners that support distribution channels

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**.

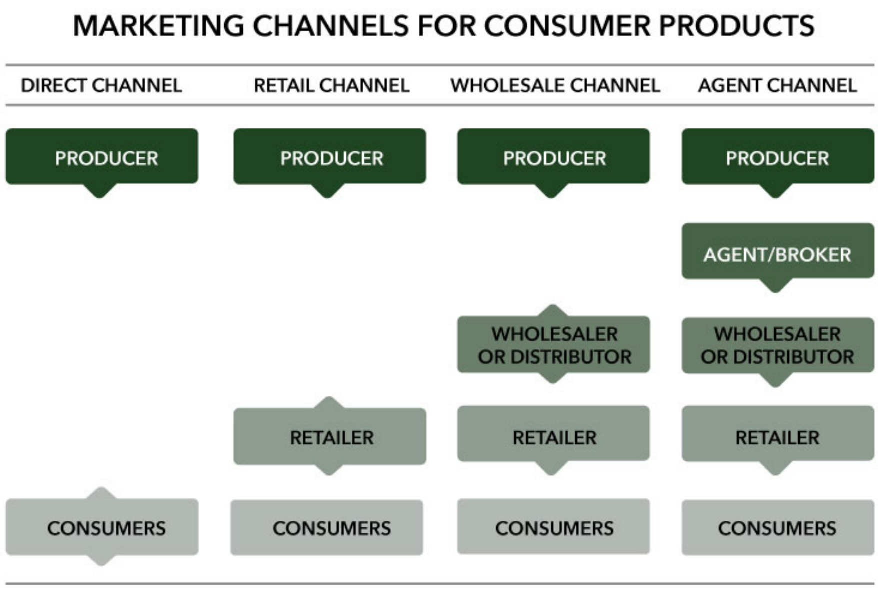

Figure 29.15.1: Marketing channels for consumer products

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.

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29.16: The Role of Wholesale Intermediaries

Learning Objectives

- Explain 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 Company, Inc. is one of the largest supply chain services leaders, providing grocery and foodservice supply chain solutions for convenience stores, mass merchants, drug stores and chain restaurants throughout the United States. McLane, through McLane Grocery and McLane Foodservice, operates over 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 110,000 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. (NYSE: BRK) and employs more than 20,000 teammates.*[1]

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 22 modern distribution centers around the country. It relies on its own vast trucking fleet of over 1,600 tractors and 2,700 multi-temperature trailers to handle the transportation of product.[2]

Grading and Packaging

Wholesalers buy a very large quantity of goods that they then break down into smaller lots. The process of breaking large quantities into smaller lots to 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.

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.[3]

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 provide 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.

? Practice Question

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3. Durtschi, Susan. "Why McLane Is 2016's General Merchandise Category Captain." Convenience Store News. February 15, 2016. Accessed June 25, 2019. http://www.csnews.com/industry-news-and-trends/special-features/why-mclane-2016s-general-merchandise-category-captain. ↵

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29.17: Retailers that Distribute Products

Learning Objectives

- Describe the different types of retailers businesses use to 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, a large portion of retail sales still take place in brick-and-mortar stores.

Beyond the distinction 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 housewares such as dishes and luggage.

Chain Stores

The 1920s saw the evolution of the chain store movement. Because chain store businesses were so large, they were able to buy a wide variety of merchandise at discounted prices. 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 1920s 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 stable 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 $129 billion in sales in 2017. 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 including 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. View the *Entrepreneur* magazine 500 Top Franchises list. 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 or anchors. *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 Overstock.com 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.[1]

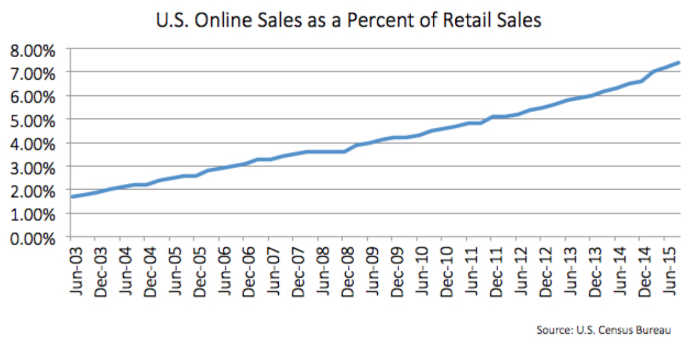

Figure 29.17.1: US online sales as a percent of retail sales

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.[2]

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.

❓ Practice Question

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29.18: Supply Chains and Distribution Channels

Learning Objectives

- Differentiate between supply chains and distribution channels

What Is a Supply Chain?

Figure 29.18.1: Supply Chain of Peanut Butter.

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*.

A supply chain is the system through which an organization acquires raw material, produces products, and delivers the products and services to its customers. Figure 1 illustrates a typical supply chain. Supply chain management helps increase the efficiency of logistics service by minimizing inventory and moving goods efficiently from producers to the ultimate users.

On their way from producers to end users and consumers, products pass through a series of marketing entities known as a **distribution channel**.

The Functions of Distribution Channels

Why do distribution channels exist? Why can't every firm sell its products directly to the end user or consumer? Why are go-betweens needed? Channels serve a number of functions.

Channels Reduce the Number of Transactions

Channels make distribution simpler by reducing the number of transactions required to get a product from the manufacturer to the consumer. For example, if there are four students in a course and a professor requires five textbooks (each from a different publisher), a total of 20 transactions would be necessary to accomplish the sale of the books. If the bookstore serves as a go-between, the number of transactions is reduced to nine. Each publisher sells to one bookstore rather than to four students. Each student buys from one bookstore instead of from five publishers (see Figure 2).

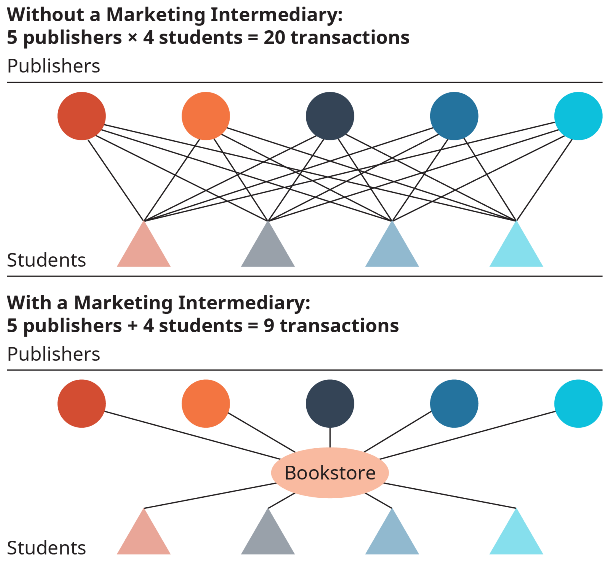

Figure 29.18.2: How Distribution Channels Reduce the Number of Transactions (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Dealing with channel intermediaries frees producers from many of the details of distribution activity. Producers are traditionally not as efficient or as enthusiastic about selling products directly to end users as are channel members. First, producers may wish to focus on production. They may feel that they cannot both produce and distribute in a competitive way. On the other hand, manufacturers are eager to deal directly with giant retailers, such as Walmart, which offer huge sales opportunities to producers.

Channels Ease the Flow of Goods

Channels make distribution easier in several ways. The first is by *sorting*, which consists of the following:

- *Sorting out:* Breaking many different items into separate stocks that are similar. Eggs, for instance, are sorted by grade and size. Another example would be different lines of women's dresses—designer, moderate, and economy lines.
- *Accumulating:* Bringing similar stocks together into a larger quantity. Twelve large Grade A eggs could be placed in some cartons and 12 medium Grade B eggs in other cartons. Another example would be to merge several lines of women's dresses from different designers together.
- *Allocating:* Breaking similar products into smaller and smaller lots (allocating at the wholesale level is called **breaking bulk**.) For instance, a tank-car load of milk could be broken down into gallon jugs. The process of allocating generally is done when the goods are dispersed by region and as ownership of the goods changes.

Without the sorting, accumulating, and allocating processes, our modern consumer society would not exist. Instead, there would be home-based industries providing custom or semicustom products to local markets. In short, society would return to a much lower level of consumption.

A second way channels ease the flow of goods is by locating buyers for merchandise. A wholesaler must find the right retailers to sell a profitable volume of merchandise. A sporting-goods wholesaler, for instance, must find the retailers who are most likely to reach sporting-goods consumers. Retailers have to understand the buying habits of consumers and put stores where consumers want and expect to find the merchandise. Every member of a distribution channel must locate buyers for the products it is trying to sell.

Channel members also store merchandise so that goods are available when consumers want to buy them. The high cost of retail space often means many goods are stored by the wholesaler or manufacturer.

? Practice Question

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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 promotional strategy.

Successful organizations develop effective, respectful partnerships between the marketing and supply chain teams. When the supply chain team understands 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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29.19: Introduction to 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.

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29.20: Customer Value and Price

Learning Objectives

- Explain pricing from the customer’s viewpoint

Figure 29.20.1: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—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 price tag, 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.

? Practice Question

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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.

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29.21: Pricing Objectives

Learning Objectives

- Describe the objectives businesses hope to achieve with product pricing

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.

Practice Question

https://assessments.lumenlearning.co...essments/14507

1. Jordan. "Nike Price Hikes Drive U.S. Sneaker Growth." Footwear News. July 14, 2014. Accessed June 25, 2019. http://footwearnews.com/2014/business/news/nike-price-hikes-drive-u-s-sneaker-growth-144128/. ↵
2. Trefis Team, and Great Speculations. "Airlines' Stocks Drop As Fear Of Price War Clouds The Industry." Forbes. June 11, 2015. Accessed June 25, 2019. http://www.forbes.com/sites/greatspeculations/2015/06/11/airlines-stocks-drop-as-fear-of-price-war-clouds-the-industry/. ↵

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29.22: Cost-Plus Pricing Method

Learning Objectives

- Explain the 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

Markup is the calculation of the difference between the cost and selling price of 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, if a man's tie costs $14.50 and is sold for $30 in a Department store, the dollar markup would be $15.50 ($30.00 − $14.50 = $15.50). Markup is most commonly expressed as a percent of the selling price of the merchandise. In this example, the markup of the neckwear is 51.7% ($30.00 − $14.50 / $30.00). A can of soup in a supermarket may cost $.79 and retail for $1.00 which would be a markup of 21% (gross margins of supermarkets is significantly lower than that of department stores).

Given a specific gross margin, you can easily calculate the retail price of a product by dividing the cost of a product by 1 minus the gross margin. For example, if you have a 45% gross margin on a product that costs $20 to produce, it would have a retail price of $36.50:

100% − 45% = 55% or .55

$20.00/.55 = $36.50

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 in 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 may be disappointed if their customers do not see sufficient value in the cost-based price.

PRactice Question

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29.23: Discounting Strategies

Learning Objectives

- Explain the methods businesses use for discounts and allowances

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. In a B2B environment, 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.[1]

B2C examples of quantity discounts are everywhere: "two-fors" (buy one for $2.00 or buy two for $3.00), "BOGO" (Buy One Get One free), etc. There are as many quantity discount deals as there are products to price.

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 B2B 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.

> **? Practice Question**
>
> https://assessments.lumenlearning.co...essments/14509

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1. Home Depot. "Pro Loyalty Program." Pro Xtra. Accessed June 25, 2019. http://www.homedepot.com/c/Pro_Xtra. ↵

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29.24: Putting It Together- Marketing Mix

Synthesis

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

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

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

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

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

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

Summary

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

Product Marketing

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

Pricing Strategies

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

Place: Distribution Channels

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

Promotion: Integrated Marketing Communication (IMC)

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

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1. Coca-Cola. "Homepage." Official Coca-Cola® US Website. Accessed June 25, 2019. https://us.coca-cola.com/. ↵
2. Ibid. ↵
3. Ibid. ↵
4. SEC Filings, 2015 ↵

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29.25: Discussion- Marketing Mix

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

For this discussion you will need to select a product, good, or service that you purchase on a regular basis. This could be anything from your morning coffee to the make of your car to your favorite chain restaurant. Conduct some formal research on the marketing strategy of the company or brand before you start your posts.

For Discussion

- Name of product and company: Use the proper corporate name, not a nickname. For example: Tide Pods by Proctor & Gamble. Include pictures if you're handy with uploading/inserting images.
- Product description: Briefly describe the product you've selected along with any relevant history that led you to choose this product/brand.
- Describe the key marketing strategies of your selected product. You should base your evaluation and report on what you can observe about how the four Ps are applied to the product you chose.
  - **Product**: Describe the want or need your product addresses.
  - **Placement**: Describe the physical location of the product among its closest competitors (a quick picture of the shelf would tell a good story!), and describe what this placement says about the marketing strategy.
  - **Pricing**: Describe the pricing strategy. A good description would include observations about the closest competitive product and its relative pricing.
  - **Promotion**: Describe how the product is being promoted. You could include any obvious physical/in-store promotions seen on the shelf, as well as flyers, coupons, social media, online advertising, etc.
  - **Other factors**: You might notice other important factors about your product that lie outside the four Ps. You can include them in your report here. One example might be a unique distribution system for your product.

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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29.26: Discussion- The Four Ps of the Competition

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz Background."

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda is relaxing after a long day of treat baking and turns on her tablet to check Facebook and see what all of her friends have been doing while she has been baking Chicken Cuties. While she is scrolling along, an ad pops up on the side of her page for "Woofables"—The Gourmet Dog Bakery. Wanda is stunned and immediately picks up her phone and starts texting you. Her first text is, "How dare they advertise their dog treats to me?" and the texts go downhill from there. Clearly, Wanda has not done much research regarding how her competition is marketing their products.

For Discussion

1. Search the Internet for products that are similar to those sold by Salty Pawz. Google terms like *gourmet dog treats*, *healthy dog biscuits*, or *gourmet pet treats*.
2. Select a product that has a Web site associated with it to get sufficient information about the product for your posting. Put yourself in Wanda's place as though she were researching the competition.
3. Evaluate the product you select based on the four Ps of marketing. How is the company using each of the four Ps to market their line of dog treats?
4. In your initial post you should include the following:
    1. Name of the product, name of the company, and the URL for the Web site
    2. How the company is using EACH of the four Ps to market their line of gourmet dog treats
5. What, if anything, can Wanda learn from your research that she can apply to Salty Pawz?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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29.27: Assignment- The Four Ps of Gourmet Dog Treats

Scenario

Wanda has been very fortunate to have so much success selling her treats through her Web site, Etsy, and by word of mouth. However, if she intends to expand the business and take on the additional expenses and responsibilities this entails, Wanda will need a marketing plan to support the success and profitability of Salty Pawz. In order to create this plan, Wanda needs to examine what she is *currently* doing.

When you talk to her about the marketing she is doing now, she talks a lot about advertising, but you know that marketing involves a great deal more than just advertising. You ask her how she is applying the four Ps of marketing to her product, and she just shrugs. Once again, you find yourself walking away, shaking your head, and planning what you will prepare for Wanda to explain this facet of her business.

Your Task

- Evaluate how Wanda is *currently* applying each of the four Ps of marketing to the products Salty Pawz sells. Capture this in your written document so that Wanda can refer back to it as she begins to draft a marketing plan.
- Once you have evaluated how Wanda is *currently* applying the four Ps to the products Salty Pawz sells, identify at least one *new* way that each of the four Ps could be improved. When making your recommendations, be as specific as possible so that she can execute some of your ideas immediately.

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain the *product* element of the four Ps of marketing as it relates to Salty Pawz.	0 points	5.5 points	8 points	10 points	10%
Explain the *place* element of the four Ps of marketing as it relates to Salty Pawz.	0 points	5.5 points	8 points	10 points	10%
Explain the *price* element of the four Ps of marketing as it relates to Salty Pawz.	0 points	5.5 points	8 points	10 points	10%
Explain the *promotion* element of the four Ps of marketing as it relates to Salty Pawz.	0 points	5.5 points	8 points	10 points	10%

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Recommend marketing strategies for the *product* element of the four Ps of marketing as it relates to Salty Pawz. Plan is well-supported and plausible.	0 points	5.5 points	8 points	10 points	10%
Recommend marketing strategies for the *place* element of the four Ps of marketing as it relates to Salty Pawz. Plan is well-supported and plausible.	0 points	5.5 points	8 points	10 points	10%
Recommend marketing strategies for the *price* element of the four Ps of marketing as it relates to Salty Pawz. Plan is well-supported and plausible.	0 points	5.5 points	8 points	10 points	10%
Recommend marketing strategies for the *promotion* element of the four Ps of marketing as it relates to Salty Pawz. Plan is well-supported and plausible.	0 points	5.5 points	8 points	10 points	10%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100.

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29.28: Assignment- I Can See the Four Ps of Marketing

Preparation

For this assignment you will write a product report focused on a single product of your choice. Your submission will follow the formatting and address the questions/issues specified in the Product Report Outline.

Go to the store where your product is sold. This can be your local grocery store, Walmart, Target, or wherever your product is sold and displayed alongside competing brands and products. When selecting your product or good, keep in mind that in this assignment you will be analyzing the product based on the four Ps of marketing.

Your Task

Gather the information necessary to complete your Product Report. Among the information you will need to collect is the following:

- Name of product and company: Use the proper corporate name, not a nickname. For example: Tide Pods by Proctor & Gamble. Include pictures if you're handy with uploading/inserting images.
- Product description: Briefly describe the product you've selected along with any relevant history that led you to choose this product/brand.
- Describe the key marketing strategies behind your selected product. You should base your evaluation and report on what you can observe about how the four Ps are applied to the product you chose.
  - **Product**: Describe the want or need your product addresses.
  - **Placement**: Describe the physical location of the product among its closest competitors (a quick picture of the shelf would tell a good story!), and describe what this placement says about the marketing strategy.
  - **Pricing**: Describe the pricing strategy. A good description would include observations about the closest competitive product and its relative pricing.
  - **Promotion**: Describe how the product is being promoted. You could include any obvious physical/in-store promotions seen on the shelf, as well as flyers, coupons, social media, online advertising, etc.
  - **Other factors**: You might notice other important factors about your product that lie outside the four Ps. You can include them in your report here. One example might be a unique distribution system for your product.

When putting together your assignment for submission, it should follow the format and organization shown in the Product Report Outline provided below.

Product Report Outline

Your Name

Introduction to Business Marketing Report

Date

TITLE

Company/Product Name Here

Name of product and company: Use the proper corporate name, not a nickname. For example: Tide Pods by Proctor & Gamble. Include pictures if you're handy with uploading/inserting images.

Introduction

Briefly describe the product you've selected along with any relevant history that led you to choose this product/brand. Minimum of three, maximum of five sentences.

Four Ps of Marketing

Describe the key marketing strategies of your selected product. You should base your evaluation and report on what you can observe about how the four Ps are applied to the product you chose. You should write a minimum of three sentences about each aspect.

- **Product**: Describe the want or need your product addresses.

- **Placement**: Describe the physical location of the product among its closest competitors (a quick picture of the shelf would tell a good story!), and describe what this placement says about the marketing strategy.
- **Pricing**: Describe the pricing strategy. A good description would include observations about the closest competitive product and its relative pricing.
- **Promotion**: Describe how the product is being promoted. You could include any obvious physical/in-store promotions seen on the shelf, as well as flyers, coupons, social media, online advertising, etc.
- **Other factors**: You might notice other important factors about your product that lie outside the four Ps. You can include them in your report here. One example might be a unique distribution system for your product.

Conclusion and Recommendation

In this section you should draw a conclusion about the proven or possible success of your selected product. How has the company used the four marketing Ps to try to ensure the success of your selected product? This should be a minimum of three, maximum of five sentences.

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CHAPTER OVERVIEW

30: Module 14 Readings - Financial Markets and System

30.1: Reading- The Functions of Money

The Functions of Money

So our first question is, what is money? If you happen to have one on you, take a look at a $5 bill. What you'll see is a piece of paper with a picture of Abraham Lincoln on one side and the Lincoln Memorial on the other. Though this piece of paper—indeed, money itself—has no intrinsic value, it's certainly in demand. Why? Because money serves three basic functions. Money is the following:

1. A medium of exchange
2. A measure of value
3. A store of value

To get a better idea of the role of money in a modern economy, let's imagine a system in which there is no money. In this system, goods and services are ***bartered***—traded directly for one another. Now, if you're living and trading under such a system, for each barter exchange that you make, you'll have to have something that another trader wants. For example, say you're a farmer who needs help clearing his fields. Because you have plenty of food, you might enter into a barter transaction with a laborer who has time to clear fields but not enough food: he'll clear your fields in return for three square meals a day.

This system will work as long as two people have exchangeable assets, but needless to say, it can be inefficient. If we identify the functions of money, we'll see how it improves the exchange for all the parties in our hypothetical set of transactions.

Medium of Exchange

Money serves as a medium of exchange because people will accept it in exchange for goods and services. Because people can use money to buy the goods and services that they want, everyone's willing to trade something for money. The laborer will take money for clearing your fields because he can use it to buy food. You'll take money as payment for his food because you can use it not only to pay him but also to buy something else you need (perhaps seeds for planting crops).

For money to be used in this way, it must possess a few crucial properties:

1. It must be *divisible*—easily divided into usable quantities or fractions. A $5 bill, for example, is equal to five $1 bills. If something costs $3, you don't have to rip up a $5 bill; you can pay with three $1 bills.
2. It must be *portable*—easy to carry; it can't be too heavy or bulky.
3. It must be *durable*. It must be strong enough to resist tearing and the print can't wash off if it winds up in the washing machine.
4. It must be *difficult to counterfeit*; it won't have much value if people can make their own.

Measure of Value

Money simplifies exchanges because it serves as a measure of value. We state the price of a good or service in monetary units so that potential exchange partners know exactly how much value we want in return for it. This practice is a lot better than bartering because it's much more precise than an ad hoc agreement that a day's work in the field has the same value as three meals.

Store of Value

Money serves as a store of value. Because people are confident that money keeps its value over time, they're willing to save it for future exchanges. Under a bartering arrangement, the laborer earned three meals a day in exchange for his work. But what if, on a given day, he skipped a meal? Could he "save" that meal for another day? Maybe, but if he were paid in money, he could decide whether to spend it on food each day or save some of it for the future. If he wanted to collect on his "unpaid" meal two or three days later, the farmer might not be able to "pay" it; unlike money, food could go bad.

The Money Supply

Now that we know what money does, let's tackle another question: How much money is there? How would you go about "counting" all the money held by individuals, businesses, and government agencies in this country? You could start by counting the money that's held to pay for things on a daily basis. This category includes *cash* (paper bills and coins) and funds held in demand deposits—checking accounts, which pay given sums to "payees" when they demand them.

Then, you might count the money that's being "saved" for future use. This category includes *interest-bearing accounts*, *time deposits* (such as *certificates of deposit*, which pay interest after a designated period of time), and money market mutual funds, which pay interest to investors who pool funds to make short-term loans to businesses and the government.

M-1 and M-2

Counting all this money would be a daunting task (in fact, it would be impossible). Fortunately, there's an easier way—namely, by examining two measures that the government compiles for the purpose of tracking the money supply: M-1 and M-2.

- The narrowest measure, M-1, includes the most *liquid* forms of money—the forms, such as cash and checking-accounts funds, that are spent immediately.
- M-2 includes everything in M-1 plus *near-cash items* invested for the short term—savings accounts, time deposits below $100,000, and money market mutual funds.

So what's the bottom line? How much money *is* out there? To find the answer, you can go to the Federal Reserve Board Web site. The Federal Reserve reports that in September 2011, M-1 was about $2.1 trillion and M-2 was $9.6 trillion. Figure 1, "The U.S. Money Supply, 1980–2010," shows the increase in the two money-supply measures since 1980.

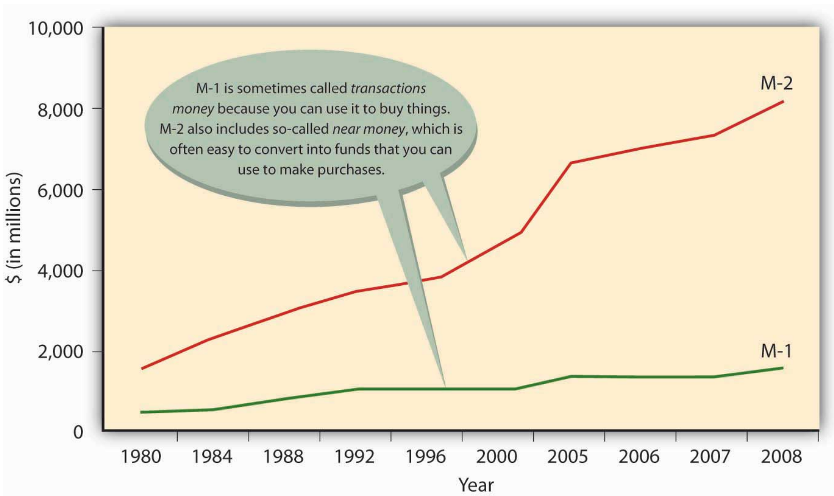

Figure 30.1.1: The U.S. Money Supply, 1980–2010

If you're thinking that these numbers are too big to make much sense, you're not alone. One way to bring them into perspective is to figure out how much money *you'd* get if all the money in the United States were redistributed equally. According to the U.S. Census Population Clock, there are more than three hundred million people in the United States. Your share of M-1, therefore, would be about $6,700 and your share of M-2 would be about $31,000.

What, Exactly, Is "Plastic Money"?

Are credit cards a form of money? If not, why do we call them plastic money? Actually, when you buy something with a credit card, you're not spending money. The principle of the credit card is buy-now-pay-later. In other words, when you use plastic, you're taking out a loan that you intend to pay off when you get your bill. And the loan itself is not money. Why not? Basically because the credit card company can't use the asset to buy anything. The loan is merely a promise of repayment. The asset doesn't become money until the bill is paid (with interest). That's why credit cards aren't included in the calculation of M-1 and M-2.

KEY TAKEAWAYS

- Money serves three basic functions:
  - *Medium of exchange*: because you can use it to buy the goods and services you want, everyone's willing to trade things for money.
  - *Measure of value*: it simplifies the exchange process because it's a means of indicating how much something costs.
  - *Store of value*: people are willing to hold onto it because they're confident that it will keep its value over time.
- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.

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30.2: Reading- The Federal Reserve System

What Is the Federal Reserve System?

The Federal Reserve System was established by Congress nearly a century ago to serve as the U.S. central bank. President Woodrow Wilson signed the Federal Reserve Act into law on December 23, 1913. Prior to the creation of the Fed, the U.S. economy was plagued by frequent episodes of panic, bank failures, and credit scarcity. The history of the Federal Reserve is bound up in the effort to build a more stable and secure financial system.

The American colonists were limited to using European coinage, barter, and commodity money as their primary means of exchange before independence from British rule. Troubled by foreign coin shortages and the inefficiencies of barter and commodity money, many colonies began minting coins and issuing paper currency by the end of the 17th century. This was ineffective. People lacked faith in colonial currency and the authority of the colonies to issue money was periodically interrupted by their British rulers.

Colonial banks were not like modern banks. They did not take deposits from the public or make loans. Instead, they issued paper currency backed by land or precious metals such as gold. Merchants and other individuals were the primary sources of credit.

The origins of central banking in the United States began with the ratification of the Constitution in 1789. Secretary of the Treasury Alexander Hamilton developed a plan for a federal banking system to solve the nation's credit problems after the War of Independence. This was controversial. Hamilton's plan, backed by commercial and financial interests centered in the northeastern states, called for the creation of a federal bank to provide credit to government and businesses, and to establish a national currency. The federal bank would act as the government's fiscal agent and provide a safe place to store government funds.

Secretary of State Thomas Jefferson led the opposition to Hamilton's plan. Jefferson represented the country's agrarian interests, which looked with suspicion at a central government bank and generally favored state over federal powers. He argued that the Constitution did not expressly authorize the federal government to charter a national bank or issue paper currency.

Hamilton, supported by the Federalist Party, won the debate. The First Bank of the United States was chartered in 1791. A bill to re-charter the bank failed in 1811. Without a centralized banking and credit structure, state banks filled the vacuum, issuing a multitude of paper currencies of questionable value. Congress attempted to solve the country's financial problems by chartering the Second Bank of the United States in 1816. This second bank lasted until President Andrew Jackson declared it unconstitutional and vetoed its re-charter in 1836.

A period known as the Free Banking Era followed the demise of the Second Bank of the United States. Over the next quarter century, U.S. banking was a hodgepodge of state-chartered banks not subject to federal regulation. By 1860, nearly 8,000 state banks operated, each issuing its own paper notes. Some of the more marginal institutions were known as "wildcat banks" supposedly because they maintained offices in remote areas ("where the wildcats are") in order to make it difficult for customers to redeem their notes for precious metals.

The need for reliable financing during the Civil War prompted the passage of the National Banking Act in 1863. The legislation created a uniform national currency and permitted only nationally chartered banks to issue bank notes, but did not create a strong central banking structure.

As the industrial economy expanded, the weaknesses of the nation's decentralized banking system became more acute. Bank panics or "runs" occurred frequently. Many banks did not keep enough cash on hand to meet unusually heavy demand. Panics and runs often occurred when customers lost confidence in their banks after hearing news of failures of other banks. Fearful customers would rush to their banks to withdraw money, which often could not meet the sudden demand for cash. That sometimes created a contagion that triggered a succession of bank failures. A particularly severe panic took place in 1907 that abated only when a private individual, the financier J.P. Morgan, personally intervened to arrange emergency loans for financial institutions. This episode fueled a reform movement, which prompted Congress to establish the Federal Reserve System in 1913.

Since the creation of the Federal Reserve, other pieces of legislation have shaped the structure and operation of the nation's central bank. Following the Great Depression, Congress passed the Banking Act of 1935, which established the Federal Open Market Committee (FOMC) as the Fed's monetary policymaking body. The Federal Reserve Reform Act of 1977 was enacted during a period of surging inflation. It explicitly set price stability as a national policy goal for the first time. The Full Employment and Balanced Growth Act, approved in 1978 and known informally as the Humphrey–Hawkins Act, established full employment as a second goal of monetary policy and required the Fed to report to Congress on its policy twice a year. Most recently, following the severe financial crisis of 2007-08, Congress passed the Wall Street Reform and Consumer Protection Act of 2010. The law, known as the Dodd-Frank Act, affects the Fed in many ways. It changes the Fed's governance, increases its transparency, expands its regulatory responsibilities, and transfers most Fed consumer protection responsibilities to a new Consumer Financial Protection Bureau.

The Tools of the Fed

Now that we understand some of the history of the Federal Reserve, The Fed seeks to stabilize prices by regulating the money supply and interest rates. In turn, stable prices promote economic growth and full employment—at least in theory. To conduct monetary policy, the Fed relies on three tools: *reserve requirements*, the *discount rate*, and *open market operations*. Remember, these tools are used to help the Fed achieve three major goals:

1. Price stability
2. Sustainable economic growth
3. Full employment

Reserve Requirements

Under what circumstances would the Fed want to change the reserve requirement for banks? The purpose of controlling the money supply is primarily to lessen the threat of *inflation* (a rise in the overall price level) or *recession* (an economic slowdown gauged by a decline in gross domestic product). Here's how it works (again, in theory). If the Fed *raises* the reserve requirement (for example, from 10 percent to 11 percent), banks must set aside more money. Consequently, they have *less to lend* and so raise their interest rates. Under these conditions, it's harder and more expensive for people to borrow money, and if they can't borrow as much, they can't spend as much, and if people don't spend as much, prices don't go up. Thus, the Fed has lessened the likelihood of inflation.

Conversely, when the Fed *lowers* the reserve requirement (for example, from 10 percent to 9 percent), banks need to set aside less money. Because they have *more money to lend*, they keep interest rates down. Borrowers find it easier and cheaper to get money for buying things, and the more consumers buy, the higher prices go. In this case, the Fed has reduced the likelihood of a recession.

A 1 percent change in the reserve requirement, whether up to 11 percent or down to 9 percent, may not seem like much, but remember our earlier discussion of the *money multiplier*: because of the money-multiplier effect, a small change in the reserve requirement has a dramatic effect on the money supply. (For the same reason, the Fed changes reserve requirements only rarely.)

The Discount Rate

To understand how the Fed uses the discount rate to control the money supply, let's return to our earlier discussion of reserves. Recall that banks must keep a certain fraction of their deposits as reserves. The bank can hold these reserve funds or deposit them into a Federal Reserve Bank account. Recall, too, that the bank can lend out any funds that it doesn't have to put on reserve. What happens if a bank's reserves fall below the required level? The Fed steps in, permitting the bank to "borrow" reserve funds from the Federal Reserve Bank and add them to its reserve account at the Bank. There's a catch: the bank must pay interest on the borrowed money. The rate of interest that the Fed charges member banks is called the discount rate. By manipulating this rate, the Fed can make it appealing or unappealing to borrow funds. If the rate is high enough, banks will be reluctant to borrow. Because they don't want to drain their reserves, they cut back on lending. The money supply, therefore, decreases. By contrast, when the discount rate is low, banks are more willing to borrow because they're less concerned about draining their reserves. Holding fewer excess reserves, they lend out a higher percentage of their funds, thereby increasing the money supply.

Even more important is the carryover effect of a change in the discount rate to the overall level of interest rates.Robert Heilbroner and Lester Thurow, *Economics Explained* (New York: Simon & Schuster, 1998), 134. When the Fed adjusts the discount rate, it's telling the financial community where it thinks the economy is headed—up or down. Wall Street, for example, generally reacts unfavorably to an increase in the discount rate. Why? Because the increase means that interest rates will probably rise, making future borrowing more expensive.

Open Market Operations

The Fed's main tool for controlling the money supply and influencing interest rates is called open market operations: the sale and purchase of U.S. government bonds by the Fed in the open market. To understand how this process works, we first need to know a few facts:

- The Fed's assets include a substantial dollar amount of government bonds.
- The Fed can buy or sell these bonds on the open market (consisting primarily of commercial banks).

- Because member banks use cash to buy these bonds, they decrease their reserve balances when they buy them.
- Because member banks receive cash from the sale of the bonds, they increase their reserve balances when they sell them.
- Banks must maintain a specified balance in reserves; if they dip below this balance, they have to make up the difference by borrowing money.

If the Fed wants to decrease the money supply, it can *sell* bonds, thereby reducing the reserves of the member banks that buy them. Because these banks would then have less money to lend, the money supply would decrease. If the Fed wants to increase the money supply, it will *buy* bonds, increasing the reserves of the banks that sell them. The money supply would increase because these banks would then have more money to lend.

The Federal Funds Rate

In conducting open market operations, the Fed is trying to do the same thing that it does in using its other tools—namely, to influence the money supply and, thereby, interest rates. But it also has something else in mind. To understand what that is, you need to know a few more things about banking. When a bank's reserve falls below its required level, it may, as we've seen, borrow from the Fed (at the discount rate). But it can also borrow from other member banks that have excess reserves. The rate that banks pay when they borrow through this channel is called the federal funds rate.

How does the federal funds rate affect the money supply? As we've seen, when the Fed sells bonds in the open market, the reserve balances of many member banks go down. To get their reserves back to the required level, they must borrow, whether from the Fed or from other member banks. When Bank 1 borrows from Bank 2, Bank 2's supply of funds goes down; thus, it increases the interest rate that it charges. In short, the increased demand for funds drives up the federal funds rate.

All this interbank borrowing affects you, the average citizen and consumer. When the federal funds rate goes up, banks must pay more for their money, and they'll pass the cost along to their customers: banks all over the country will raise the interest rates charged on mortgages, car loans, and personal loans. Figure 1, "Key Interest Rates, 2002–2011," charts ten-year fluctuations in the discount rate, federal funds rate, and prime rate—the rate that banks charge their best customers. Because all three rates tend to move in the same direction, borrowers—individuals, as well as organizations—generally pay more to borrow money when banks have to pay more and less when banks have to pay less. Notice that the prime rate (which banks charge their customers) is higher than both the federal funds and discount rates (which banks must pay when they need to borrow). That's why banks make profits when they make loans. Note, too, that the Fed lowered the discount rate and federal funds rate drastically in 2008 in an attempt to stimulate a weakening economy. Despite continued low rates through 2011, the economy is still very weak. The U.S. Mone

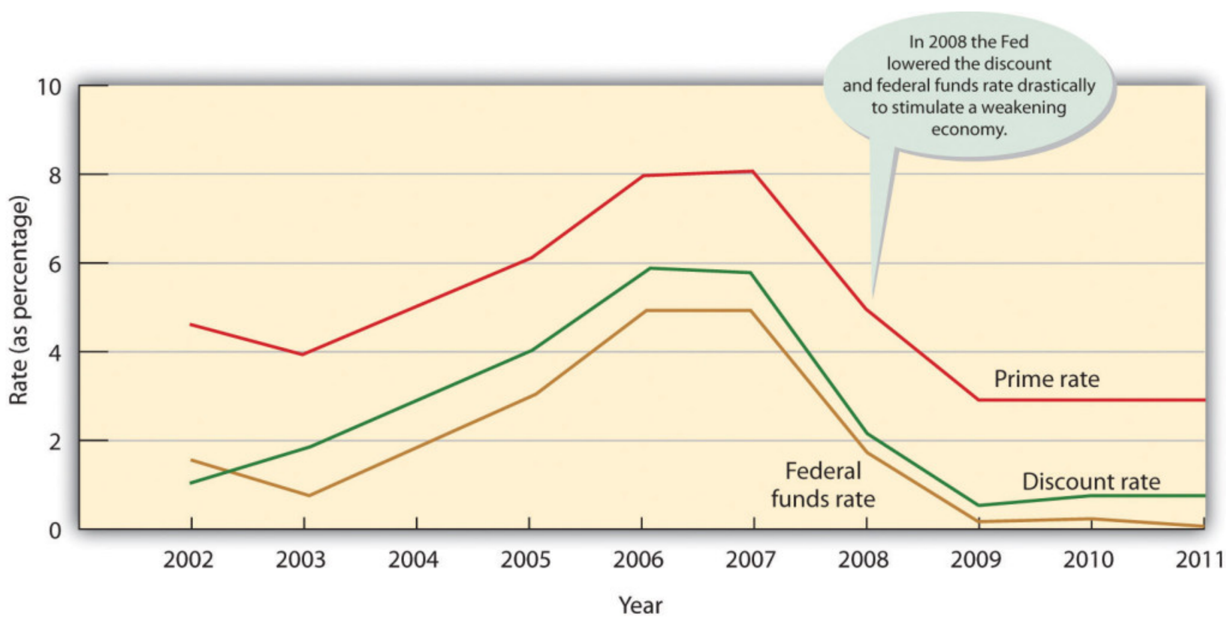

Figure 30.2.1: Key Interest Rates, 2002–2011

The Banker's Bank and the Government's Banker

The Fed performs another important function: it serves its member banks in much the same way as your bank serves you. When you get a check, you deposit it in your checking account, thereby increasing your balance. When you pay someone by check, the dollar amount of the check is charged to your account, and your balance goes down. The Fed works in much the same way, except that its customers are member banks. Just as your bank clears your check, the Fed clears the checks that pass through its member banks. The monumental task of clearing more than fifteen billion checks a year is complicated by the fact that there are twelve district banks. If someone in one district (for example, Boston) writes a check to a payee in another district (say, San Francisco), the check must be processed through both districts.

Prior to 2004, clearing checks took days because the checks themselves needed to be physically moved through the system. But thanks to the passage of Check 21 (a U.S. federal law), things now move much more quickly. Instead of physically transporting checks, banks are allowed to make an image of the front and back of a check and send the digital version of the original check, called a "substitute" check, through the system electronically. The good news is that Check 21 shortened the time it takes to clear a check, often down to one day. The bad news is that Check 21 shortened the time it takes to clear a check, which increases the risk that a check you write will bounce. So be careful: don't write a check unless you have money in the bank to cover it.

In performing the following functions, the Fed is also the U.S. government's banker:

- Holding the U.S. Treasury's checking account
- Processing the paperwork involved in buying and selling government securities
- Collecting federal tax payments
- Lending money to the government by purchasing government bonds from the Treasury

The Fed also prints, stores, and distributes currency and destroys it when it's damaged or worn out. Finally, the Fed, in conjunction with other governmental agencies, supervises and regulates financial institutions to ensure that they operate soundly and treat customers fairly and equitably.

KEY TAKEAWAYS

- Most large banks are members of the central banking system called the **Federal Reserve System** (commonly known as "the Fed").
- The Fed's goals include price stability, sustainable economic growth, and full employment. It uses *monetary policy* to regulate the money supply and the level of interest rates.
- To achieve these goals, the Fed has three tools:
  1. it can raise or lower **reserve requirements**—the percentage of its funds that banks must set aside and can't lend out;
  2. it can raise or lower the **discount rate**—the rate of interest that the Fed charges member banks to borrow "reserve" funds;
  3. it can conduct **open market operations**—buying or selling government securities on the open market.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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30.3: Reading- Financial Institutions

Financial Institutions

For financial transactions to happen, money must change hands. How do such exchanges occur? At any given point in time, some individuals, businesses, and government agencies have more money than they need for current activities; some have less than they need. Thus, we need a mechanism to match up savers (those with surplus money that they're willing to lend out) with borrowers (those with deficits who want to borrow money). We could just let borrowers search out savers and negotiate loans, but the system would be both inefficient and risky. Even if you had a few extra dollars, would you lend money to a total stranger? If you needed money, would you want to walk around town looking for someone with a little to spare?

Depository and Nondepository Institutions

Now you know why we have financial institutions: they act as intermediaries between savers and borrowers and they direct the flow of funds between them. With funds deposited by savers in checking, savings, and money market accounts, they make loans to individual and commercial borrowers. In the next section, we will discuss the most common types of depository institutions (banks that accept deposits), including *commercial banks*, *savings banks*, and *credit unions*. We'll also discuss several nondepository institutions (which provide financial services but don't accept deposits), including finance companies, insurance companies, brokerage firms, and pension funds.

Commercial Banks

Commercial banks are the most common financial institutions in the United States, with total financial assets of about $13.5 trillion (85 percent of the total assets of the banking institutions). They generate profit not only by charging borrowers higher interest rates than they pay to savers but also by providing such services as check processing, trust- and retirement-account management, and electronic banking. The country's 7,000 commercial banks range in size from very large (Bank of America, J.P. Morgan Chase) to very small (local community banks). Because of mergers and financial problems, the number of banks has declined significantly in recent years, but, by the same token, surviving banks have grown quite large. If you've been with one bank over the past ten years or so, you've probably seen the name change at least once or twice.

Savings Banks

Savings banks (also called *thrift institutions* and *savings and loan associations*, or *S&Ls*) were originally set up to encourage personal saving and provide mortgages to local home buyers. Today, however, they provide a range of services similar to those offered by commercial banks. Though not as dominant as commercial banks, they're an important component of the industry, holding total financial assets of almost $1.5 trillion (10 percent of the total assets of the banking institutions). The largest S&L, Sovereign Bancorp, has close to 750 branches in nine Northeastern states. Savings banks can be owned by their depositors (mutual ownership) or by shareholders (stock ownership).

Credit Unions

To bank at a credit union, you must be linked to a particular group, such as employees of United Airlines, employees of the state of North Carolina, teachers in Pasadena, California, or current and former members of the U.S. Navy. Credit unions are owned by their members, who receive shares of their profits. They offer almost anything that a commercial bank or savings and loan does, including savings accounts, checking accounts, home and car loans, credit cards, and even some commercial loans. Collectively, they hold about $812 billion in financial assets (around 5 percent of the total assets of the financial institutions).

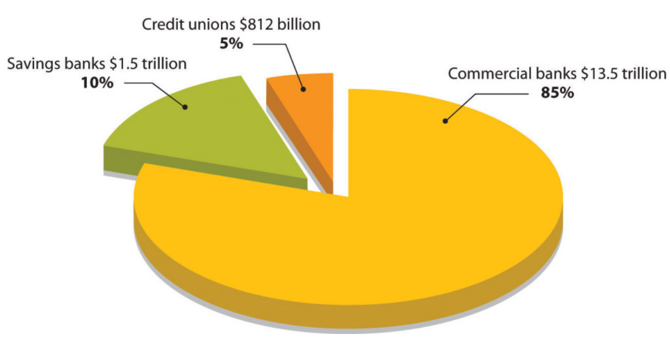

Figure 30.3.1: Where Our Money Is Deposited

Finance Companies

Finance companies are nondeposit institutions because they do not accept deposits from individuals or provide traditional banking services, such as checking accounts. They do, however, make loans to individuals and businesses, using funds acquired by selling securities or borrowed from commercial banks. They hold about $1.9 trillion in assets. Those that lend money to businesses, such as General Electric Capital Corporation, are *commercial finance companies*, and those that make loans to individuals or issue credit cards, such a Citgroup, are *consumer finance companies*. Some, such as General Motors Acceptance Corporation, provide loans to both consumers (car buyers) and businesses (GM dealers).

Insurance Companies

Insurance companies sell protection against losses incurred by illness, disability, death, and property damage. To finance claims payments, they collect premiums from policyholders, which they invest in stocks, bonds, and other assets. They also use a portion of their funds to make loans to individuals, businesses, and government agencies.

Brokerage Firms

Companies like A.G. Edwards & Sons and T. Rowe Price, which buy and sell stocks, bonds, and other investments for clients, are brokerage firms (also called *securities investment dealers*). A mutual fund invests money from a pool of investors in stocks, bonds, and other securities. Investors become part owners of the fund. Mutual funds reduce risk by diversifying investment: because assets are invested in dozens of companies in a variety of industries, poor performance by some firms is usually offset by good performance by others. Mutual funds may be stock funds, bond funds, and money market funds, which invest in safe, highly liquid securities. (Liquidity is the speed with which an asset can be converted to cash.)

Finally, pension funds, which manage contributions made by participating employees and employers and provide members with retirement income, are also nondeposit institutions.

Financial Services

You can appreciate the diversity of the services offered by commercial banks, savings banks, and credit unions by visiting their Web sites. For example, Wells Fargo promotes services to four categories of customers: individuals, small businesses, corporate and institutional clients, and affluent clients seeking "wealth management." In addition to traditional checking and savings accounts, the bank offers automated teller machine (ATM) services, credit cards, and debit cards. It lends money for homes, cars, college, and other personal and business needs. It provides financial advice and sells securities and other financial products, including individual retirement account (IRA), by which investors can save money that's tax free until they retire. Wells Fargo even offers life, auto, disability, and homeowners insurance. It also provides electronic banking for customers who want to check balances, transfer funds, and pay bills online.

Bank Regulation

How would you react if you put your life savings in a bank and then, when you went to withdraw it, learned that the bank had failed—that your money no longer existed? This is exactly what happened to many people during the Great Depression. In response to the crisis, the federal government established the Federal Depository Insurance Corporation (FDIC) in 1933 to restore confidence in the banking system. The FDIC insures deposits in commercial banks and savings banks up to $250,000. So today if your bank failed, the government would give you back your money (up to $250,000). The money comes from fees charged member banks.

To decrease the likelihood of failure, various government agencies conduct periodic examinations to ensure that institutions are in compliance with regulations. Commercial banks are regulated by the FDIC, savings banks by the Office of Thrift Supervision, and credit unions by the National Credit Union Administration. As we'll see later in the chapter, the Federal Reserve System also has a strong influence on the banking industry.

How Banks Expand the Money Supply

When you deposit money, your bank doesn't set aside a special pile of cash with your name on it. It merely records the fact that you made a deposit and increases the balance in your account. Depending on the type of account, you can withdraw your share whenever you want, but until then, it's added to all the other money held by the bank. Because the bank can be pretty sure that all its depositors won't withdraw their money at the same time, it holds on to only a fraction of the money that it takes in—its *reserves*. It lends out the rest to individuals, businesses, and the government, earning interest income and expanding the money supply.

The Money Multiplier

Precisely how do banks expand the money supply? To find out, let's pretend you win $10,000 at the blackjack tables of your local casino. You put your winnings into your savings account immediately. The bank will keep a fraction of your $10,000 in reserve; to keep matters simple, we'll use 10 percent. The bank's reserves, therefore, will increase by $1,000 ($10,000 × 0.10). It will then lend out the remaining $9,000. The borrowers (or the parties to whom they pay it out) will then deposit the $9,000 in their own banks. Like your bank, these banks will hold onto 10 percent of the money ($900) and lend out the remainder ($8,100). Now let's go through the process one more time. The borrowers of the $8,100 (or, again, the parties to whom they pay it out) will put this amount into their banks, which will hold onto $810 and lend the remaining $7,290. As you can see in Figure 2, "The Effect of the Money Multiplier," total bank deposits would now be $27,100. Eventually, bank deposits would increase to $100,000, bank reserves to $10,000, and loans to $90,000. A shortcut for arriving at these numbers depends on the concept of the money multiplier, which is determined using the following formula:

$$\text{Money multiplier} = 1/\text{Reserve requirement}$$

In our example, the money multiplier is 1/0.10 = 10. So your initial deposit of $10,000 expands into total deposits of $100,000 ($10,000 × 10), additional loans of $90,000 ($9,000 × 10), and increased bank reserves of $10,000 ($1,000 × 10). In reality, the multiplier will actually be less than 10. Why? Because some of the money loaned out will be held as currency and won't make it back into the banks.

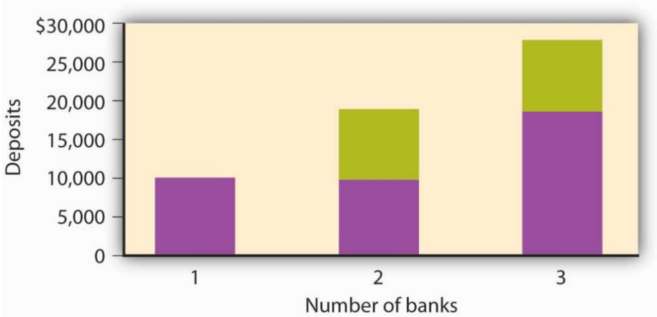

Figure 30.3.2: The Effect of the Money Multiplier

KEY TAKEAWAYS

- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Those that accept deposits from customers—depository institutions—include **commercial banks**, **savings banks**, and **credit unions**; those that don't—nondepository institutions—include **finance companies**, **insurance companies**, and **brokerage firms**.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
- A bank holds onto only a fraction of the money that it takes in—an amount called its **reserves**—and lends the rest out to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The **money multiplier** effect ensures that the cycle expands the money supply.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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30.4: Reading- Electronic Alternatives to Raw Cash- The Advent of Cashless Society

Electronic Alternatives to Raw Cash: The Advent of Cashless Society

Money makes the world go ’round, but not always as conveniently as you might wish. There is never enough cash in your wallet; the coins in your purse often weigh you down. Then, in the advanced countries, there is the pile of bank cards to squeeze in, and as if that weren’t enough, store cards just keep multiplying. But that is all set to change. A raft of new technologies is arriving to suck up that cash and dump it into a handy electronic device, liberating one’s pockets from crumpled notes, jangling change, and stacks of cards.

Implementation of electronic commerce based on e-cash as the main engine driving global economic activity will determine the future shape of society. These electronic alternatives are promising to bring about an explosion in the number of ways of paying for things and perhaps usher in currencies that work quite differently from dollars, pounds, yen, or euros. In the advanced industrialized countries and some developing economies people are already used to paying with credit or debit cards rather than checks or cash. But what if one wants to make a payment on the Internet that is as anonymous as cash? An international system being developed could do the trick. Other times one might buy goods with one’s frequent-flier miles. Or if you commute every day, you might use a payment card that will net you a discount on your next underground railway ride. You might even choose a payment system that is designed to benefit your community. And because it’s all computerized, the pain of managing all these accounts is handled automatically.

We will examine this trend further in the next sections of the module.

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30.7: Reading- Investments and Markets- A Brief Overview

Investments and Markets: A Brief Overview

Investing is primarily about using the capital markets to invest surplus cash for long-term growth of wealth.

The following video, “Electronic Trading,” will give you an idea of what trading stocks, bonds, mutual funds, and other investments looks like and how it impacts the financial wealth of the world economy.

What you saw in the video was an example of how “capital markets” work. The capital markets developed as a way for buyers to buy liquidity. In Western Europe, where many of our ideas of modern finance began, those early buyers were usually monarchs or members of the nobility, raising capital to finance armies and navies to conquer or defend territories or resources. Many devices and markets were used to raise capital, but the two primary methods that have evolved into modern times are the **bond** and **stock** markets. These bonds and stocks are traded on the exchanges mentioned earlier (NYSE, OTC, NASDAQ). So, what are stocks and bonds?

Bonds and Bond Markets

Bonds are **debt**. The bond issuer borrows by selling a bond, promising the buyer regular interest payments and then repayment of the principal at maturity. If a company wants to borrow, it could just go to one lender and borrow. But if the company wants to borrow a lot, it may be difficult to find any one investor with the capital and the inclination to make large a loan, taking a large risk on only one borrower. In this case the company may need to find a lot of lenders who will each lend a little money, and this is done through selling bonds.

A bond is a formal contract to repay borrowed money with interest (often referred to as the coupon) at fixed intervals. Corporations and (e.g., federal, state, municipal, and foreign) governments borrow by issuing bonds. The interest rate on the bond may be a fixed interest rate or a floating interest rate that changes as underlying interest rates—rates on debt of comparable companies—change. (Underlying interest rates include the prime rate that banks charge their most trustworthy borrowers and the target rates set by the Federal Reserve Bank.)

There are many features of bonds other than the principal and interest, such as the issue price (the price you pay to buy the bond when it is first issued) and the maturity date (when the issuer of the bond has to repay you). Bonds may also be “callable”: redeemable before maturity (paid off early). Bonds may also be issued with various covenants or conditions that the borrower must meet to protect the bondholders, the lenders. For example, the borrower, the bond issuer, may be required to keep a certain level of cash on hand, relative to its short-term debts, or may not be allowed to issue more debt until this bond is paid off.

Because of the diversity and flexibility of bond features, the bond markets are not as transparent as the stock markets; that is, the relationship between the bond and its price is harder to determine. The U.S. bond market is now more than twice the size (in dollars of capitalization) of all the U.S. stock exchanges combined, with debt of more than $27 trillion by the end of 2007. Financial Industry Regulatory Authority (FINRA), (accessed May 20, 2009).

U.S. Treasury bonds are auctioned regularly to banks and large institutional investors by the Treasury Department, but individuals can buy U.S. Treasury bonds directly from the U.S. government. To trade any other kind of bond, you have to go through a broker. The brokerage firm acts as a principal or dealer, buying from or selling to investors, or as an agent for another buyer or seller.

Stocks and Stock Markets

Stocks or equity securities are shares of **ownership**. When you buy a share of stock, you buy a share of the corporation. The size of your share of the corporation is proportional to the size of your stock holding. Since corporations exist to create profit for the owners, when you buy a share of the corporation, you buy a share of its future profits. You are literally sharing in the fortunes of the company.

Unlike bonds, however, shares do not promise you any returns at all. If the company does create a profit, some of that profit may be paid out to owners as a dividend, usually in cash but sometimes in additional shares of stock. The company may pay no dividend at all, however, in which case the value of your shares should rise as the company's profits rise. But even if the company is profitable, the value of its shares may not rise, for a variety of reasons having to do more with the markets or the larger economy than with the company itself. Likewise, when you invest in stocks, you share the company's losses, which may decrease the value of your shares.

Corporations issue shares to raise capital. When shares are issued and traded in a public market such as a stock exchange, the corporation is "publicly traded." There are many stock exchanges in the United States and around the world. The two best known in the United States are the New York Stock Exchange (now NYSE Euronext), founded in 1792, and the NASDAQ, a computerized trading system managed by the National Association of Securities Dealers (the "AQ" stands for "Automated Quotations").

Only members of an exchange may trade on the exchange, so to buy or sell stocks you must go through a broker who is a member of the exchange. Brokers also manage your account and offer varying levels of advice and access to research. Most brokers have Web-based trading systems. Some discount brokers offer minimal advice and research along with minimal trading commissions and fees.

The Shanghai Stock Exchange (SSE), one of three exchanges in China, is not open to foreign investors. It is the sixth largest stock exchange in the world. The other exchanges in China are the Shenzhen Stock Exchange (SZSE) and the Hong Kong Stock Exchange (HKE). The Hang Seng is an index of Asian stocks on the HKE that is popular with investors interested in investing in Asian companies.

Commodities

Commodities are resources or raw materials, including the following:

- Agricultural products (food and fibers), such as soybeans, pork bellies, and cotton
- Energy resources such as oil, coal, and natural gas
- Precious metals such as gold, silver, and copper
- Currencies, such as the dollar, yen, and euro

Commodity trading was formalized because of the risks inherent in producing commodities—raising and harvesting agricultural products or natural resources—and the resulting volatility of commodity prices. As farming and food production became mechanized and required a larger investment of capital, commodity producers and users wanted a way to reduce volatility by locking in prices over the longer term.

For example, suppose it is now July 2013. If you know that you will want to have wheat in May of 2015, you could wait until May 2015 and buy the wheat at the market price, which is unknown in July 2013. Or you could buy it now, paying today's price, and store the wheat until May 2015. Doing so would remove your future price uncertainty, but you would incur the cost of storing the wheat.

Alternatively, you could buy a futures **contract** for May 2015 wheat in July 2013. You would be buying May 2015 wheat at a price that is now known to you (as stated in the futures contract), but you will not take delivery of the wheat until May 2015. The *value* of the futures contract to you is that you are removing the future price uncertainty without incurring any storage costs. In July 2013 the value of a contract to buy May 2015 wheat depends on what the price of wheat actually turns out to be in May 2015. Investors are hoping it will be substantially higher, allowing them to sell the contract, make a profit and never actually take possession of the wheat!

Mutual Funds, Index Funds, and Exchange-Traded Funds

A mutual fund is an investment **portfolio** consisting of securities that an individual investor can invest in all at once without having to buy each investment individually. The fund thus allows you to own the performance of many investments while actually buying—and paying the transaction cost for buying—only one investment. Mutual funds have become popular because they can provide diverse investments with a minimum of transaction costs. In theory, they also provide good returns through the performance of professional portfolio managers.

An index fund is a mutual fund designed to mimic the performance of an index, a particular collection of stocks or bonds whose performance is tracked as an indicator of the performance of an entire class or type of security. For example, the Standard & Poor's (S&P) 500 is an index of the five hundred largest publicly traded corporations, and the famous Dow Jones Industrial Average is an index of thirty stocks of major industrial corporations. An index fund is a mutual fund invested in the same securities as the index and so requires minimal management and should have minimal management fees or costs.

Mutual funds are created and managed by mutual fund companies or by brokerages or even banks. To trade shares of a mutual fund you must have an account with the company, brokerage, or bank. Mutual funds are a large component of individual retirement accounts and of defined contribution plans.

Mutual fund shares are valued at the close of trading each day and orders placed the next day are executed at that price until it closes. An exchange-traded fund (ETF) is a mutual fund that trades like a share of stock in that it is valued continuously throughout the day, and trades are executed at the market price.

The ways that capital can be bought and sold is limited only by the imagination. When corporations or governments need financing, they invent ways to entice investors and promise them a return. The last thirty years has seen an explosion in financial engineering, the innovation of new financial instruments through mathematical pricing models. This explosion has coincided with the ever-expanding powers of the computer, allowing professional investors to run the millions of calculations involved in sophisticated pricing models. The Internet also gives amateurs instantaneous access to information and accounts.

For individual investors, investing is a process of balancing the demands and desires of returns with the costs of risk, before time runs out.

KEY TAKEAWAYS

- Bonds are
  - a way to raise capital through borrowing, used by corporations and governments;
  - an investment for the bondholder that creates return through regular, fixed or floating interest payments on the debt and the repayment of principal at maturity;
  - traded on bond exchanges through brokers.
- Stocks are
  - a way to raise capital through selling ownership or equity;
  - an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value;
  - traded on stock exchanges through member brokers.
- Commodities are
  - natural or cultivated resources;
  - traded to hedge revenue or production needs or to speculate on resources' prices;
  - traded on commodities exchanges through brokers.
- Mutual funds are portfolios of investments designed to achieve maximum diversification with minimal cost through economies of scale.
  - An index fund is a mutual fund designed to replicate the performance of an asset class or selection of investments listed on an index.
  - An exchange-traded fund is a mutual fund whose shares are traded on an exchange.

- Institutional and individual investors differ in the use of different investment instruments and in using them to create appropriate portfolios.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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30.8: Reading- Measuring Return

Return

You want to choose investments that will combine to achieve the return objectives and level of risk that's right for you, but how do you know what the right combination will be? You can't predict the future, but you can make an educated guess based on an investment's past history. To do this, you need to know how to read or use the information available. Perhaps the most critical information to have about an investment is its potential **return** and susceptibility to types of **risk**.

Returns are typically calculated as annual rates of return, or the percentage of return created for each unit (dollar) of original value. If an investment earns 5 percent, for example, that means that for every $100 invested, you would earn $5 per year (because $5 = 5% of $100).

Returns are created in two ways: the investment creates income or the investment gains (or loses) value. To calculate the annual rate of return for an investment, you need to know the income created, the gain (loss) in value, and the original value at the beginning of the year. The percentage return can be calculated as follows:

(Income + Gain) / Original value = Percentage rate of return

(Income + (Ending value – Original value)) / Original value = Percentage rate of return

Note that if the ending value is greater than the original value, then Ending value − Original value > 0 (is greater than zero), and you have a **gain** that adds to your return. If the ending value is less, then Ending value − Original value < 0 (is less than zero), and you have a **loss** that detracts from your return. If there is no gain or loss, if Ending value − Original value = 0 (is the same), then your return is simply the income that the investment created.

For example, if you buy a share of stock for $100, and it pays no dividend, and a year later the market price is $105, then your return = [0 + (105 − 100)] ÷ 100 = 5 ÷ 100 = 5%. If the same stock paid a dividend of $2, then your return = [2 + (105 − 100)] ÷ 100 = 7 ÷ 100 = 7%.

While information about current and past returns is useful, investment professionals are more concerned with the expected return for the investment, that is, how much it may be expected to earn in the future. Estimating the expected return is complicated because many factors (i.e., current economic conditions, industry conditions, and market conditions) may affect that estimate.

For investments with a long history, a strong indicator of future performance may be past performance. Economic cycles fluctuate, and industry and firm conditions vary, but over the long run, an investment that has survived has weathered all those storms. So you could look at the average of the returns for each year. There are several ways to do the math, but if you look at the average return for different investments of the same asset class or type (e.g., stocks of large companies) you could compare what they have returned, on average, over time. Figure 2 shows average returns on investments in the S&P 500, an index of large U.S. companies since 1990.

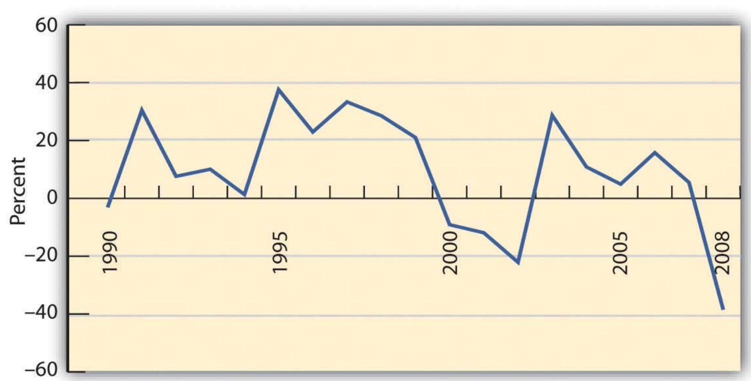

Figure 30.8.1: S&P 500 Average Annual Return Based on data from Standard & Poor's, Inc., (accessed November 24, 2009).

If the time period you are looking at is long enough, you can reasonably assume that an investment's average return over time is the return you can expect in the next year. For example, if a company's stock has returned, on average, 9 percent per year over the last twenty years, then if next year is an average year, that investment should return 9 percent again. Over the eighteen-year span from 1990 to 2008, for example, the average return for the S&P 500 was 9.16 percent. Unless you have some reason to believe that next year will *not* be an average year, the average return can be your expected return. The longer the time period you consider, the less volatility there will be in the returns, and the more accurate your prediction of expected returns will be.

Returns are the value created by an investment, through either income or gains. Returns are also your compensation for investing, for taking on some or all of the risk of the investment, whether it is a corporation, government, parcel of real estate, or work of art. Even if there is no risk, you must be paid for the use of liquidity that you give up to the investment (by investing).

Returns are the benefits from investing, but they must be larger than its costs. There are at least two costs to investing: the opportunity cost of giving up cash and giving up all your other uses of that cash until you get it back in the future and the cost of the risk you take—the risk that you won't get it all back.

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31.5: Reading- Bitcoin and Virtual Currencies

Background Information and Key Technical and Legal Issues

Bitcoin, a peer-to-peer digital currency, operates without the involvement of traditional financial institutions and provides a direct digital alternative to physical currencies and commodities. Governments worldwide generally do not yet see it and other digital currencies as a destabilizing "threat," and some scholars have argued that it may best be seen as a speculative investment. Bitcoin has certainly had its ups and downs: As of April 1, 2015, its value stood at $242 per bitcoin, after a January 14 low of $177 and a March 11 high of $296.

The currency has also had a long run of troubles with hackers and fraud, most spectacularly in 2014 when the exchange Mt. Gox declared bankruptcy after bitcoins worth $460 million at the time were apparently stolen. Bitcoin's decentralized model and degree of anonymity have also raised concerns over its use in illegal money transfers, fueling potential illicit commerce across the "dark web" and on sites such as Silk Road.

The organization Bitcoin.org, meanwhile, touts the currency's potential for opening up a "whole new platform for innovation":

Basic truths about Bitcoin can be hard to discern amid the hype and turmoil, but a 2015 Congressional Research Service (CRS) report, "Bitcoin: Questions, Answers and Analysis of Legal Issues," provides key background information as well as an overview of major issues.

Bitcoin transactions take place online directly between the buyer and seller, with each having a unique encryption. Transactions are recorded on a decentralized public ledger available for network users to verify valid transactions. Special users on the network ("miners") oversee this verification process. After verifying a block of transactions, miners are paid with 25 newly generated bitcoins and the transactions are processed and approved; this is how the total number of bitcoins grows. The number in circulation as of January 2015 was approximately 13.7 million, with the maximum set at 21 million. As of April 2015, their total value was $3 to $4 billion. This relatively small figure prevents bitcoins from having a significant effect on the Federal Reserve's monetary policy (an argument that is frequently, and incorrectly, brought up as one of the dangers of Bitcoin).

The CRS report explores the following technical, functional and legal issues:

Bitcoin advantages:

- Lower transaction costs: Because Bitcoin operates without a third-party intermediary, merchants are able to avoid the fees traditionally charged by payment systems such as credit cards.
- The possibility of increased privacy: Bitcoin provides a heightened degree of privacy for purchases and transactions, though by the system's nature, a complete list of all transactions is forever recorded to each user's encrypted identity.
- Protection from inflation: Since Bitcoin's circulation is not linked to currency or government regulation, it is not subject to standard inflation. However, it more than makes up for this in volatility.

Bitcoin disadvantages:

- Severe price volatility: The value of a bitcoin is determined by supply and demand, and as a result, can fluctuate rapidly. The value was as high as $1,100 in December 2013, then hit a low of $177 in January 2015. This extreme fluctuation is more characteristic of a commodity than a currency.
- Not legal tender: Debtors are not required to accept it, and without any formal backing other than the computer program to which it is linked, Bitcoin can be seen as an "unattractive vehicle" for holding and accumulating wealth.
- Uncertain security from theft and fraud: While the counterfeiting of bitcoins is allegedly impossible, the system has at times found itself vulnerable to large security breaches and cyber-attacks. Most recently, Bitstamp, a large European Bitcoin exchange, lost 19,000 bitcoins (valued at about $5 million) in a digital security breach. This follows the massive problems with Mt. Gox in 2014 and the collapse of other exchanges in 2011.
- Vulnerability of Bitcoin "wallets": Purchased or mined bitcoins are stored in a digital wallet on the user's computer or mobile device, and digital keys can be lost, damaged or stolen. Paper or offline storage is an option, but not always practiced.

The CRS report notes that, given the powers articulated in the U.S. Constitution, specifically the authority "to coin money" and "regulate the value thereof," the responsibility to oversee digital currency falls upon Congress. As of now, Congressional actions remain in the exploratory phase, with the Senate Finance Committee having only recently asked the Government Accountability Office (GAO) to review tax requirements and compliance risks. The tax code lacks clarity on how such currency should be treated: Is it digital currency, property, barter or foreign currency? Early concerns have focused more on tackling consumer protection issues than tax ambiguities, and as a result, the GAO recommended increased inclusion of the Consumer Financial Protection Bureau in questions related to Bitcoin.

Federal banking regulators have yet to issue guidance or regulations governing how banks are to deal with bitcoins. In a February 2014 statement, Federal Reserve chair Janet Yellen said: “Bitcoin is a payment innovation that’s taking place outside the banking industry…. There’s no intersection at all, in any way, between Bitcoin and banks that the Federal Reserve has the ability to supervise and regulate.” (See a 2014 paper from the Federal Reserve on technical background and data analysis.) Some state financial authorities have taken steps to devise regulations, with New York’s Department of Financial Services (NYDFS) in the lead.

According to the CRS report, other legal issues with Bitcoin include:

- Counterfeiting criminal statutes: It is illegal to counterfeit both U.S. and foreign currency, but current monetary laws do not mention digital currency. Given that Bitcoin is a peer-to-peer transaction without any formal involvement by a regulatory body or a government, it is unclear if there is a role or responsibility for the U.S. legal system to intervene if counterfeiting occurred in such a situation.
- Federal tax laws: To date, the IRS has done little to address the tax implications of virtual currencies. Instead, the IRS has focused on public education by issuing guidelines indicating that for now, virtual currency will be treated as property for tax purposes, and within that framework, all corresponding tax laws apply.
- Federal anti-money laundering laws: To fight illegal and terrorist-related financial transactions, the Bank Secrecy Act (BSA) requires financial institutions to keep records. This allows suspicious withdrawals and transactions to be tracked. These requirements would conceivably be placed on any business that engages in the exchange of bitcoins for U.S. or foreign currency.

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31.6: Reading- Mobile Commerce and Mobile Payment Systems

Mobile Commerce

The phrase **mobile commerce** was originally coined in 1997 by Kevin Duffey at the launch of the Global Mobile Commerce Forum, to mean "the delivery of electronic commerce capabilities directly into the consumer's hand, anywhere, via wireless technology." Many choose to think of Mobile Commerce as meaning "a retail outlet in your customer's pocket."

Mobile commerce is worth US$230 billion, with Asia representing almost half of the market, and has been forecast to reach US$700 billion in 2017. According to BI Intelligence in January 2013, 29% of mobile users have now made a purchase with their phones. Walmart estimated that 40% of all visits to their internet shopping site in December 2012 was from a mobile device. Bank of America predicts $67.1 billion in purchases will be made from mobile devices by European and U.S. shoppers in 2015. Mobile retailers in UK alone are expected to increase revenues up to 31% in FY 2013–14.

Mobile Payment

Mobile payment, also referred to as mobile money, mobile money transfer, and mobile wallet generally refer to payment services operated under financial regulation and performed from or via a mobile device. Instead of paying with cash, cheque, or credit cards, a consumer can use a mobile phone to pay for a wide range of services and digital or hard goods. Although the concept of using non-coin-based currency systems has a long history, it is only recently that the technology to support such systems has become widely available.

Mobile payment is being adopted all over the world in different ways. In 2008, the combined market for all types of mobile payments was projected to reach more than $600B globally by 2013, which would be double the figure as of February, 2011. The mobile payment market for goods and services, excluding contactless Near Field Communication or NFC transactions and money transfers, is expected to exceed $300B globally by 2013.

In developing countries mobile payment solutions have been deployed as a means of extending financial services to the community known as the "unbanked" or "underbanked," which is estimated to be as much as 50% of the world's adult population, according to Financial Access's 2009 Report "Half the World is Unbanked."

Near Field Communications (NFC)

Have you ever wondered what makes tap-and-go services like Apple Pay, Google Wallet and Amiibo work? As much as it seems like pure magic, it isn't. So what is it exactly? Simply put, it's a method of wireless data transfer that detects and then enables technology in close proximity to communicate without the need for an Internet connection. It's easy, fast, and works automagically.

No pairing code is necessary to link up and because it uses chips that run on very low amounts of power (or passively, using even less), it's much more power-efficient than other wireless communication types. At its core, NFC works to identify us by our enabled cards and devices (and by extension, our bank accounts and other personal info.)

NFC chips stocked inside credit cards for contactless payments is nothing new. But a more recent and admittedly more enticing use case for NFC is with your smartphone, which can digitize your entire wallet. Virtually every mobile OS maker has their own apps that offer unique NFC functionality. Android users have the widest variety to choose from. First off, US users can nab Google Wallet, which accesses your funds for contactless payments. Samsung Pay, which operates similarly, is on the way for Samsung phone users in the United States and Korea this Summer.

However, a feature that all Android owners have been able to enjoy is called Android Beam. It was implemented in Ice Cream Sandwich 4.0 as a nifty, simple process that allows for the transfer of photos, contacts and directions that works by holding two phones together.

Apple's iPhone 6 and iPhone 6 Plus received NFC functionality, albeit with limited use so far, only for Apple Pay. It's a lot like Google Wallet, in that it's an app which gives users the ability to pay for goods and services at participating retailers. Lastly, those who prefer Microsoft's Windows Phone will be able to use Microsoft Payments when it launches likely around the launch of Windows 10.

Whichever device you have, it's likely that a local supermarket, train station, taxi or coffee shop supports contactless payments via your phone's NFC chip. Go try it out! Simply hold it close to a contactless payment terminal and instantly, like swiping a credit card, the payment will complete.

Looking toward the future, it's possible that NFC chips could be used to replace every card in your wallet. That means the unique info on your frequent shopper loyalty cards, library card, business cards and the like could be contained and transmitted simply via NFC.

Forms of Mobile Payment

Apple Pay is a mobile payment service that lets certain Apple mobile devices make payments at retail and online checkout. It digitizes and replaces the credit or debit magnetic stripe card transaction at credit card terminals. The service lets Apple devices wirelessly communicate with point of sale systems using a near field communication (NFC) antenna, a "dedicated chip that stores encrypted payment information" (known as the Secure Element), and Apple's Touch ID and Passbook. The service is compatible with the iPhone 6, iPhone 6 Plus, and the Apple Watch. Users with iPhone 5, 5C, 5S, 6, or 6 Plus can use the service through an Apple Watch, though the watch lacks the added Touch ID security. By default, Apple Pay is disabled, and the owner must enter a code to enable Apple Pay after putting on the watch. The watch's sensors will then ensure that it is still being worn by its owner. If the watch is removed at any point, then Apple Pay is disabled again.

The service keeps customer payment information private from the retailer, and creates a "dynamic security code [. . .] generated for each transaction." Apple added that they would not track usage, which would stay between the customers, the vendors, and the banks. Users can also remotely halt the service on a lost phone via the Find My iPhone service.

To check out at brick and mortar stores, users hold their authenticated Apple device to the point of sale system. iPhone users authenticate by holding their fingerprint to the phone's Touch ID sensor, and Apple Watch users authenticate by double clicking a button on the device. There will be 220,000 participating vendors at the time of launch, including department stores Macy's and Bloomingdales, drugstores Walgreens and Duane Reade, restaurants Subway and McDonald's, and other retailers including Target and Whole Foods. To check out online in supported mobile apps, users choose "Apple Pay" as their payment method and authenticate with Touch ID. Groupon, Panera Bread, and Uber apps will be compatible with Apple Pay at the service's launch. Users can add credit cards to the service in any of three ways: through their iTunes accounts, by taking a photo of the card, or by entering the card information manually. The service will only work in the United States, though Apple plans to expand to other countries.

Google Wallet is a mobile payment system developed by Google that allows its users to store debit cards, credit cards, loyalty cards, and gift cards among other things, as well as redeeming sales promotions on their mobile phone. Google Wallet can use near field communication (NFC) to "make secure payments fast and convenient by simply tapping the phone on any PayPass-enabled terminal at checkout."

Google demonstrated the app at a press conference on May 26, 2011. The app was released in the United States only on September 19, 2011. The service works with the 300,000 plus MasterCard PayPass merchant locations, with Visa licensing their Visa payWave system to Google for use in Wallet as of September 20, 2011. On May 15, 2013, Google announced the integration of Google Wallet and Gmail, allowing users to send money through Gmail attachments. Like the main service, Google Wallet's Gmail integration is also currently only available in the United States, to those 18 or older. On February 23, 2015, Google announced that it would acquire the intellectual property of the carrier-backed competitor Softcard and integrate it into Google Wallet, and that AT&T Mobility, T-Mobile U.S., and Verizon Wireless would bundle the Google Wallet app on their compatible devices later in the year. The effective merger aims to build a stronger competitor to the recently introduced Apple Pay mobile payment service. The new service will be known as Android Pay.

Where this new technology will lead the world economy and its impact on the existing monetary system remains to be seen, but we are certain it will continue to evolve rapidly!

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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31.9: Reading- Measuring Risk

Risk

Investment risk is the idea that an investment will not perform as expected, that its actual return will deviate from the expected return. Risk is measured by the amount of volatility, that is, the difference between actual returns and average (expected) returns. This difference is referred to as the standard deviation. Returns with a large standard deviation (showing the greatest variance from the average) have higher volatility and are the riskier investments.

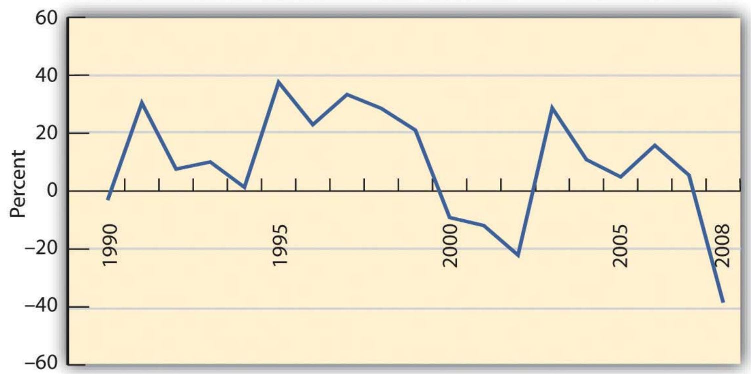

Figure 31.9.1: S&P 500 Average Annual Return Based on data from Standard & Poor's, Inc., (accessed November 24, 2009).

As Figure 31.9.1 shows, an investment may do better or worse than its average. Thus, standard deviation can be used to define the expected range of investment returns. For the S&P 500, for example, the standard deviation from 1990 to 2008 was 19.54 percent. So, in any given year, the S&P 500 is expected to return 9.16 percent but its return could be as high as 67.78 percent or as low as −49.46 percent, based on its performance during that specific period.

What risks are there? What would cause an investment to unexpectedly over- or underperform? Starting from the top (the big picture) and working down, there are

- economic risks,
- industry risks,
- company risks,
- asset class risks,
- market risks.

Economic risks are risks that something will upset the economy as a whole. The economic cycle may swing from expansion to recession, for example; inflation or deflation may increase, unemployment may increase, or interest rates may fluctuate. These macroeconomic factors affect everyone doing business in the economy. Most businesses are cyclical, growing when the economy grows and contracting when the economy contracts.

Consumers tend to spend more disposable income when they are more confident about economic growth and the stability of their jobs and incomes. They tend to be more willing and able to finance purchases with debt or with credit, expanding their ability to purchase durable goods. So, demand for most goods and services increases as an economy expands, and businesses expand too. An exception is businesses that are countercyclical. Their growth accelerates when the economy is in a downturn and slows when the economy expands. For example, low-priced fast food chains typically have increased sales in an economic downturn because people substitute fast food for more expensive restaurant meals as they worry more about losing their jobs and incomes.

Industry risks usually involve economic factors that affect an entire industry or developments in technology that affect an industry's markets. An example is the effect of a sudden increase in the price of oil (a macroeconomic event) on the airline industry. Every airline is affected by such an event, as an increase in the price of airplane fuel increases airline costs and reduces profits. An industry such as real estate is vulnerable to changes in interest rates. A rise in interest rates, for example, makes it harder for people to borrow money to finance purchases, which depresses the value of real estate.

Company risk refers to the characteristics of specific businesses or firms that affect their performance, making them more or less vulnerable to economic and industry risks. These characteristics include how much debt financing the company uses, how well it creates economies of scale, how efficient its inventory management is, how flexible its labor relationships are, and so on.

The asset class that an investment belongs to can also bear on its performance and risk. Investments (assets) are categorized in terms of the markets they trade in. Broadly defined, asset classes include

- corporate stock or equities (shares in public corporations, domestic, or foreign);
- bonds or the public debts of corporation or governments;
- commodities or resources (e.g., oil, coffee, or gold);
- derivatives or contracts based on the performance of other underlying assets;
- real estate (both residential and commercial);
- fine art and collectibles (e.g., stamps, coins, baseball cards, or vintage cars).

Within those broad categories, there are finer distinctions. For example, corporate stock is classified as large cap, mid cap, or small cap, depending on the size of the corporation as measured by its market capitalization (the aggregate value of its stock). Bonds are distinguished as corporate or government and as short-term, intermediate-term, or long-term, depending on the maturity date.

Risks can affect entire asset classes. Changes in the inflation rate can make corporate bonds more or less valuable, for example, or more or less able to create valuable returns. In addition, changes in a market can affect an investment's value. When the stock market fell unexpectedly and significantly, as it did in October of 1929, 1987, and 2008, all stocks were affected, regardless of relative exposure to other kinds of risk. After such an event, the market is usually less liquid; that is, there is less trading and less efficient pricing of assets (stocks) because there is less information flowing between buyers and sellers.

As you can see, the link between risk and return is reciprocal. The question for investors and their advisors is: How can you get higher returns with less risk?

KEY TAKEAWAYS

- There is a direct relationship between risk and return because investors will demand more compensation for sharing more investment risk.
- Actual return includes any gain or loss of asset value plus any income produced by the asset during a period.
- Actual return can be calculated using the beginning and ending asset values for the period and any investment income earned during the period.
- Expected return is the average return the asset has generated based on historical data of actual returns.
- Investment risk is the possibility that an investment's actual return will not be its expected return.
- Investment risk is exposure to
  - economic risk,
  - industry risk,
  - company- or firm-specific risk,
  - asset class risk, or
  - market risk.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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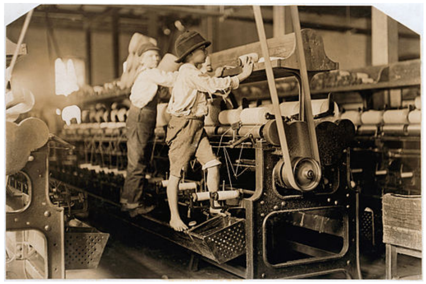
CHAPTER OVERVIEW

32: Module 15- Human Resource Management

31.1: Why It Matters- Human Resource Management

Why explain the role of human resource management in planning, recruiting, and managing a workforce?



It's the early 1900s and you are twelve years old, living in an American city where industrialization has begun to boom. On Monday morning at 5 a.m., you line up with the rest of your family to begin your long workday at a textile factory. If it isn't terribly busy you will end your day around 8:00 p.m. You visit with your parents and siblings during your fifteen-minute lunch break. The factory where you work is not heated, has no ventilation system, and the windows can't be opened to let out the exhaust fumes from machinery. Since you are small, your responsibility is to climb in between the machinery and dislodge pieces of material that get caught in the gears and belts—while the machines are still running. You have to be especially careful because the only light in the factory is the sunlight that comes through the dirty windows. If you are not killed or maimed by the equipment, chances are good that your life will be cut short by the toxic fumes you inhale while in the factory. Every member of your family works there, including your four-year-old sister. Your father, the most highly skilled worker in the family, makes about ten cents per hour, your mother makes about half that since she's a woman, and you, as a child, make even less. Fortunately you don't have to worry about doing homework, because you don't attend school, and you'll learn to read and write only if your parents teach you on Sunday—the one day of the week when you don't go to work.

Similar grim working conditions continued for decades in America until labor unions formed and activists began to lobby for worker protections. It's hard, today, to imagine what those conditions really must have been like. We have always worked in conditions regulated for health and safety. We aren't forced to work for pennies per day. Understanding how far we have come in terms of employee rights and protections is an important context for thinking about human resource management. As you work through this section, try to keep this historical perspective in mind.

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31.2: Introduction to 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.

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31.3: Human Resource Management

Learning Objectives

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

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. Hiring a new employee is a costly process and there's always a risk that the incoming employee won't match the performance of the person who previously worked in that position. 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 position requirements)
- 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.

Practice Questions

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31.4: Introduction to Human Resources and Laws

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

A business needs more than a big idea to be successful. If the business employs workers, it needs to adhere to a range of laws designed to ensure equal opportunity and workplace safety. In this section, we introduce key anti-discrimination and labor and safety legislation and related resources and provide perspective on the cost of failing to comply with the law.

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31.5: Employment Legislation

Learning Objectives

- Explain the function of the Equal Employment Opportunity Commission
- Summarize key anti-discrimination legislation
- Summarize key labor and safely legislation
- Discuss key laws affecting human resource management

Figure 31.5.1: 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.

Equal opportunity is one of our nation's core values and should be a core company policy. However, as the following examples illustrate, equal opportunity isn't always business practice.

What happens when businesses make decisions that violate laws and regulations designed to protect working Americans? As a Society for Human Resource Management (SHRM) training manual emphasizes: "Discrimination cost employers millions of dollars every year, not to mention the countless hours of lost work time, employee stress and the negative public image that goes along with a discrimination lawsuit."

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. companies 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]

Equal employment opportunity isn't just the right thing to do, it's the law. Specifically, it's a series of federal laws and amendments designed to eliminate employment discrimination. Employment discrimination laws and regulations are enforced by the **Equal Employment Opportunity Commission (EEOC)**, an agency established by the Civil Rights Act of 1964 (Title VII). The agency's mission is to stop and remedy unlawful employment discrimination. Specifically, the EEOC is charged with "enforcing federal laws that make it illegal to discriminate against a job applicant or an employee because of the person's race, color, religion, sex (including pregnancy, gender identity, and sexual orientation), national origin, age (40 or older), disability or genetic information."[6] Since its creation in 1964, Congress has gradually expanded EEOC powers to include the authority to investigate claims, negotiate settlements and file lawsuits. The agency also conducts outreach and educational programs in an effort to prevent discrimination. Finally, the EEOC provides equal employment opportunity advisory services and technical support to federal agencies.

Anti-Discrimination Legislation

The intent of U.S. anti-discrimination legislation is to protect workers from unfair treatment. In brief, illegal discrimination is the practice of making employment decisions based on factors unrelated to performance.

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 enforces laws that prohibit discrimination based on seven protected categories including age, disability, genetic information, national origin, pregnancy, race and color and religion and sex. Federal anti-discrimination laws apply to a broad range of employee actions. Specifically, any employment decision – including hiring, compensation, scheduling, performance evaluation, promotion, firing or any other term or condition of employment – that is based on factors unrelated to performance is illegal.

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.

As discussed above, the **EEOC** is the organization charged with implementing Title VII and related anti-discrimination legislation. There are currently seven categories protected under federal law: age, disability, genetic information, national origin, race and color, religion and sex. The EEOC's authority includes enforcing the following federal statutes summarized below. Unless otherwise stated, these laws apply to most employers with at least 15 employees (20 employees for the ADEA), including employment agencies and labor unions.

- **Title VII of the Civil Rights Act of 1964:** Prohibits discrimination on the basis of race, color, religion, sex or national origin. The law also makes it illegal to retaliate against a person who has voiced a grievance, filed a charge of discrimination or participated in an investigation or lawsuit. 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.
- An amendment to Title VII, **The Pregnancy Discrimination Act** prohibits discrimination against a woman based on pregnancy, childbirth or a related condition. As in the original law, it also makes retaliation illegal.
- **The Equal Pay Act of 1963 (EPA):** 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. Since the EPA's enactment, there has been significant – if slow – progress in achieving pay equity. Although progress has often stalled or reversed, the wage gap has narrowed consistently in recent years. Since 1963, the wage has decreased from 58.9% to 80.5% in 2017. For perspective: at this percentage, a woman would need to work through April 10 of the next year to make what a man in an equivalent role earned the prior year.
- **The Age Discrimination in Employment Act of 1967 (ADEA):** Prohibits employment discrimination against individuals 40 years of age or older based on age. As with other anti-discrimination legislation, the law makes retaliation illegal.
- **Title I of the Americans with Disabilities Act of 1990 (ADA):** Prohibits discriminate against a qualified person with a disability and requires employers to make reasonable accommodations for applicants and employees with known physical or mental limitations who are otherwise qualified unless that accommodation would pose an "undue hardship" or material impact (significant difficulty or expense) on an employer's business operations. As with other anti-discrimination legislation, the law makes retaliation illegal. This law applies to private sector and state and local government employers only. Disability discrimination protection at the federal level is provided in **Sections 501 and 505 of the Rehabilitation Act of 1973.** There are three kinds of *reasonable accommodations* defined by the EEOC:[7]
  - "modifications or adjustments to a job application process that enable a qualified applicant with a disability to be considered for the position such qualified applicant desires; or
  - modifications or adjustments to the work environment, or to the manner or circumstances under which the position held or desired is customarily performed, that enable a qualified individual with a disability to perform the essential functions of that position; or
  - modifications or adjustments that enable a covered entity's employee with a disability to enjoy equal benefits and privileges of employment as are enjoyed by its other similarly situated employees without disabilities."
- **The Genetic Information Nondiscrimination Act of 2008 (GINA):** Prohibits discrimination against applicants or employees based on an individual's or his or her family's genetic information or family medical history (for example, a hereditary disease, disorder or medical condition). As with other anti-discrimination legislation, the law makes retaliation illegal.

Despite the public relations and financial risk of discriminatory hiring practices, charges of workplace discrimination are in the tens of thousands annually. Since 1997, the number of charges has ranged from a low of 75,428 in 2005 to a high of 99,947 in 2011. In fiscal year 2017, the EEOC received 84,254 charges of workplace discrimination charges and obtained $398 million in monetary benefits for victims through a combination of voluntary resolutions and litigation. As was true for the last few years, retaliation was the most frequently filed charge (49%), followed by race (34%), disability (32%), sex (30%) and age (22%). Percentages for the remaining categories range from less than 1% to 10%.

Although retaliation charges are up 3 percentage points from the prior year, 2016 percentages in the remaining top five categories were within a percentage point, with race at 35%, disability at 31%, sex at 29% and age at 23%. Note that percentages add up to more than 100 due to charges alleging multiple bases of discrimination.

Note that state and local laws may provide broader discrimination protections. If in doubt, contact your state department of labor for clarification. Note as well that laws are subject to interpretation. For example, an EEOC notice emphasizes that their interpretation of the Title VII reference to "sex" is broadly applicable to gender, gender identity and sexual orientation. And, further, that "these protections apply regardless of any contrary state or local laws."

In the Press Release announcing the 2017 data, EEOC Acting Chair Victoria A Lipnic stated that results for the fiscal year demonstrate that "the EEOC has remained steadfast in its commitment to its core values and mission: to vigorously enforce our nation's civil rights laws."

? Practice Questions

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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**, which established the Occupational Safety and Health Administration (OSHA), a Department of Labor agency charged with setting and enforcing standards for "safe and healthful working conditions for working men and women"[8] and supporting this objective through outreach, training and public education. OSHA's website—with content available in both English and Spanish—is a resource for both employers and employees. OSHA's training programs include free on-site consultations for small and medium-sized businesses. An OSHA landing page for employees emphasizes workers' right to a safe workplace and advises employees on when and how to file a complaint. As is true with complaints based on discrimination, the act provides protection against retaliation for voicing a concern or submitting a complaint. An employee who believes that he or she has been retaliated against in exercising his/her rights under this law has 30 days (from the alleged retaliation action) to file a whistleblower complaint. Key point: The act does not cover workers who are not employees. For more on how to interpret the employer-employee relationship, refer to Safety School's "Who is covered (or not) by OSHA."
- **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 non-citizens. 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.

? Practice Question

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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.

You can view the transcript for "The Top 5 Manager Mistakes that Cause Lawsuits" (opens in new window) or the text alternative for "The Top 5 Manager Mistakes that Cause Lawsuits" (opens in new window).

Practice Question

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31.6: Introduction to Recruitment and Hiring

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

Human Resource personnel play a critical role in building organizational capacity and that often starts with candidate recruitment and selection. Achieving a diverse workforce is generally considered the Holy Grail, but it can also be a point of confusion and friction. In this section, we will present a working definition of diversity, highlight why diversity matters in terms of business performance and outline what responsibilities Human Resource personnel have in managing the overall diversity of the organization. We will also address some of the challenges of achieving workplace diversity. Moving into the recruitment process, we will discuss common recruitment strategies, outline the hiring process and highlight the importance of measuring recruitment and selection effectiveness.

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31.7: Diversity in Human Resources

Learning Objectives

- Discuss how business benefit from diversity in the workforce

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 various consumer markets 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.

Practice Question

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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.

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31.8: Recruitment

Learning Objectives

- Describe common recruitment strategies

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 résumés 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.[1] 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.[2]
- **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.[3]

? Practice Question

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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.

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31.9: The Hiring Process

Learning Objectives

- Describe the components of 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.[1] 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."[2] 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.[3] Structured interviews also help 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.

In a behavioral interview, the interviewer asks the applicant to reflect on his or her past experiences.[4] 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?

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.[5] 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."[6] 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.

? Practice Question

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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.

You can view the transcript for “Zappos Only Hires People Who Are Weird And Lucky In Life” (opens in new window) or the text alternative for “Zappos Only Hires People Who Are Weird And Lucky In Life” (opens in new window).

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Contributors and Attributions

31.10: Introduction to Training, Development, and Rewards

What you'll learn to do: discuss effective approaches to training, developing, and rewarding employees

In this section you'll learn about employee training and development, evaluation and compensation. We'll start with a discussion of training benefits and needs assessment and differentiate between and identify different approaches to training and professional development. On the evaluation topic, we will present the purpose, development and process of employee evaluation systems, identifying common methods of performance appraisal. Finally, we'll discuss compensation, including various forms of financial payment, the concept of "total rewards" and benefits.

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31.11: Training and Professional Development

> **Learning Objectives**
>
> - Describe different approaches to employee training
> - Describe different approaches to professional development

Figure 31.11.1: A medieval baker with his apprentice

In the late Middle Ages, craft guilds allowed master craftsmen to employ young people as an inexpensive form of labor in exchange for food, lodging, and formal training in the craft. Consequently, if a young man or woman wanted to obtain skills as a craftsperson, he or she would spend at least seven years as an apprentice, supervised by a master craftsman before being released to work independently. Clearly the world of work has changed and so has the way that individuals obtain and hone their workplace skills.

Training is teaching, or developing in oneself or others, any skills and knowledge that relate to specific useful competencies. Training has specific goals of improving one's capability, capacity, productivity, and performance. In business, training is the investment of resources in the employees of a company so they are better equipped to perform their job. The types of resources invested may include time and money to develop, implement, and evaluate training programs.

Benefits of Training

Training can be a source of a competitive advantage for a company. The primary benefit to the company is the result of an accumulation of smaller benefits. Training provides greater skill and knowledge to employees, which translate to improved job performance. Improved job performance, in turn, means greater efficiency, fewer errors, better productivity. The end result is reduced costs and higher profits. The company is not the only beneficiary of employee training, though; the employee can realize rewards, too.

The well-trained employee acquires an advantage for him- or herself. By participating in training, employees can deepen or expand their existing skill set and increase their understanding of the organization. In addition, a well-trained employee may be able to take advantage of internal promotion opportunities and becomes more marketable if he or she leaves the company. Other potential benefits are listed below:

- Increased job satisfaction and morale among employees
- Increased employee motivation
- Increased efficiencies in processes, resulting in financial gain
- Increased capacity to adopt new technologies and methods
- Increased innovation in strategies and products
- Reduced employee turnover
- Enhanced company image, e.g., building a reputation as a "great place to work"
- Risk management, e.g. training about sexual harassment, diversity training[1]

Need for Training

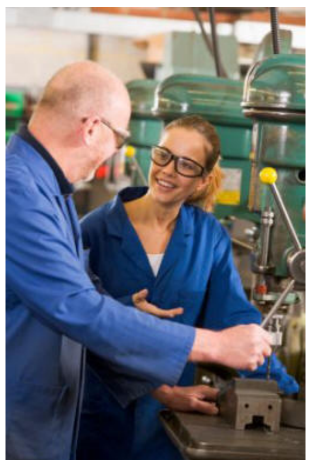
The need for training exists in every business. However the nature of training varies depending on the type of business and operations involved. For example, a manufacturing company may have a need for technical skills training while an insurance company may emphasize customer service training. So, how does a company determine what sort of training is needed? The process begins with a **training needs assessment**. A training needs assessment is a systematic and objective analysis of both the employee and organizational knowledge, skills, and abilities to identify gaps or areas of need.

Generally, training needs assessments are conducted as follows:

1. **Identify the need.** In this first step, the assessor looks for answers to questions such as: Why is the needs assessment being conducted? What is the desired result? What issues are trying to be addressed? Will training alone resolve the issues?
2. **Perform a gap analysis.** This involves comparing current knowledge, skills, and abilities against company standards. Training assessors may use HR records, interviews, questionnaires, or observation to identify gaps.
3. **Assess training options**. Once completed, the assessment will present a list of options for training that management can evaluate based on criteria such as cost and duration.

Not all training is the result of a needs assessment. Unforeseen circumstances may create an immediate need for training. For example, consider the Wells Fargo scandal of 2016, when it came to light that employees had secretly created millions of unauthorized bank and credit card accounts in order to generate bank fees and boost their sales figures. The bank fired 5,300 employees and had to put in place a rapid training and retraining program to mitigate the legal consequences of their employees' actions. Other situations that might compel a company to conduct impromptu training are changes in legal requirements, new regulations, natural disasters or other crises.

Types of Training



The goal of training is for the trainee to acquire relevant knowledge, skills, and competencies from the trainer as a result of being taught vocational or practical skills. More generally, training is aimed at improving the trainee's capability, capacity, and performance.

Generally training is categorized as on-the-job or off-the-job:

On-the-job training takes place in a normal working situation, using the actual tools, equipment, documents, or materials that trainees will use once they are fully trained. On-the-job training is not limited to, but is most commonly used for, technical or skills training.

Off-the-job training takes place away from the normal work situation, and as a result, the employee is not a directly productive worker while such training takes place. Businesses often cite this as one of the disadvantages of off-the-job training. However, this type of training has the advantage of allowing people to get away from work and concentrate more thoroughly on the training itself. Off-the-job of training has proven very effective in helping people acquire and master new concepts and ideas.

Professional Development

In addition to the basic training required for a trade, occupation, or profession, the labor market recognizes the need to continue training beyond initial qualifications in order to maintain, upgrade, and update skills throughout working life. This is known as professional development.

Professional development refers to skills and knowledge attained for both personal development and career advancement. Professional development encompasses all types of facilitated learning opportunities, ranging from college degrees and formal coursework to conferences and workshops.

Individuals who take part in professional development run the gamut from teachers to military officers. Individuals may pursue professional development because of an interest in lifelong learning, a sense of moral obligation, to maintain and improve professional competence, enhance career progression, keep abreast of new technology and practice, or to comply with professional regulatory organizations. In fact, there are many professions that have requirements for annual professional development to renew a license or certification, such as accountants, lawyers, and engineers.

There are a variety of approaches to professional development, including consultation, coaching, communities of practice, lesson study, mentoring, reflective supervision, and technical assistance. Professional development may include formal types of vocational education—typically post-secondary or technical training leading to a qualification or credential required to obtain or retain employment. Professional development may also come in the form of pre-service or in-service professional development programs. These programs may be formal or informal, group or individual. It's possible to pursue professional development on one's own, or through the company's human resource departments. Professional development on the job may develop or enhance "process skills"—sometimes referred to as leadership skills—as well as task skills. Some examples of process skills are effectiveness skills, team-functioning skills, and systems-thinking skills.

The twenty-first century has seen a significant growth in online professional development. Content providers have become well informed about using technology in innovative ways, incorporating collaborative platforms such as discussion boards and Wikis to maximize participant interaction. These content providers offer training on topics ranging from sexual harassment awareness to promoting diversity in the workplace. The ability to customize training for a business or industry has placed these providers in a position to supplement or even replace in-house training departments. Because businesses can purchase access on an as-needed basis for as many or as few employees as necessary, the cost of training is reduced. Thus, businesses can provide more training and professional development opportunities to their employees at reduced costs and at times that are more convenient for both the employer and employee.

? PRactice Questions

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Human resource management is all about increasing employee performance to their highest level corresponding to their role in the organization. Consequently, the importance of training to the organization and as a key function of HR management cannot be understated.

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1. Duening & Ivancevich, 2003 ↩

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31.12: Performance Appraisals

Learning Objectives

- Describe different approaches to performance appraisals

The Purpose of Performance Appraisals

A **performance appraisal** (PA) or performance evaluation is a systematic and periodic process that assesses an individual employee's job performance and productivity, in relation to certain pre-established criteria and organizational objectives. Other aspects of individual employees are considered as well, such as organizational citizenship behavior, accomplishments, potential for future improvement, strengths, and weaknesses. A PA is typically conducted annually. However, the frequency of an evaluation, and policies concerning them, varies widely from workplace to workplace. Sometimes an evaluation will be given to a new employee when a probationary period ends, after which they may be conducted on a regular basis (such as every year). Usually, the employee's supervisor (and frequently, a more senior manager) is responsible for evaluating the employee, and he or she does so by scheduling a private conference to discuss the evaluation. The interview functions as a way of providing feedback to employees, counseling and developing employees, and conveying and discussing compensation, job status, or disciplinary decisions.

Historically, performance appraisals have been used by companies for a range of purposes, including salary recommendations, promotion and layoff decisions, and training recommendations.[1] In general, "performance elements tell employees what they have to do, and standards tell them how well they have to do it."[2] This broad definition, however, can allow for appraisals to be ineffective, even detrimental, to employee performance. "Second only to firing an employee, managers cite performance appraisal as the task they dislike the most," and employees generally have a similar feeling.[3] One key item that is often forgotten during the appraisal process (by managers and employees alike) is that the appraisal is for improvement, not blame or harsh criticism.[4]

Developing an Appropriate Appraisal Process

One significant problem in creating an appraisal process is that no single performance appraisal method will be perfect for every organization.[5] Establishing an appropriate process involves significant planning and analysis in order to provide quality feedback to the employee. The most crucial task in the process is determining proper job dimensions that can be used to evaluate the employee against accepted standards that affect the performance of the team, business unit, or company.[6] Peter Drucker developed a method termed "Management by Objectives," or MBO, in order to address the need for specifying such job dimensions. Drucker suggests that objectives for any employee can be validated if they pass the following SMART test:[7]

- **S**pecific
- **M**easurable
- **A**chievable
- **R**ealistic
- **T**ime-related

The process of an evaluation typically includes one or more of the following:

- An assessment of how well the employee is doing. Sometimes this includes a scale rating indicating strengths and weaknesses in key areas (e.g., ability to follow instructions, complete work on time, and work with others effectively). It's also common for the supervisor and manager to discuss and determine the key areas.
- Employee goals with a deadline. Sometimes the employee may voluntarily offer a goal, while at other times it will be set by his or her boss. A significantly underperforming employee may be given a performance improvement plan, which details specific goals that must be met to keep the job.

- Feedback from coworkers and supervisors. The employee may also have the chance to share feelings, concerns, and suggestions about the workplace.
- Details about workplace standing, promotions, and pay raises. Sometimes an employee who has performed very well since the last review period may get an increase in pay or be promoted to a more prestigious position.

Methods of Performance Appraisal

Numerous methods exist for gauging an employee's performance, and each has strengths and weaknesses depending on the environment. The following outlines some of the more commonly used methods, as well as some recently developed ones that can be useful for various feedback situations:

- **Graphic rating scales**: This method involves assigning some form of rating system to pertinent traits. Ratings can be numerical ranges (1–5), descriptive categories (below average, average, above average), or scales between desirable and undesirable traits (poor ↔ excellent). This method can be simple to set up and easy to follow but is often criticized for being too subjective, leaving the evaluator to define broad traits such "leadership ability" or "conformance with standards."[8]
- **Behavioral methods**: A broad category encompassing several methods with similar attributes. These methods identify to what extent an employee displays certain behaviors, such as asking a customer to identify the usefulness of a sales representative's recommendation. While extremely useful for jobs where behavior is critical to success, identifying behaviors and standards for employees can often be very time-consuming for an organization.[9]
- **2+2**: A relative newcomer in performance appraisal methodology, the 2+2 feedback system demonstrates how appraisals can be used primarily for improvement purposes. By offering employees two compliments and two suggestions for improvement focused around high-priority areas, creators Douglas and Dwight Allen suggest that organizations can become "more pleasant, more dynamic, and more productive."[10] If the goal is employee improvement, this system can provide significant benefits; however, if the goals are compensation changes and rankings, the system provides little benefit.

? Practice Question

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Appraisal methodologies depend greatly on the type of work being done; an assembly worker will require a very different appraisal system from a business consultant. Significant planning will be required to develop appropriate methods for each business unit in an organization in order to obtain maximum performance towards the appraisal goals.

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1. Kulik, 2004 ↵
2. United States Department of the Interior, 2004 ↵
3. Heathfield, Performance Appraisals Don't Work ↵
4. Bacal, 1999 ↵
5. Kulik, 2004 ↵
6. Fukami, Performance Appraisal, 2007 ↵
7. Management by Objectives—SMART, 2007 ↵
8. Kulik, 2004 ↵
9. Kulik, 2004 ↵
10. Formula 2+2, 2004 ↵

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31.13: Compensation

Learning Objectives

- Summarize different forms of employee compensation

People talk about loving or hating their job, but do they ever mean that they love or hate how much compensation they receive for the job that they perform? Can someone pay you enough to take on jobs like Mike Rowe did on his television show, *Dirty Jobs*? How much an employee or manager is paid and the different ways that their compensation can be structured is an area in which HR managers find themselves competing with other employers. As the business environment become more complex, so do the forms of employee financial compensation. From a business standpoint, employee compensation can be thought of as the cost of acquiring human resources for running operations.

Salary

A salary is a form of compensation paid periodically by an employer to an employee, the amount and frequency of which may be specified in an employment contract. In general, employees paid a salary do not "punch a clock," and they work however many hours are necessary to accomplish organizational goals and objectives. Most managers are paid a salary that is calculated in terms of annual, monthly, or weekly earnings instead of hourly pay. U.S. employment law distinguishes between exempt (salaried) and nonexempt (hourly) workers. Employers can require exempt employees to work long hours without paying overtime.

Today, the idea of a salary continues to evolve as part of a system of all the combined rewards that employers offer to employees. Salary is coming to be seen as part of a "total rewards" system, which includes bonuses, incentive pay, commissions, benefits, perks, and various other tools that help employers link rewards to an employee's measured performance.

Something that has become increasingly common is to offer salaried employees options to purchase stock in the company. An employee stock option (ESO) is a call option on the common stock of a company, granted by the company to an employee as part of the employee's compensation package. The objective is to give employees an incentive to behave in ways that will boost the company's stock price. In many cases, the ESO represents an amount considerably higher than the employee's base salary. For example, in 2015 Satya Nadella, CEO of Microsoft, was paid a salary of $4.5 million, but his stock options earned him an additional $79.8 million.

Wage Systems

Wage payment systems offer another means by which organizations compensate employees. Unlike salary, wage systems are based on either hours worked or some other measure of production. Some of the most common wage systems are the following:

- **Time rate**: Under this system, a worker is paid by the hour for time worked. Time worked beyond a set amount (generally 40 hours per week) is paid as "overtime" and at a higher base hourly wage, usual 1 1/2 times higher.
- **Differential time rate**: According to this method, different hourly rates are fixed for different shifts or different assignments. The most common differential time rate occurs in production facilities where workers who are assigned to a graveyard shift (e.g., 11:00 p.m.–7:00 a.m.) are paid a "shift differential" that can range from a few cents to many dollars per hour.
- **Payment by piecework**: The worker's wages depends on his or her output and the rate of each unit of output; it is in fact independent of the time taken by the worker. In other words, for every "piece" a worker produces, he or she is paid a set amount. This type of pay has fallen out of favor with many businesses since it emphasizes quantity over quality. That said, today's "gig economy" relies on a kind of payment by piecework. According to Uber, the company's drivers are independent contractors, receiving payment for each trip.

Hybrid Wage Systems

Figure 31.13.1: Piecework system: A family in New York City making dolls' clothes by piecework in 1912. Each family member earns money based on how many pieces he or she produces.

Some employees' positions are structured in a way that doesn't fit with conventional salary or wage systems. In these cases, employers pay their employees by a "hybrid method." Hybrid wage systems are most common in sales positions or management positions. The most common hybrid wage systems are the following:

- **Straight Commission**. Under a straight commission system, the employee receives no compensation from their employer unless they close a sale or transaction. Real-estate agents and car sales staff are two of the best-known examples of professions in which straight commission is the standard form of compensation. One hundred percent of such employees' compensation is dependent upon selling the customer a product, good, or service. This approach to compensation has fallen out of favor in many businesses because it can lead to salespeople to make high-pressure sales—putting undue pressure on customers to buy something so the salesperson can get paid.
- **Salary plus commission.** Similar to the straight commission, salary plus commission requires an employee to make a sale or "close a deal" in order to earn compensation. However, only a portion of the employee's compensation comes from the commission. The employer pays the employee some level of wages every pay period, regardless of his or her sales level. This reduces the necessity for high-pressure sales tactics, so long as the base salary is an adequate wage. Wait staff are essentially paid salary plus commission (they receive an hourly wage plus tips), but the hourly wage for such work can be as little as $2.10 per hour.
- **Salary plus bonus**. When an employee is paid a salary plus bonus, the bonus is not paid unless sales-volume or production goals are met or exceeded. For example, the manager of a real-estate firm may be paid a substantial salary but will earn a bonus only if the office he or she manages exceeds some pre-established sales figure for the month, quarter, or year. The advantage of a salary plus bonus is that it's tied to the performance of a department or division, thereby motivating the entire team to work together to reach organizational goals or sales targets.

Benefits

Compensation includes more than just salary, and benefits are a key legal, motivational, and organizational consideration when it comes to employee relations. Standard benefits address a range of employee needs, and they can be a key reason for employees to seek out employers who offer them. Human resource professionals must familiarize themselves with the various benefit options that are out there. The following lists the most common types of benefits:

- **Relocation assistance**: Often enough, hiring someone means moving the new employee to a different location. The talent an employer needs may come from another city or country, and attracting the right person may entail providing assistance with visas, housing, flights, and a range of other moving costs.
- **Medical, prescription, vision, and dental plans**: Particularly in countries with poor social benefits (such as the U.S.), medical insurance is a necessity for employers hiring full-time workers (sometimes it's even legally required). In countries with strong social welfare systems (such as Canada), these benefits are provided by the government.
- **Dependent care**: Many employees obtain health insurance coverage through their employer not only for themselves but for their spouse and/or children, too.
- **Retirement benefit plans (pension, 401(k), 403(b))**: Larger employers usually offer employees various retirement-related benefits such as long-term investments, pensions, and other savings for retirement. The primary draw for most of these benefits is the tax benefit (the ability to set aside pretax income for retirement savings).
- **Group term life and long-term care insurance plans**: Life insurance and long-term care are benefits paid by employers to insure individuals against various types of risks and disasters. Employees with life insurance or long-term care insurance will see their dependents (and themselves, in the case of long-term care) financially supported if a serious ailment or tragedy occurs.

- **Legal assistance plans**: Not quite as standard as the rest of the benefits above, legal assistance plans can be established for jobs in which personal liability is high. Legal assistance is expensive, and such plans draw on organizational resources to cover the employee under circumstances when legal aid is needed.
- **Child care benefits**: Supporting employees' families is absolutely critical to retaining great talent. Especially in families with two working parents, employer-covered child care is a key benefit that provides cost savings to the employee while enabling the employee to focus on work (which benefits the employer).
- **Transportation benefits**: Another common benefit is paid transportation. Particularly in countries/regions where public transportation is the norm, it's quite common for the employer to pay for all work-related transportation.
- **Paid time off (PTO) in the form of vacation and sick pay**: All organizations must provide paid time off, vacation, and sick pay under certain circumstances. Many countries have stringent legislation governing minimum requirements for paid time off and vacation leave to ensure that employees have a healthy work-life balance.

While there are other, less common benefits that employers can offer, the list above describes the standard benefits that employees can expect to encounter.

Fringe Benefits

Figure 31.13.2: One of the perks this lifeguard enjoys is the use of a company car.

The term *fringe benefits* was coined by the War Labor Board during World War II to describe the various indirect benefits that industry had devised to attract and retain labor when direct wage increases were prohibited. The term perks (from "perquisites") is often used colloquially to refer to those benefits of a more discretionary nature.

Perks are often given to employees who are doing notably well or have seniority or particularly high-value skills. Common perks are hotel stays, free refreshments, leisure activities on work time, stationery, allowances for lunch, and use of a company vehicle. When numerous options are available, select employees may also be given first choice on such things as job assignments and vacation scheduling. They may also be given first chance at job promotions when vacancies exist.

Benefits may also include formal or informal employee discount programs that grant workers access to specialized offerings from local and regional vendors (e.g., movies and theme-park tickets, wellness programs, discounted shopping, hotels and resorts, and so on). Companies that offer these types of work-life perks seek to increase employee satisfaction, boost loyalty and minimize turnover by providing valued benefits that go beyond a base salary. Fringe benefits are thought of as the costs of keeping employees (besides, of course, salary).

Practice Question

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31.14: Introduction to Termination

What you'll learn to do: describe the different HR management options for employee termination

In this section you'll learn about different types of and reasons for termination. We will differentiate between voluntary and involuntary termination and identify the types of involuntary termination and their implications for the terminated employee. We'll also discuss the implications of "at will" employment and factors that affect rehire, including the terminology "with prejudice" and "without prejudice."

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31.15: Termination

Learning Objectives

- Differentiate between voluntary and involuntary termination
- Describe the different HR management options for employee termination

Terminations can occur for a range of reasons, both voluntary and involuntary. The type of termination, however, determines the employee's future relationship with the employer (or lack thereof).

Being Fired

Being fired is usually thought to be the employee's fault and considered to be dishonorable and a sign of failure. It can hinder the job seeker's chances of finding new employment, particularly if the person has been fired from earlier jobs. Prospective employees don't always include jobs they were fired from on their résumés. As a result, employers may view unexplained gaps in employment or an applicant's refusal to provide references from previous employers as "red flags."

Being Laid Off

A less severe form of involuntary termination is often referred to as a layoff. Usually a layoff isn't strictly related to personal performance but is instead the result of economic cycles or the company's need to restructure itself, the firm itself going out of business, or a change in the function of the employer. In a postmodern risk economy, such as that of the United States, a large proportion of workers may be laid off at some point in their life for reasons other than job competence or performance.

Layoffs may occur as a result of downsizing (a reduction in the size of the workforce) or redundancy (the view that certain posts aren't needed). Such layoffs are not technically classified as firings; laid-off employees' positions are terminated and not refilled, because either the company wishes to reduce its size or operations or otherwise lacks the economic stability to retain the position. In some cases, laid-off employees may be offered back their old positions with the firm, though by that time they may have moved on to a new job.

Attrition

Some companies resort to attrition as a means of reducing their workforce. Under such a plan, the company doesn't force anyone to leave, but those who depart voluntarily are not replaced. Sometimes companies give workers the option to resign in exchange for a fixed amount of money, typically a few years of their salary. The U.S. Government under President Bill Clinton in the 1990s and the Ford Motor Company in 2005 have both followed the practice of attrition.

Mutual-Agreement Termination

Some terminations occur as a result of mutual agreement between the employer and employee. It may be a matter of debate as to whether such terminations are really mutual. In many of these cases, the employer wants the employee to quit but decides to offer a mutual-termination agreement in order to soften the firing (as in a forced resignation). There are also times when a termination date is agreed upon in an employment contract before the employment starts.

Forced Resignation

Firms that want an employee to leave of his or her own accord, but don't wish to pursue firing, may degrade the employee's working conditions, hoping that he or she will leave "voluntarily." The employee may be moved to a different geographical location, assigned to an undesirable shift, given too few hours if part time, demoted, or assigned to work in uncomfortable conditions. Companies may use other forms of manipulation to force an employee's resignation, often so they won't have to fill out termination papers in jurisdictions without at-will employment. (*At–will employment* is a term used in U.S. labor law for contractual relationships in which an employee can be dismissed by an employer without warning and for any reason—without having to establish "just cause" for termination.) In addition, with a few exceptions, employees who leave voluntarily usually cannot collect unemployment benefits. Such tactics may amount to constructive dismissal, which is illegal in some jurisdictions.

Practice Question

https://assessments.lumenlearning.co...essments/14523

Rehire Following Termination

Depending on the circumstances, one whose employment has been terminated may or may not be able to be rehired by the same employer. If the decision to terminate was the employee's, the willingness of the employer to rehire is often contingent upon the relationship the employee had with the employer, the amount of notice given by the employee prior to departure, and the needs of the employer.

In some cases, when an employee departed on good terms, he or she may be given special priority by the employer when seeking rehire. An employee may be terminated *without prejudice*, meaning that the fired employee may be rehired readily for the same or a similar job in the future. This is usually true in the case of a layoff. Conversely, a person can be terminated *with prejudice*, meaning that an employer will not rehire the former employee to a similar job in the future. This judgment can be made for a number of reasons including incompetence, misconduct, insubordination, or attitude.

Practice Question

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31.16: Introduction to HR Challenges

What you'll learn to do: discuss the challenges facing today's HR managers

In this final section, we will consider the trends impacting Human Resource professionals. Given HR's fundamental human capital management responsibility, we start the section with one of the most critical issues: retaining talent. Specifically, we will explore why employees leave and what can be done to minimize turnover. Finally, we will highlight the challenges and opportunities facing HR managers, including issues identified by Society of Human Resource Management's panel of experts.

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31.17: Reducing Turnover

Learning Objectives

- Summarize the common causes of employee turnover
- Describe HR strategies for reducing employee turnover

The following is a list of the top reasons why people change jobs:

- The downsizing or the restructuring of an organization (54 percent)
- New challenges or opportunities that arise (30 percent)
- Poor or ineffective leadership (25 percent)
- Having a poor relationship with a manager (22 percent)
- For better work-life balance (21 percent)
- Contributions are not being recognized (21 percent)
- For better compensation and benefits (18 percent)
- For better alignment with personal and organizational values (17 percent)
- Personal strengths and capabilities are not a good fit with an organization (16 percent)
- The financial instability of an organization (13 percent)
- An organization relocated (12 percent)

In a human resources context, **turnover** is the rate at which employees leave an organization. Simple ways to describe it are "how long employees tend to stay" or "the rate of traffic through the revolving door." Staff turnover can be optimal when a poorly performing employee decides to leave an organization or dysfunctional when the high turnover rate increases the costs associated with recruiting and training new employees or if good employees consistently decide to leave.

Turnover is measured for individual companies and for industries as a whole. If an employer is said to have high turnover relative to its competitors, it means that employees of that company have a shorter average tenure than those of other companies in the same industry. High turnover may be harmful to a company's productivity if skilled workers are often leaving and the worker population contains a high percentage of novice workers.

PRactice Question

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Preventing the turnover of employees is important in any business. Without them, the business would be unsuccessful. However, according to the Bureau of Labor Statistics, more and more employers today are finding that employees remain for approximately 23 to 24 months. The Employment Policy Foundation reports that it costs a company an average of $15,000 per employee turnover, which includes separation costs such as paperwork and unemployment; vacancy costs, including overtime or temporary employees; and replacement costs including advertisement, interview time, relocation, training, and decreased productivity when colleagues depart.

Research on employee job turnover has attempted to understand the causes of individual decisions to leave an organization. It has been found that lower performance, lack of reward contingencies for performance, and better external job opportunities are the main causes. Other variables related to turnover are the conditions in the external job market, the availability of other job opportunities, and the length of employee tenure.

Providing a stimulating workplace environment, which fosters happy, motivated, and empowered individuals, lowers employee turnover and absentee rates. Creating a work environment that supports personal and professional growth promotes harmony and encouragement on all levels, so the effects are felt companywide.

Continual training and reinforcement also help to develop a workforce that is competent, consistent, competitive, effective, and efficient. Beginning on the first day of work, providing individuals with the necessary skills to perform their job is important. Before the first day, it is important for the interview and hiring process to expose new hires to the mission and culture of the company, so individuals know whether the job is a good fit and their best choice.

Networking and strategizing within the company provide ongoing performance management and help build relationships among coworkers. It is also important to motivate employees to focus on customer success, profitable growth, and the company well-being. Employers can keep their employees informed and involved by including them in future plans, new purchases, and policy changes, and by introducing new employees to the employees who have gone above and beyond in meetings. Engagement with employees—by sharing information with them or giving out recognition rewards—makes them feel included and shows them that they are valuable.

In addition, when organizations pay above-market wages, the worker's motivation to leave and look for a job elsewhere is be reduced. This strategy makes sense because it is often expensive to train replacement workers.

? Practice Question

https://assessments.lumenlearning.co...essments/14526

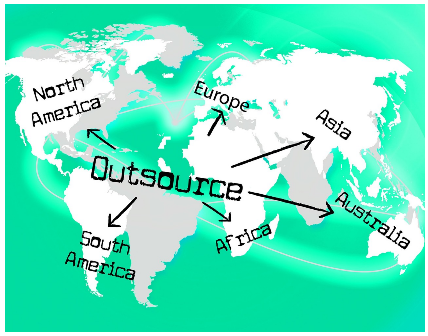
When companies hire the best people, newly hired talent and veterans are positioned to reach company goals, maximizing the investment of each employee. Taking the time to listen to employees and help them feel involved will create loyalty, which, in turn, can have a big impact on employee turnover.

Contributors and Attributions

31.18: HR Challenges

Learning Objectives

- Summarize the challenges facing today’s HR managers



Ultimately, the role of an HR manager is maintaining the level of human capital needed by the business to meet its organizational goals. In working to meet the demands for a high-quality and dedicated workforce, HR managers must cope with challenges and trends that often lie beyond their control. How they react to and address these challenges can have a big effect on the success of the organization. The following is a summary of the major challenges facing human resource managers today.

Increased Competition for Qualified Workers

As economies continue to expand, the demand for labor is increasing and companies are drawing from the same pool of skilled workers. Employees who possess skills sets that are in short supply find that they can have their pick of employers, and HR managers need to be ready to respond with benefits beyond salary, such as flexible working hours, employee-oriented working conditions, and long-term job security. The degree to which an organization is reputed to be a “great place to work” can affect the success of recruitment and retention efforts, as prospective employees now often rate employers on criteria such as CSR, intellectual-property policies, and environmental issues.

Changing Worker Demographics

With the aging of the baby-boom generation, older workers are expected to make up a much larger share of both the population and the labor force than in the past. The aging of the overall population has a significant impact on the labor pool and its growth. Populations age as a result of increases in life expectancy and/or a decrease in their fertility rates. According to the U.S. Census Bureau, the ratio of people 65 years and older to those between 20 and 64 years could **double** between now and the middle of the century. In addition, the ethnic and gender composition of the workforce is changing. Historical data and projections from the BLS shown in the table below highlight some of the trends in the demographics of the U.S. workforce.

Median age of the labor force, by gender, race, and ethnicity, 1992, 2002, 2012, and projected 2022

Group	1992	2002	2012	2022
Total	37.1	39.8	41.9	42.6
Men	37.2	39.8	41.8	42.2
Women	37.0	40.0	42.1	43.1
White	37.3	40.2	42.6	43.3
Black	35.5	38.1	39.7	40.3
Asian	36.2	38.8	40.9	42.9
Hispanic origin	32.5	34.0	36.9	38.9
White non-Hispanic	37.8	41.1	44.2	44.8
Source: U.S. Bureau of Labor Statistics.				

Increased Globalization of Economies

As countries enter into more and more global trade agreements such as the Trans Pacific Partnership (TPP), companies are finding it easier to go offshore and/or outsource key functions within the organization. When processes go offshore, an entire division of a company may be relocated to another country, eliminating jobs in the U.S. permanently. For example, Hewlett Packard laid off five hundred employees working in customer service and technical support in Conway, Arkansas, when it moved the division to India. Many colleges now outsource their bookstore services to companies such as Barnes & Noble, thus eliminating the positions associated with managing and running the college bookstore. In such cases, it often falls to the HR manager to lay off the personnel in the departments whose responsibilities have been outsourced.

Workplace Violence

While more and more information on the causes of workplace violence and ways of handling it is available, there is often no reasonable explanation for its occurrence, and, despite everything we know or do, violent situations happen. No employer is immune from workplace violence, and no employer can totally prevent it. Today's HR managers are tasked with informing employees about workplace violence policies and programs, investigating all acts of violence, threat, and similar disruptive behavior, and encouraging employees who show signs of stress or possible violence to seek counseling or help through employee assistance programs.

Employee Turnover

In a human resources context, turnover is the rate at which employees leave an organization. Simple ways to describe it are "how long employees tend to stay" or "the rate of traffic through the revolving door." Staff turnover can be beneficial when a poorly performing employee decides to leave an organization or detrimental when the high turnover rate increases the costs associated with recruiting and training new employees or if good employees consistently decide to leave. High turnover can be harmful to a company's productivity if skilled workers are steadily leaving and the worker population contains a high percentage of novice workers. HR managers must constantly be on the lookout for ways of reducing employee turnover. As you'll recall, it costs a company, on average, $15,000 when it loses an employee.

Data-Driven HR Practices

The increasing availability and importance of data represents both a challenge and opportunity for HR management. As is true in other functional areas, HR professionals are being held accountable for performance metrics and are expected to use "big data" effectively to improve decision making and prove the return on HR-related investments.[1]

? Practice Question

https://assessments.lumenlearning.co...essments/14527

These are just a few of the emerging topics and trends that today's HR managers must handle, while still recruiting, hiring, and maintaining the organizations' existing workforce. As the world becomes increasingly complex, so do the roles and responsibilities of today's human resource professionals.

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31.19: Putting It Together- Human Resource Management

Synthesis

Since the 1900s, American society has evolved, and the working conditions of employees have improved dramatically. Workplace discrimination and inequities still exist, however, and human resource professionals play an important role in reducing and eliminating them. How can such efforts impact your work life?

If your position in a company gives you human resource management responsibilities, then it is essential that you understand the employer-employee relationship from both a legal and ethical perspective. Failure to properly apply laws, regulations, and policies in your management of the workforce can result in high turnover rates, grievances, and even worse—lawsuits. A discrimination lawsuit can potentially be a death blow to a company, displacing hundreds or thousands of workers and negatively impacting the economy.

If you are an employee, then it's crucial for you to understand your rights under employment law. Knowing and exercising your rights is important not only for your own protection but for the general progress of improving conditions, pay, and benefits for other workers. Human resource managers are skilled in these areas and are a resource for employees should they experience discrimination, unfair treatment, or unsafe working conditions.

Recall the nineteenth-century workers you read about at the start of this module—they didn't have a human resource manager to act as their advocate in the face of dismal and dangerous conditions. Today, the work environment for most employees is certainly better—not perfect, but better. Just how much has it improved? Take a few minutes to watch the following video to see just how far we've come.

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/afm/?p=768

You can view the transcript for "Office Space – Jansen" (link opens in new window) or the text alternative for "Office Space – Jansen" (link opens in new window.

Summary

Human Resource Management

Human resource managers are responsible for the activities needed to recruit, hire, train, develop, and retain a workforce that meets the requirements of the companies strategic human resource plan. At all levels within the organization, the process of hiring workers results from a process of job analysis, operational planning, and the careful crafting of job descriptions that set out clear requirements for job performance.

Human Resources and Laws

Federal and state legislation have been enacted to prevent discrimination, set minimum wages, establish maximum work hours, and set standards for health and safety. Laws such as the ADA, EEOC, and the Civil Rights Act combine to create a work environment that affords workers protection from discrimination and exploitation.

Recruitment and Hiring

HR professionals manage the recruitment process in order to identify the pool of qualified applicants. Both internal and external candidates are selected based on job specifications, which are the result of an analysis of the job/position.

Training, Development, and Rewards

Once employees are hired, the HR managers must manage the process by which employees are trained and compensated, and also evaluate their performance. Performance evaluations involve setting goals, completing a formal written evaluation, communicating the results to the employee, and then taking corrective action where needed. HR professionals also oversee employees' professional development.

Termination

Terminations can occur for a range of reasons, both voluntary and involuntary. Types of termination include layoffs, being fired, attrition, mutual-agreement termination, and forced resignation. Some states allow at-will employment, which means that an employee can be dismissed by an employer without warning and for any reason—without the employer having to establish "just cause" for termination. Of course, the flip side is also true: employees can quit without notice or cause.

Challenges in Human Resource Management

The future holds many challenges for HR Managers. An aging workforce, increased diversity, working from home, and advances in technology all create an environment that brings new challenges to human resources.

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31.20: Discussion- People Won’t Work for Dog Treats!

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document “Salty Pawz Background.”

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda is concerned about how much it will cost her to pay all of the new employees she needs to hire in order to expand her business. She has been profitable, but isn’t making millions. She is thinking she might be able to pay some employees a salary, but looking at some of the employment Web sites, she is shocked to see how much some of the positions she needs to fill are demanding in her market. She is becoming discouraged and thinks that maybe the expansion of Salty Pawz will have to be placed on hold until she can figure out this whole employee pay thing.

For Discussion

1. As you have learned in this module, Wanda has several options for paying employees, such as salary, payment by piecework, time rate, and differential time rate. Other options include straight commission, salary plus commission, and salary plus bonus. Which would you recommend she use?
2. Would you recommend that Wanda use a single pay plan for *all* of the positions she needs to hire or are some pay methods better suited to some positions than others are? Remember, her employees will eventually cover the following areas:
    1. Production/Inventory/Warehousing
    2. Administrative Support
    3. Retail/Marketing/Customer Service
    4. Shipping
3. Thinking about a job you have now, have had in the past, or hope to have in the future, how would you prefer to be paid and why? Chances are very good that Wanda’s employees are not so different from you!

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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31.21: Discussion- Are Interviews a Waste of Time?

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

Whether for a full- or part-time job, a summer job, a work-study position, or volunteer work, almost everyone in your class has been interviewed. If you haven't been interviewed yet, then it's something you have to look forward to!

Interviews are the most widely used form of employee selection, but as Google HR manager Lazlo Blok said, "Most interviews are a waste of time, because 99.4 percent of the time is spent trying to confirm whatever impression the interviewer formed in the first ten seconds."

For Discussion

- Why do you think interviews are ineffective at determining a prospective employee's potential to be successful and perform well on the job?
- What can human resource managers do in order to make the interview process a more reliable indicator of an individual's ability to be successful?
- What alternatives to interviews would you recommend if you were a human resource manager? Is there something you would add to the hiring process to make it more reliable?
- If you have been interviewed for a job, what, if anything, did the interviewer do that you believe made the process more or less reliable?

Posts 2 and 3: Respond to Classmates' Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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31.22: Assignment- Wanda's Hiring Approach, or How to Be Sued in One Easy Lesson

Scenario

With her decision to expand Salty Pawz, Wanda needs a workforce. However, she has never interviewed or hired anyone in her life. While putting labels on bags of dog treats one afternoon, you ask Wanda how she intends to recruit and select her workforce. She smiles and says, "Well, for once I have a plan!" You can't wait to hear her plan, and you feel that maybe after all this time she is getting the hang of running Salty Pawz like a business effectively.

Wanda's plan is to place an ad in a local newspaper and have people who are interested in working for her stop by the local coffee shop to speak with her. She thinks that filling out application forms at this point is premature, so she will have them leave their name and phone number in her planner for now. Wanda doesn't have any particular questions in mind to ask the applicants. Instead, she thinks it is more natural to just let the conversations evolve, so she can figure out who she "clicks with." She doesn't want them to feel like they are being interrogated! However, she is particularly interested in hiring mothers with young children who can start work after they drop their kids at school. She also is going to keep her eyes open for at least one young man, because sacks of flour are heavy. The only thing she is certain about is asking each person for his or her salary requirements, so she can set her pay schedule and budget accordingly.

Your Task

- Explain to Wanda why virtually everything in this hiring plan is a bad idea based on the key role that human resource management plays in the success of her business.
- Be sure to inform Wanda about the laws that govern the employer-employee relationship and what could happen if she became the subject of an employee lawsuit. (For reference, Wanda's business is located in the state of North Carolina.)

Grading Rubric

Sample Grading Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Explain the role of human resource management in the success of a business.	0 points	11 points	16 points	20 points	20%
Describe hiring strategies appropriate for Salty Pawz expansion.	0 points	11 points	16 points	20 points	20%
Summarize the laws that govern employer-employee relationships.	0 points	11 points	16 points	20 points	20%
Explain the consequences if Salty Pawz became the subject of an employee lawsuit.	0 points	11 points	16 points	20 points	20%

Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	11 points	16 points	20 points	20%

Total points possible: 100

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31.23: Assignment- Career Choices

Preparation

For this assignment you will explore options available to you either in your current field or a field you are interested in. The key to this exploration is not just to uncover opportunities but to determine the qualifications, skills, and abilities that employers are seeking.

Your Task

1. Visit one of the job Web sites such as Snagajob.com or Indeed.com, and search for a position that meets your requirements for a great job.
2. Describe the position you identify (you can copy and paste the posting into your paper if you prefer).
3. What is it about this position that appeals to you? Be specific.
4. What are the minimum job requirements for the position in terms of education, experience, skills, knowledge, or abilities?
5. Compare the job requirements to your own qualifications. How close are you to meeting them?
6. If there is a difference between what the job requires and the qualifications you now possess, what, specifically, are you doing or can you do in the future to close that gap?

Remember, your submission must follow the Guidelines for Written Assignments provided, including the requirements for length, formatting, and citations.

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CHAPTER OVERVIEW

32: Module 16- Accounting and Finance

32.1: Why It Matters- Accounting and Finance

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

Figure 32.1.1: 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. "Billy Joel Biography." Billy Joel Official Site. Accessed June 25, 2019. http://www.billyjoel.com/biography. ↵

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32.2: Introduction to Accounting in Business

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

In this section, we'll define accounting, accounting terms such as GAAP or Generally Accepted Accounting Principles and associated regulatory bodies, including the FASB or Financial Accounting Standards Board. We'll discuss the three primary audiences for accounting information and the form or language each expects information to be presented in. Finally, we'll discuss how each audience or stakeholder group uses accounting information.

32.3: What Is Accounting?

Learning Objectives

- Explain the role of accounting as a form of business communication
- Identify the users and uses of financial accounting
- Identify the users and uses of managerial accounting

Why Do We Need Financial Information?

Businesses have large groups of stakeholders who have a vested interest 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?

You can view the transcript for “Accountant Jobs – What is Accounting ?” (opens in new window).

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 "establish and improve financial accounting and reporting standards to provide useful information to investors and other users of financial reports and educate stakeholders on how to most effectively understand and implement those standards."[1]

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.

? Practice Questions

https://assessments.lumenlearning.co...essments/14528

https://assessments.lumenlearning.co...essments/14529

https://assessments.lumenlearning.co...essments/14530

1. "FASB, Financial Accounting Standards Board." FAS 131 (as Issued). Accessed March 01, 2019. https://fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495. ↵

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32.4: Introduction to 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.

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32.5: Financial Statements

Learning Objectives

- Define the accounting equation
- Identify the use and components of the balance sheet
- Identify the use and components of the income statement
- Identify the use and components of the statement of owner’s equity
- Identify the use and components of the statement of cash flows

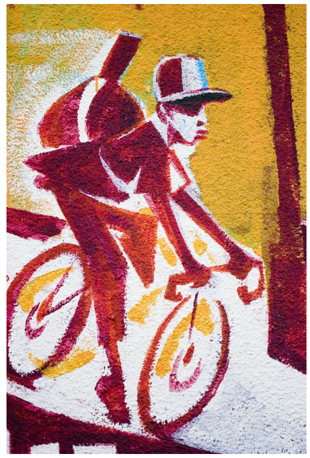
Financial statements are the means by which companies communicate their story. Together these statements represent the profitability and financial strength of a company. The financial statement that reflects a company’s profitability is the **income statement**. The **statement of owner’s equity**—also 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.

You can view the transcript for “Financial Statements – An Introduction” (opens in new window) or the text alternative for “Financial Statements – An Introduction” (opens in new window).



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

Item	Item Type	Dollar Amount
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

? Practice Question

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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	
Cash	$ 66,800
Accounts Receivable	5,000
Supplies	500
Prepaid Rent	1,800
Equipment	5,500
Truck	8,500
Total Assets	**$ 88,100**
Liabilities	
Accounts Payable	$ 200
Total Liabilities	**$200**
Equity	
Common Stock	$ 30,000
Retained Earnings	57,900
Total Equity	**$ 87,900**
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.

Practice Questions

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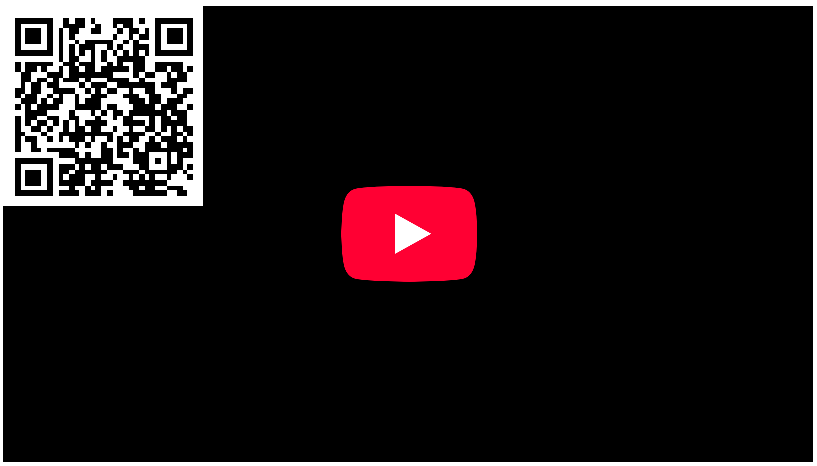
Statement of Cash Flows

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.



You can view the transcript for "Cash Flow Introduction" (opens in new window) or text alternative for "Cash Flow Introduction" (opens in new window).

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, if a company issued a mortgage note to acquire land and buildings.

? Practice Question

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32.6: Financial Statements- Interconnectivity

Learning Objectives

- Explain how the balance sheet, income statement, statement of owner’s equity, and statement of cash flows are connected

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

You can view the transcript for “Financial Statements – Interconnectivity” (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/14536

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32.7: Introduction to 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."

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32.8: Finding the Break-Even Point

Learning Objectives

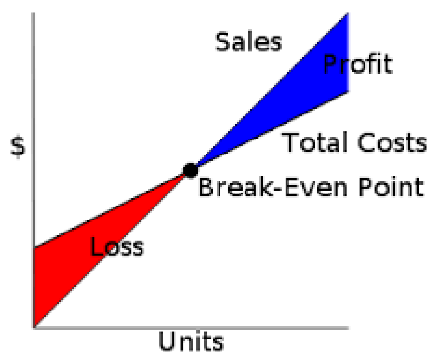
- Define the break-even point
- Differentiate between fixed and variable costs
- Calculate the break-even point
- Calculate the contribution margin
- Calculate the contribution margin ratio
- Calculate the margin of safety

Try It

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

You can view the transcript for “Break-Even Analysis – How to Calculate Your Safe Point” (opens in new window) or the text alternative for “Break-Even Analysis – How to Calculate Your Safe Point” (opens in new window).

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.

? Practice Questions

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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:

Variable and Fixed Costs of a Lemonade Stand

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

? Practice Questions

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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:

$$\begin{aligned} \text{BE units} &= \frac{\text{Fixed Costs}}{\text{Contribution Margin per unit}} \\ \text{BE units} &= \frac{\text{40,000 USD}}{\text{8 USD per unit}} \\ \text{BE units} &= \text{5,000 units} \end{aligned} \tag{32.8.1}$$

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.

$$\text{BE dollars} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Ratio}} \tag{32.8.2}$$

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:

$$\text{Contribution Margin Ratio} = \frac{\text{Contribution Margin per unit}}{\text{Selling Prince per unit}} \tag{32.8.3}$$

$$\frac{\text{USD 20 - USD 12}}{\text{USD 20}} = \frac{\text{USD 8}}{\text{USD 20}} = 0.40 \tag{32.8.4}$$

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:

$$\text{Contribution Margin Ratio} = \frac{\text{Total Contribution Margin}}{\text{Total Revenues}} \tag{32.8.5}$$

$$\frac{\text{USD 48,000}}{\text{USD 120,000}} = 0.40 \tag{32.8.6}$$

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:

$$\text{BE dollars} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Rate}} \tag{32.8.7}$$

$$\text{BE dollars} = \frac{\text{USD 40,000}}{0.40} = \text{USD 100,000} \tag{32.8.8}$$

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:

Break-Even Analysis Data for Wonderfood

	Product 1: Raisin Flakes		Product 2: Sugar Wheat		Product 3: Rice Cereal		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:

$$\text{BE units} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Ratio}} \tag{32.8.9}$$

$$\text{BE units} = \frac{\text{USD 50,000}}{0.40} = \text{USD 125,000} \tag{32.8.10}$$

[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:

$$\text{Margin safety} = \text{Current sales} - \text{Break-even sales} \tag{32.8.11}$$

$$= \text{USD } 120{,}000 - \text{USD } 100{,}000 \tag{32.8.12}$$

$$= \text{USD } 20{,}000 \tag{32.8.13}$$

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

$$\text{Margin of Safety Rate} = \frac{\text{Current Sales} - \text{Break Even Sales}}{\text{Current Sales}} \tag{32.8.14}$$

$$\frac{\text{USD } 120{,}000 - \text{USD } 100{,}000}{\text{USD } 120{,}000} = 16.67\ \% \tag{32.8.15}$$

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

Practice Question

https://assessments.lumenlearning.co...essments/14542

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32.9: Simulation- The Rise of the Business Guru

Learning Objectives

- Define the break-even point
- Differentiate between fixed and variable costs
- Calculate the break-even point
- Calculate the contribution margin
- Calculate the contribution margin ratio
- Calculate the margin of safety

Try It

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

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- The Rise of the Business Guru. **Authored by**: Clark Aldrich for Lumen Learning. **License**: *CC BY: Attribution*

32.10: Introduction to 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.

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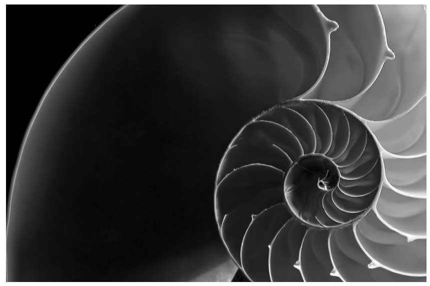
32.11: Financial Ratio Analysis

Learning Objectives

- Explain how financial ratios are used
- Calculate the current ratio using information from financial statements
- Calculate the acid-test (quick) ratio using information from financial statements
- Calculate inventory turnover using information from financial statements



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.” By using liquidity ratios to assess risk and equity ratios to assess profitability (as well as other ratios), you can easily assess and compare different companies.

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:

Financial Ratios

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

Ratio	Use	Components
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.

Practice Question

https://assessments.lumenlearning.co...essments/14543

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:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} \tag{32.11.1}$$

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:

Current Ratio Values for Synotech and Company B

Current Ratio Variables	**Synotech**	**Company B**
Current assets (variable a)	$ 2,846.7	$120.0
Current liabilities (variable 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.

? Practice Question

https://assessments.lumenlearning.co...essments/14544

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:

$$\text{Acid Test Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} \tag{32.11.2}$$

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 (dollar values are in USD millions):

Synotech Acid Test Values for 2010 and 2009

Period Ending (all amounts in USD Millions)	December 31, 2010	December 31, 2009
Quick assets (variable a)	$1,646.6	$1,648.3
Current liabilities (variable b)	2,285.6	2,103.8
Net quick assets (a – b)	$ (639.0)	$ (455.5)
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.

? Practice Question

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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:

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \tag{32.11.3}$$

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 is about 63 and 62 (365/5.76 and 365/5.85) in 2010 and 2009, respectively.

Inventory Turnover Variables	2010	2009
Cost of goods sold (variable a)	$5,341.3	$5,223.7

Merchandise inventory:		
January 1	$929.8	$856.7
December 31	$924.8	$929.8
Total Merchandise Inventory (variable b)	$1,854.6	$1,786.5
Average inventory (variable 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.

Practice Question

https://assessments.lumenlearning.co...essments/14546

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. All values shown are in USD Millions.

Xerox Corporation	
Balance Sheet	
December 31, 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**

Supplementary data for Xerox:

- 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.

Answers

1. Current ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{USD }13{,}022{,}000{,}000}{6{,}268{,}000{,}000} = 2.08{:}1 \tag{32.11.4}$$

2. Acid-test ratio:

$$\frac{\text{Quick Assets}}{\text{Current Liabilities}} = \frac{\text{USD }9{,}119{,}000{,}000}{6{,}268{,}000{,}000} = 1.45{:}1 \tag{32.11.5}$$

3. Inventory turnover:

$$\frac{\text{Net Sales}}{\text{Average Inventory}} = \frac{\text{USD }18{,}701{,}000{,}000}{2{,}111{,}000{,}000} = 1.45{:}1 \tag{32.11.6}$$

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

Contributors and Attributions

32.12: Introduction to Ethical Practices in Accounting

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

Stakeholders rely on accurate accounting information to make decisions that have financial and human implications at the individual, business, societal and the macroeconomic level. In this section you'll be introduced to the primary associations for accounting professionals and gain perspective on the guidance they provide to help practitioners evaluate ethical dilemmas. This section also outlines key provisions of the Sarbanes-Oxley Act, its enforcement and implications for auditors, senior executives and major stockholders.

Contributors and Attributions

32.13: Ethics in Accounting

Learning Objectives

- Discuss the consequences of unethical practices in the accounting profession
- Discuss the impact of the Sarbanes-Oxley Act on accounting practices

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.

You can view the transcript for “Tax Shelters” (opens in new window) or the text alternative for “Tax Shelters” (opens in new window).

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.

The AICPA (American Institute of Certified Public Accountants) has its own **Code of Professional Conduct** that prescribes the ethical conduct members should strive to achieve. Similarly, the Institute of Management Accountants (IMA)—the primary national organization of accountants working in industry and government—has its own code of ethics, as does the Institute of Internal Auditors—the national organization of accountants providing internal auditing services.

The AICPA issued guidance to help CPAs solve ethical dilemmas not explicitly addressed in the code. Even though this guidance is for CPAs, it makes sense for anyone facing an ethical dilemma:

- Recognize and consider all relevant facts and circumstances, including applicable rules, laws or regulations,
- Consider the ethical issues involved,
- Consider established internal procedures, and then
- Formulate alternative courses of action.
- After weighing the consequences of each course of action, you select the best course of action based on your own judgment.

It is important to note that these codes of ethics only apply to members of their respective organizations. Thus, 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.

Practice Question

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The Sarbanes-Oxley Act

Senator Paul Sarbanes and Representative Michael G. Oxley, the co-sponsors of the Sarbanes–Oxley Act

Figure 32.13.1: Senator Paul Sarbanes and Representative Michael G. Oxley, the co-sponsors of the Sarbanes–Oxley Act

Over the past 15 years, a number of accounting reforms have been put in place to set better standards for accounting, auditing, and financial reporting. Investors, now aware of the possibility of various accounting shenanigans, are avoiding companies that use complicated financial structures and off-the-books financing.

In 2002, the **Sarbanes-Oxley Act** (commonly referred to as SOX) went into effect. This law, one of the most extensive pieces of business legislation passed by Congress, was designed to address the investing public's lack of trust in corporate America. It redefines the public corporation–auditor relationship and restricts the types of services auditors can provide to clients. The Act clarifies auditor-independence issues, places increased accountability on a company's senior executives and management, strengthens disclosure of insider transactions (an employee selling stock based on information not known by the public), and prohibits loans to executives.

An independent five-member Public Company Accounting Oversight Board (PCAOB) was given the authority to set and amend auditing, quality control, ethics, independence, and other standards for audit reports. The Act specifies that all PCAOB members be financially literate. Two members must have their CPA designation, and the other three cannot be or have been CPAs. Appointed and overseen by the Securities and Exchange Commission (SEC), the PCAOB can also inspect accounting firms; investigate breaches of securities law, standards, competency, and conduct; and take disciplinary action. The corporate Board registers public accounting firms, as the Act now requires. Altering or destroying key audit documents now carries felony charges and increased penalties.

Other key provisions of the Act cover the following areas:

- **Auditing standards:** The Board must include in its standards several requirements, such as maintaining audit work papers and other documentation for audit reports for seven years, the review and approval of audit reports by a second partner, and audit standards for quality control and review of internal control procedures.

- **Financial disclosure:** Companies must clearly disclose all transactions that may have a material current or future effect on their financial condition, including those that are off the books or with unconsolidated entities (related companies whose results the company is not required to combine with its own financial statements under current accounting rules). Management and major stockholders must disclose transactions such as sales of company stock within two days of the transaction. The company must disclose its code of ethics for senior financial executives. Any significant changes in a company's operations or financial condition must be disclosed "on a rapid and current basis."
  Financial statement certification: Chief executive officers and chief financial officers must certify company financial statements, with severe criminal and civil penalties for false certification. If securities fraud results in restatement of financial reports, these executives will lose any stock-related profits and bonuses they received prior to the restatement.
- **Internal controls:** Each company must have appropriate internal control procedures in place for financial reporting, and its annual report must include a report on implementation of those controls to assure the integrity of financial reports.
- **Consulting work:** The Act restricts the non-auditing work auditors may perform for a client. In the past, the large accounting firms had expanded their role to include a wide range of advisory services that went beyond their traditional task of validating a company's financial information. Conflicts of interest arose when the same firm earned lucrative fees for both audit and consulting work for the same client.[1]

Other regulatory organizations also took steps to prevent future abuses. In September 2002, the AICPA Auditing Standards Board (ASB) issued expanded guidelines to help auditors uncover fraud while conducting audits. The New York Stock Exchange stiffened its listing requirements so that the majority of directors at listed companies must be independent and not employees of the corporation. Nor can auditors serve on clients' boards for five years. Companies listed in the Nasdaq marketplace cannot hire former auditors at any level for three years.

In response to the passage of Sarbanes-Oxley and other regulations, companies implemented new control measures and improved existing ones. The burdens in both cost and time have been considerable. Many companies had to redesign and restructure financial systems to improve efficiency. Some finance executives believe that their investment in increased controls has improved shareholder perceptions of their company's ethics. Others, however, reported that costs depressed earnings and negatively affected stock prices. Despite the changes and costs associated with SOX compliance, 15 years after the law's implementation, many business executives believe that the process has helped them fine-tune financial activities and reporting while addressing dynamic changes in the market and other economic challenges.[2]

? PRactice Question

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

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1. "A Guide to the Sarbanes-Oxley Act," http://www.soxlaw.com, accessed August 11, 2017; Ken Tysiac, "Companies Spending More Time on SOX Compliance," *Journal of Accountancy*, http://www.journalofaccountancy.com, June 12, 2017. ↵
2. "Fine-Tuning the SOX Compliance Process," https://www.protiviti.com, accessed August 11, 2017. ↵

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32.14: Putting It Together- Accounting and Finance

Synthesis

Whether or not this module convinced you to pursue a career in accounting, by now you have acquired a working knowledge of some of the basics of financial accounting, as well as the importance of accuracy in the presentation of financial information to stakeholders. Whether you are running a bake sale or a multinational corporation, understanding the relationship between revenues and expenses is critical for success. The misdeeds of corporate executives and their accountants have peppered the news for the last decade; but, the vast majority of accountants and their clients follow a strict code of ethics and observe the laws and guidance provided by Congress, FASB, and AICPA. One of the best ways to protect yourself and your business against becoming involved in a financial scandal is to have a solid working knowledge of basic accounting principles so that you can recognize and correct any irregularities.

Summary

Accounting in Business

In short, accounting is the language of business—all business. Accounting represents all of the financial transactions of a business in a format that can be interpreted and understood by both internal and external stakeholders.

Key Financial Statements

When businesses present their financial condition to external stakeholders, taxing authorities, investors, and the general public, the most common format for this information is one of four key financial statements. These four statements are the Balance Sheet, Income Statement, Statement of Owners Equity, and Statement of Cash Flows. These four statements, although representing different facets of the company's finances, are all interconnected and create a birds-eye view of the company's financial position.

Break-Even Point

Businesses, both large and small, are concerned with determining the point at which their revenues exceed their expenses and they begin to make a profit. The point at which revenue equals expenses (and profit is therefore $0) is called the break-even point.

Financial Ratios

Financial ratios allow business to represent the relationships between components of their financial operations as ratios. Financial ratios are used to measure a firm's financial health in four areas: liquidity, long-term solvency, profitability tests, and the market. These ratios can be used to compare the company's performance across periods (months, quarters, years) or to similar companies within the same industry.

Ethical Practices in Accounting

Certified public accountants (CPAs) and certified management accountants (CMAs) are bound to the Code of Ethics established by their licensing bodies. Generally accepted accounting principles (GAAP) and the Financial Accounting Standards Board (FASB) have established practices designed to ensure that the financial status of a company is "fairly and accurately" presented. Legislation such as the Sarbanes-Oxley Act has been passed by Congress to strengthen the emphasis on ethical practices in accountancy. Although stories of unethical conduct by companies such as Enron, WorldCom, and HP have made headlines, the overwhelming majority of individuals working as internal or external accountants follow the code of ethics and work hard to ensure that the information provided to stakeholders is fair and accurate.

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32.15: Discussion- Cooking More Than Dog Treats

General Discussion Instructions

In order to prepare for this assignment, READ the information contained in the document “Salty Pawz Background.”

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda is reviewing her tax returns from the previous year and is shocked at how much tax she paid the government. She had good income but had to pay a large number of self-employment taxes on top of her normal federal and state tax liabilities. She slumps back onto the sofa and tells Cosmo, “You know, Cosmo, some days I feel like I work for nothing. The government gets to keep more of my money than I do.” He just wags his tail, thinking she is talking about how handsome he is.

Wanda can’t get her tax bill off her mind and decides that she is going to handle this the way “rich people do” and start keeping two sets of books—one for her and one for the tax man. After all, since she is the sole proprietor, no one really has to know how much she really takes in from selling dog treats. She starts to plan how she is going to make this work, but as her plan comes together, she feels increasingly uncomfortable about her decision.

For Discussion

1. What are the legal and ethical consequences of Wanda keeping two sets of financial records and failing to report all of the income from Salty Pawz?
2. Even though Wanda is a sole proprietor, who else could be harmed by her actions?
3. Are there long-term problems she could be creating for herself that she doesn’t see at this point? If so, what are they?

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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32.16: Discussion- CPAs and Financial Crisis

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for details regarding how your performance will be assessed. NOTE: Please be certain to read the entire discussion assignment since in some cases there is more than one question you need to discuss, respond to, or address. Be sure that you have answered the entire question!

Post 1: Initial Post

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the 100–200-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Preparation

- Watch the two videos posted below:

You can view the transcript for “Financial Fraud Public Service Announcement” (opens in new window) or the text alternative for “Financial Fraud Public Service Announcement” (opens in new window).

You can view the transcript for “Bank Official Discusses Laundering Money” (opens in new window) or text alternative for “Bank Official Discusses Laundering Money” (opens in new window).

After watching the videos, complete the following steps:

- Follow the link to the AICPA’s Web site, and read Section 53 (Article II): The Public Interest: AICPA Code of Professional Responsibility Section 53
- Follow the link and read the Wikipedia article: “The Financial Crisis of of 2007–2008.”

For Discussion

Consider what you have read in your course materials, watched in the videos, learned from the Wikipedia article and from what the AICPA Web site says about ethics and the duty of the CPA in regard to the public interest. Based on this information, respond and discuss to the following statement: “CPAs should have been able to prevent the global financial crisis of 2007–2008.” Do you agree or disagree? Support your position.

Posts 2 and 3: Respond to Classmates’ Posts

Instructions

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the 75–100-word range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to extend discussions already taking place or pose new possibilities or opinions not previously voiced. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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32.17: Assignment- Bison Are Biting into Wanda’s Break-Even Point

Scenario

Wanda has analyzed her sales figures and decided that she is charging too much for Bison Bites, because they only represent 5 percent of her total income. She has a good profit margin on them, so she believes she can reduce the price by $0.25 per biscuit and still make the product profitable.

She comes to you with the proposal above, along with a few related questions. She has provided you with income and expense information to help you figure this out what she should do.

Note: An Excel spreadsheet with financial information needed to complete this assignment has been provided here: Salty Paws Written Assignment Excel Spreadsheet: Break Even Analysis.

Your Task

Help Wanda answer the following questions:

1. What effect will this price reduction have on Salty Pawz’s break-even point? Assume that the product sales mix remains unchanged. (Tip: Remember that because Bison Bites are included in the Party Pooch, the price change on Bison Bites would also affect the sales price of the Party Pooch.)
2. If Wanda reduces the price on the Bison Bites to $1.50, she believes it will cause customers buying Chicken Cuties to switch to the Bison Bites. The revised product mix is provided in the table below. What is the effect on Wanda’s break-even point if she reduces the bison product price and customers buy more Bison Bites and fewer Chicken Cuties? (Tip: Remember that because Bison Bites are included in the Party Pooch, the price change on Bison Bites would also affect the sales price of the Party Pooch.)
3. In addition to the numbers, provide Wanda with a written explanation of the changes to her break-even point under both of the scenarios presented.

Revised Product Mix

Products/Services	**% of Sales**
Party Pooch	45%
Chicken Cuties	13%
Bison Bites	10%
Lamb Lovies	32%

Grading Rubric

Sample Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Calculate the break-even point for the new prices if the product mix remains unchanged.	0 points	11 points	16 points	20 points	20%

Calculate the break-even point if the bison product price is reduced, assuming customers buy more Bison Bites and fewer Chicken Cuties.	0 points	11 points	16 points	20 points	20%
Illustrate the break-even points calculations.	0 points	11 points	16 points	20 points	20%
Predict the effects of the new prices based on the break-even point calculations.	0 points	16.5 points	24 points	30 points	30%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	5.5 points	8 points	10 points	10%

Total points possible: 100

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32.18: Assignment- Claire's Cuttery

Your Task

Using the information provided below, answer the series of questions presented in Part I and Part II, below. When preparing your written submission, include both your calculations and your written analysis of the financial information. Download Claire's Income Statement, which you'll need to complete this assignment.

Claire's Cuttery

Claire has always loved working with hair and beauty products and has decided that she will quit her day job and use the money her grandfather left her to start a salon. All of her friends think it's a great idea, but her brother cautions her about "leaping before she looks." She decides that, before she begins, she will project her sales for the first year to prove to her family that she has a winning idea.

She sits down with paper and pencil and completes the expense part of the Income Statement shown in the file "Claire's Income Statement." But she needs help projecting her sales, so using the following assumptions and information, complete the **"Income" section** of the Income Statement for her.

PART 1: Year 1 Projections

Her Business

Claire will have 3 stylists available. For planning purposes, she assumes the following:

- Each stylist can accommodate 6 customers per day. The stylists each work 20 days per month.
- Claire also acts as a stylist, but she can only accommodate 4 customers per day since she also serves as receptionist. However, since it is her business, she works 6 days per week (24 days per month).
- She has estimated, on average, that each customer will generate $12.00 in revenue.
- She estimates that based on her research, it will cost her about $2.50 in supplies per customer/per cut.
- She will operate January through December and close the month of February for a vacation at her favorite ski resort.

Market Share

There are 8 other salons in the area that will compete for business. Claire has talked to the local Chamber, and they estimate that about 15,000 people now live in her town. She assumes that she can capture about 24% of the market.

Sales Projections for Year 1

She assumes that the sales volume will be distributed as follows:

- January: 5% of annual sales
- February: CLOSED
- March: 10% of annual sales
- April: 10% of annual sales
- May: 10% of annual sales
- June: 20% of annual sales
- July: 5% of annual sales
- August: 5% of annual sales
- September: 10% of annual sales
- October: 10% of annual sales
- November: 5% of annual sales
- December: 10% of annual sales

Part I: Questions

1. What is the maximum number of customers Claire can take in any one month based on her assumptions, and assuming a 30-day month? Is this enough to meet her market and sales projections, or does she have to reduce the sales projections because she runs out of capacity?
2. Can Claire accommodate 20% of her annual sales in one month (June), given that she has only 3 stylists available? How should she address this?

3. Will she show a profit or a loss for the business if she achieves her sales figures as projected?

Part **II:** REVISED Year 1 Projections

Good news for Claire! Four local competitors don’t reopen in December, and Claire gets 34% (rather than the projected 24%) of the market. She believes that she will be able to reach her goals if she makes the following changes:

- Each stylist will accommodate 1 additional customer per day if she extends her salon hours.
- Claire now serves 5 customers per day, instead of 4.

With this increased market share, she has adjusted her operating expenses to include the following changes:

- The landlord levies a new common area maintenance fee of that will increase her rent by $75.00 per month.
- She hires a receptionist for $400 per month to free up her time.
- Her utilities costs increase because of the extended hours.

She needs you to adjust her sales projections and produce a new income statement for the year. (Use the “REVISED Year 1” worksheet that has been provided in the file you downloaded above.)

Part II: Questions

1. Will Claire be able to meet the revised sales projections? If not, what do you think she should do?
2. Under her current structure, will Claire be able to meet the demand for her services? If not, how can she address this?
3. Will she show a profit or a loss for the business if she achieves her sales figures as projected?

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CHAPTER OVERVIEW

33: Module 17- Using Technology to Manage Business Information

33.1: Why It Matters- Using Technology to Manage Business Information

Why learn how technology is used to manage business information?

In this module you will learn ways in which businesses use technology to turn data into information and then use that same technology to manage that information. In the 90s we talked about the dawn of the "digital age" where old processes were quickly converted to digital processes. That digital age of the 1990s and 2000s evolved into what we now refer to as the "information age." Technology has progressed so rapidly that businesses are able to capture billions of bytes of data everyday. This data is analyzed and converted into information and consequently we now consider ourselves to be living in the "information age." The primary characteristic of this information age is successful businesses are able to leverage information to create and maintain a competitive advantage over the competition. In fact, in today's world almost every aspect of business operations is impacted by technology to some extent. But, before we begin our discussion of technology, information and business, let's get some perspective on the "information age" in the video that follows.

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33.2: Introduction to Technological Changes in Business

What you'll learn to do: Discuss the role of technology in business

Not since the industrial revolution has business experienced such rapid and profound changes as it has seen since 1990 and the launch of the World Wide Web. Since the days of dial-up, access to the Internet is available almost everywhere. It is rare these days for consumers to go into a coffee shop, library or any place of business and not be able to access a Wi-Fi signal. If there isn't a Wi-Fi signal in close range, most people still have access to the Internet via their cellular data connection on their smartphones and personal hotspots, no problem. With this anywhere/anytime access to the Internet, businesses created web applications to answer common needs of consumers. These applications can do everything from tracking food portions to sending massive amounts of information in a click of a button.

More people and companies are using cloud-based services for their business and store everything online instead of on a single device. This change will continue to have an enormous impact on the way business is done, transforming our once-traditional office environments and how people interact with companies on a regular basis. Flash drives are almost extinct with the prevalence of cloud storage, like iCloud, Google Drive, Dropbox and FTP sites. With so many new technologies permeating the way people access information and access each other, the forward momentum looks promising for future technological developments.

In this module we will examine how these technological advances have impacted business.

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33.3: Using Technology

Learning Objectives

- Describe the types of technology used in business

Think about how you conduct business today as a consumer. The way that consumers identify and ultimately purchase products, goods and services has changed at an exceedingly rapid pace. This is a direct result of advances of the technology available to today's businesses. What most consumer do not see are the wide range of new and evolving technologies that businesses employ in the development, production and distribution of those products, goods and services. Although the type of technology a business employs is determined by their operations, we can classify the technologies used in business into several broad categories.

1. **Computers**. Desktop computers loaded with office and productivity software packages allow workers to write letters, analyze financial information, send and receive emails, and design sales presentations. The computer itself could be a desktop model with a separate monitor and keyboard, or a mobile laptop. There are two main types of computers. Personal computers (PCs) operate using Microsoft Windows are the most common, and Macintosh Computers using Apple Computer's operating system are popular among creative professionals.
2. **Software**. Software is loaded onto a computer to provide specific types of functionality. Software ranges from word processing programs such as MSWord to highly complex programs that allow developers to create virtual 3D images of a new product. Literally millions of software applications are available to business and selecting the most appropriate software to accomplish the business's objectives occupies much of the time of Information Technology personnel. For example, artificial intelligence/machine learning (AI) continues to gain in importance. Some estimates show that nearly 40 percent of businesses may be using AI to automate their processes by as early as 2019. Businesses are hoping that these AI programs will execute specific tasks, allowing businesses to gain a competitive edge and provide a higher-quality service experience for consumers.
3. **Networking**. Computers are often linked to form a network. This allows people within an organization to share documents or information, provide a central repository to store documents, or for people to communicate using email within an office. They also allow several computers to share a printer or storage device. A network can be limited to computers within a shared office, or span across multiple offices and locations.
4. **Telephone Systems.** You may not think of something as traditional as a telephone system as a technology, but today's business phone systems are quite complex. The most common type of phone system consists of a hardware unit that uses software to split the phone company line among individual handsets. The increasing use of automated attendants that help callers find the employee they are seeking, check their account balance, place a service call, check on the status of an order allow businesses to provide a level of customer service without the caller ever interacting with an employee of the business.
5. **Accounting Systems.** Although primarily a software package, accounting systems are a crucial to business success. Accounting systems keep track of every dollar a company spends along with every dollar of revenue. In addition, accounting systems are capable of tracking labor costs, inventory levels, asset value and other pieces of financial information that managers need in order to make decisions about business operations. These systems can range from a relatively simple system such as QuickBooks to highly complex systems such as SAP.
6. **Computer Aided Manufacturing Systems.** No longer does the manufacturing process require hundreds of employees working on a production line. Computer Aided Manufacturing (CAM) is the use of software and computer controlled machinery to automate the manufacturing process. This can be something as simple as filling cupcake tins with batter at a large bakery facility to building aircraft component parts to later be assembled into a jumbo jet. As technology continues to evolve, computers will take on an even more prominent role in the design and manufacture of everyday household goods.

These broad categories of technology can be found, to some extent, in virtually every business today. However, business cannot sit idle as technology changes around them. Today's businesses must keep informed of new technologies in the same way that they must remain vigilant of changes in consumer demands. While leveraging existing technologies to their benefit, businesses must keep a watchful eye on emerging technologies such as Block Chain, virtual reality and machine learning in order to adopt the technologies that maximize efficiency and ultimately maximize revenue.

Practice Question

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33.4: Technology’s Influence on Business

Learning Objectives

- Explain how technology changes business.

Not since the Industrial Revolution and the introduction of the assembly line has business undergone such rapid change as it has since the birth of the Internet. The technological revolution of the last 20 years has fundamentally changed the ways the businesses do business with each other, their customers, their suppliers and business partners. How customers discover a business’s products, goods and services is no longer bounded by geography. People on Main Street U.S.A. can shop the globe for goods and services that meet their needs at a price they are willing to pay. Think about the last thing you purchased. Count the ways that technology impacted your purchase.

In order to get an idea of how business is impacted by technology, let’s follow Jim as he goes to a local retailer and purchases a dishwasher.

Buying A DishWasher

Jim decides to purchase a new dishwasher, but before he heads out to the store he sits in his recliner and searches the Internet for dishwashers. He reads customer reviews and narrows his selection to 2 different models. He then goes to the websites of the companies that manufacture the two dishwashers and looks at the specifications, reads the warranty information and watches videos of people installing the dishwasher. While he is watching one of the videos a small box pops up and offers “live chat” with a customer service representative of Brand X.

He then goes to the website of the 3 local retailers that carry the dishwasher he wants and compares prices. He also checks to see if the dishwasher is in stock. He is on the website of Store A and while he is checking for the dishwasher an ad pops up and offers a 10 percent discount if he downloads and uses Store A’s app. He grabs his phone, downloads the app and logs back into the store website. Through the magic of “cookies” the information from his laptop appears on his phone and he continues shopping. With his decision made he completes the purchase online, using a verified secured server and pays for the dishwasher with his debit card.

Almost at the same time that he his the “confirm order” button on his phone the inventory level at Store A is adjusted to reflect Jim’s purchase. Since the dishwasher Jim has just purchased only leaves 1 in stock, Jim’s order triggers the store to request another dishwasher from its regional warehouse using real-time electronic data interchange. Before Jim can arrive at the store to pick up his new dishwasher, a replacement has been identified and robotic stock picking equipment is delivering it to the loading dock where it will be loaded onto a truck and delivered to Store A by 10am the next day.

Jim gets home with his new dishwasher and gets it installed thanks to the video provided by the manufacturer. He goes online and “registers” his purchase, providing his email address. Over the course of the next 6 months Jim will receive emails from the manufacturer of the dishwasher that range from a survey of customer satisfaction to an offer to purchase an extended warranty. He will also begin to see advertisements for other kitchen appliances, related products and “offers” from Store A and their competitors.

So, from the start everything about Jim’s purchase is touched by technology. We haven’t even talked about how the dishwasher was designed using CAD/CAM software, how computer integrated manufacturing produced the dishwasher or how the component parts of the dishwasher were made using robots and computerized machinery. As we said at the start of the Module —technology has revolutionized the way that business does business.

For an example of the future of technology and business, look at Amazon’s latest venture – “Amazon Go.” **Amazon Go** is a chain of grocery stores operated by the online retailer Amazon, currently with three locations in Seattle, Washington, two in Chicago, Illinois and one in San Francisco, California. The stores are partially-automated, with customers able to purchase products without being checked out by a cashier or using a self-checkout station. The first store, located in the company’s Day 1 building, opened to employees on December 5, 2016, and to the public on January 22, 2018. The flagship store has prepared foods, meal kits, limited groceries, and liquor available for purchase. The video that follows will give you some insight into how Amazon is using technology to totally transform the shopping experience. (Note that the video has no narration. Access audio description by using the widget below the video.)

You can view the text alternative for “Inside the First Amazon Go Store” here (opens in new window).

In summary, consider the following ways that technology has changed business[1].

1. **Mobile Solutions**. With the rise of Generation Y (Millennials) more people are using mobile devices to buy, sell, shop, find local businesses, and share their retail experiences with friends, acquaintances, prospects, and Facebook strangers every day.
2. **Cloud Computing.** Cloud computing allows businesses large and small to move some of their operation to third-party servers accessible via Internet connectivity. Not only does this allow for rapid (on-demand) data and mobility it does so without the fear of downtime, crashes, or permanently lost data.
3. **Extreme Customer Segmentation**. With the flow of more and more data, it’s easier now than ever before to understand the customers you’re looking for. Even a simple Google account will let you know where your visitors are from, what type of browser they’re using, how they found your website, what they do while on it, how long they stay, and at which point they decided to leave.
4. **Connectivity**. Technology has also increased the ease with which we can all stay in touch. Whether it’s having your coworkers and employees available via text/video chat at a moment’s notice, or being able to send targeted promotional email blasts to pre-qualified customers when they’re shopping at nearby businesses, the rise of mobile technology has blended almost seamlessly with communication software to create a hyper-real web of real time information.
5. **Social Impact**. The rise of social networking has figuratively shrunk the world and now users can connect without regard to geographical obstacle, financial background, or even social status. Indeed, years ago you may have been able to skate by on “okay” customer service and product offerings but now you’ll likely incur a hateful rant on Facebook or a bad review on rating sites like Yelp.

Businesses are forced to ride the wave of technology or risk going the way of Blockbuster, Toy ‘R Us, Radio Shack or Sears. The reality of business today is that technology will continue to force them to adapt and adopt or risk extinction.

? Practice Question

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1. Broberg, Orrin. "Eight Ways Technology Is Changing Business." Modus. December 5, 2013. Accessed June 25, 2019. https://gomodus.com/eight-ways-technology-changing-business/. ↵

Contributors and Attributions

33.5: Business Intelligence

Learning Objectives

- Explain Business Intelligence (BI) and its impact on business success.

Business intelligence (BI) is a technology-driven process for analyzing data and presenting useful information to help executives, managers and other end users make informed business decisions. The potential benefits of using BI tools include accelerating and improving decision-making, optimizing internal business processes, increasing operational efficiency, driving new revenues and gaining competitive advantage over business rivals. BI systems can also help companies identify market trends and spot business problems that need to be addressed. In short, BI technologies allow a business to view their operations, past, present and future.

BI technologies handle large amounts of data to help identify, develop and otherwise create new strategic business opportunities. Identifying new opportunities and implementing an effective strategy based on insights can provide businesses with competitive market advantage and long-term profitability.

The video below will provide you with an overview of how a company can use BI to improve its outcomes and attain its goals.

You can view the transcript for “What is Business Intelligence (BI)?” (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/11095

BI is most effective when it combines data derived from the market in which a company operates (external data) with data from company sources internal to the business such as financial and operations data (internal data). When combined, external and internal data can provide a complete picture which, in effect, creates an “intelligence” that cannot be derived from any singular set of data. Business intelligence tools empower organizations to gain insight into new markets, to assess demand and suitability of products and services for different market segments and to gauge the impact of marketing efforts.

Other ways a business can use BI to improve performance include:

- Business Process Management. Performance metrics and benchmarking inform business leaders of progress towards business goals. BI tools can help a business boost internal productivity by focusing their efforts on what is important.
- Decision Making. BI analytics such as data mining and statistical analysis quantify processes for a business to make the best decisions. BI can help a business identify areas to cut costs or how to distribute budget allocations.
- Business Planning. Businesses can use BI data to develop both short term goals and long term strategy. Businesses can gain insight into their customers and market trends, allowing them to make decisions about current and future operations, products, goods or services.
- Collaboration. BI can facilitate collaboration both inside and outside the business by enabling data sharing and electronic data interchange. Many businesses use BI tools to communicate with suppliers, reducing lead times and inventory levels. By sharing data among partners, each business has up-to-the-minute information on everything from delivery times to price changes.

If BI is so powerful then why hasn't it always been used by businesses? It has been used widely by businesses for decades, but in the past, only the information technology experts within a business had access to a few, highly complex BI tools and applications. As technology has evolved; however, there now exists a broad range of BI tools that a company can employ. Additionally, this new generation of BI tools are typically fairly simple to use so now a broader range of users within the business are able to get involved in analyzing and using data to make decisions. The result is that rather than the historical approach of just a few highly specialized data people being the only ones with visibility into the data, now people such as managers, supervisors, sales associates, and marketing specialists can leverage the power of internal and external data to their benefit and to the benefit of the organization.

Maidenform and BI[1]

One example of how business intelligence systems have been maximized is at women's underwear manufacturer Maidenform. Their CIO Bob Russo said recently after implementing BI, "Providing targeted information at the right place and time is central to improving the decision-making process. This would allow us to gain a competitive advantage in the marketplace as well as increase retail customer, shopper and shareholder value. We want to make sure that we are able to deliver 'one version of the truth' and deliver information that is actionable. We do not want to just deliver data."

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1. Thompson, Ed, CTO. "6 Real Life Examples of Successful Business Intelligence Systems." Matillion. March 13, 2018. Accessed June 25, 2019. https://www.matillion.com/insights/6-real-life-examples-of-successful-business-intelligence-systems/. ↵

Contributors and Attributions

33.6: Introduction to How Businesses Use Information

What you'll learn to do: discuss ways in which information is used in business

Traditionally we think about value in business in terms of assets—property, plants, equipment, inventory and even human resources. The explosion of technology over the last decade has made us re-think what is valuable. In fact, what many businesses today consider to be their most valuable asset cannot be held in your hand because it is the *information* generated by the collection of billions of bits of data. In fact, the data that businesses gather about their customers is, to the most progressive companies, invaluable! For example, when you visit a company's website, data is captured about what you looked at: what colors you preferred, how long you remained on a page and yes, even your physical location.

Companies take that "data" and turn it into useful information. They can then use this information to push advertising to you, not just through their website but to your social media accounts, your email, and even your cell phone. As the collection of data becomes easier and more cost effective, businesses are constantly generating new and better information about the business environment. In this section you will learn the difference between data and information, the types of data that businesses collect, and, finally, how businesses use information.

Contributors and Attributions

33.7: Data vs. Information

Learning Objectives

Define and distinguish between "data" and "information"

Many people are under the impression that the terms "data" and "information" are interchangeable and mean the same thing. However, there is a distinct difference between the two words. **Data** can be any character, text, word, number, and, if not put into context, means little or nothing to a human. However, **information** is data formatted in a manner that allows it to be utilized by human beings in some significant way. An individual has an almost unlimited amount of data associated with him or herself. This data is of little use to business in it's raw, unorganized form. It is not until the data is formatted or compiled into something meaningful that business has information about the individual. For example, suppose the department store Big Box is collecting data about its customers from a loyalty card program and online customer surveys. It collects the following data about a particular customer:

- Age: 34
- Big Box Account #: 123456
- Gender: Female
- Zip Code: 22322
- Children: 2
- Marital Status: Married
- Last Purchase: Jogging Pants

These pieces of data alone are not particularly useful to Big Box. It is not until the data is compiled that Big Box begins to get a "picture" of the customer behind account #123456. Transforming this data into information, Big Box is able to know that this customer is a married female who has 2 children and enjoys jogging. They also know that because she lives in zip code 22322 that she is most likely to shop at their store at Halifax Mall since the mall is in the same zip code as the customer's home address. If Big Box wants to market to her successfully, then they will use this information to include her in an upcoming active wear promotion. Also, since she has children they will also include her in promotions that include children's wear. The key to collecting data and turning it into useful information for Big Box is that it is a continual process.

So, Big Box includes Customer #123456 in a future mailing and when she comes into the store and makes a purchase her loyalty card records that she purchased several items in the toddler clothing department. This data can be useful information when Big Box sends out information about their annual "Santa Comes to Town" promotion. They can use the purchase data to inform them that Customer #123456 has a toddler and toddlers love to come see Santa!

Practice Question

https://assessments.lumenlearning.co...essments/11096

Later in the year, Customer #123456 makes an online purchase of a pair of men's work boots and a men's heavyweight coat. The data that comes into Big Box may look like this:

- Customer #123456
- Date: 10/5/2018
- Item #56-9876 Cougar Work Boots, Size 11
- Item #43-2341 Men's Heavyweight Denim Coat, Size XL

Not very interesting data by itself. But, now Big Box can use this data to have even better information about Customer #123456. They know that Mr. #123456 probably works outdoors, possibly in a skilled trade; hence the need for work boots and a heavy weight coat. When Big Box spends their promotion dollars on a men's suit sale they will not target Customer #123456 because they have "information" about them, gathered from these individual pieces of data. As Customer #123456 makes additional purchases, visits the company's web site and responds to special offers they will collect more and more data. Every piece of data collected will be useful in giving Big Box more and more information about this particular customer. Now, imagine this data is collected on every customer for every purchase over a period of years. The quantity of raw data collected is staggering and the challenge for Big Box is to store this data in a manner that allows it to be turned into information. This is where data warehousing and data mining come into play.

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33.8: Business Data

Learning Objectives

- Describe the different types of data businesses collect

Information flows in and out of a business in many different directions. The type of data a business collects is informed by a business's goals and objectives. Computing systems can collect a dizzying array of data about the world around us. Businesses must decide what type of data they need to inform their business decisions and where and how that data can be collected. The types of data that businesses collect can be broken down into five broad categories: business process, physical world observations, biological data, public data and personal data. Let's examine each of these categories of data in greater detail.

Business Process Data. In order to remain competitive businesses must find ways to increase efficiency while maintaining quality standards for their products, goods and services. In order to continuously improve their operations, businesses collect data regarding their business processes. This data can range from collecting data on the number of days it takes their customers to pay invoices to the time it takes to assemble and package a product. In order to collect this type of data, many businesses employ enterprise resource planning systems. ERP systems track business resources—cash, raw materials, production capacity—and the status of business commitments: orders, purchase orders, and payroll. The applications that make up the system share data across various departments (manufacturing, purchasing, sales, accounting, etc.) that provide the data.

Another source of process data is Point of Sale (POS) systems. We are all familiar with these – they are the systems that scan the barcodes on our purchases when we check out at the grocery store. When a cashier scans the barcode on an item that scan collects data that may be used in inventory management, loyalty programs, supplier records, bookkeeping, issuing of purchase orders, quotations and stock transfers, sales reporting and in some cases networking to distribution centers. The more data a business has about its processes the more likely it will find opportunities to improve or enhance those processes.

Physical-world observations. Technology has made it possible for business to capture real-time data about the physical world. This data is collected by the use of devices such as radio frequency identification (RFID), wireless remote cameras, GPS, sensor technology and wireless access points. By inserting computer chips into almost any object companies are able to track the movements of that item and in some cases control the object. One of the early adopters of such technology was the On-Star system installed in millions of U.S. automobiles. Through the use of a combination of RFID, GPS and satellites if car owners inadvertently locked their keys in the car they can make one call to On-Star and the doors to their vehicle would be unlocked.

In another application of RFID technology, Delta Airlines sends passengers real-time information about the location of their checked baggage. In 2016 Delta began sending fliers who check bags mobile notifications as bags are loaded onto and off of airplanes and when they arrive at carousels for pickup. By embedding RFID chips in each luggage tag, Delta has achieved an eye-popping 99.9% tracking success rate, according to the company. "In the same way that customers want information at their fingertips about flight changes, we know our customers want clear visibility to their checked bags," says Tim Mapes, Delta's chief marketing officer[1].

Biological Data. If you have a newer smartphone, then you may be able to unlock your phone by simply looking at the screen. This is made possible by facial recognition software. Unlocking your laptop with your fingerprint is another example of biological data available to businesses. Although things like voice and face recognition, retinal scans and biometric signatures are currently used primarily for security purposes, it may be possible in the future for this type of data to allow for product and service customization.

Public Data. Businesses have an almost endless source of data available to them free from public sources. Whenever you log onto the Internet, use instant messaging, or send emails, an electronic footprint is left behind. For now this data is considered to be "public" and businesses collect, share and even sell this type of data every day. This has become a very controversial topic in the past several years and recent legislation by the EU regarding this type of data may be the first step in limiting the collection and use of this type of public data. For additional information on this groundbreaking legislation follow this link to the European Commission: European Commission and Data Protection

Personal Data. Much like data that is considered to be "public" data, as we use technology we provide a wealth of personal data that businesses can use to reveal much about our personal preferences, habits, pastimes, likes and dislikes. For example, Facebook uses information people provide — such as their age, gender and interests — to target ads to a specific audience. Advertisers tell Facebook which demographics they want to reach, and then the social media giant places the ads on related accounts. How businesses collect and use this data is also highly controversial as exemplified by recent disclosures that Facebook has been collecting and selling personal information gathered from subscribers' activities on the social network. Much like the controversy surrounding publicly available data, what rights an individual has to his or her data is currently being debated globally.

The volume of data available to businesses continues to increase exponentially and as more and more data becomes available collecting, storing and analyzing that data becomes increasingly complex. This data explosion has made data warehousing and data mining of greater importance to businesses.

? Practice Question

https://assessments.lumenlearning.co...essments/11097

1. Kang, Ashton. "Delta Introduces Innovative Baggage Tracking Process." Delta News Hub. April 28, 2016. Accessed June 25, 2019. https://news.delta.com/delta-introduces-innovative-baggage-tracking-process-0. ↵

Contributors and Attributions

33.9: Data Mining and Warehousing

Learning Objectives

- Explain the difference between data mining and data warehousing

Billions and billions of bits of data flood into an organization's information system, but how does that data get utilized effectively? The challenge lies not so much with the collection or storage of the data: today, it is possible to collect and even store vast amounts of information relatively cheaply. The main difficulty is figuring out the best and most efficient way to extract and manage the relevant data. In this section you will learn how organizations not only warehouse but then mine the data they collect.

Did you ever think about how much data you yourself generate? Just remember what you went through to start college. First, you had to fill out application forms asking you about test scores, high school grades, extracurricular activities, and finances, plus demographic data about you and your family. Once you'd picked a college, you had to supply data on your housing preferences, the curriculum you wanted to follow, and the party who'd be responsible for paying your tuition. When you registered for classes, you gave more data to the registrar's office. When you arrived on campus, you gave out still more data to have your ID picture taken, to get your computer and phone hooked up, to open a bookstore account, and to buy an on-campus food-charge card. Once you started classes, data generation continued on a daily basis: your food card and bookstore account, for example, tracked your various purchases, and your ID tracked your coming and going all over campus. And you generated grades.

And all these data apply to just one aspect of your life. You also generated data every time you used your credit card and your cell phone. Who uses all these data? How are they collected, stored, analyzed, and distributed in organizations that have various reasons for keeping track of you?

Warehousing and Mining Data

How do businesses organize all of this data so that they can transform it into useful information? For most businesses this is where **data warehousing** comes into play. A data warehouse collects data from multiple sources (both internal and external) and stores the data to later be used in an analysis. The primary purpose of a data warehouse is to store the data in a way that it can later be retrieved for use by the business. Despite the name, **Data Mining** is not the process of getting specific pieces of data out of the data warehouse, but rather the goal of data mining is the identification of patterns and knowledge from large amounts of data. Large retailers such as WalMart and Target track sales on a minute-by-minute basis and data mining allows these large retailers to recognize changes in purchasing behavior in an extremely short amount of time. They can quickly make adjustments to inventory levels based on the information gathered from thousands of individual transactions as a result of data mining. Clearly understanding consumer behavior is a primary goal of data mining. The following video explains just how businesses use data mining to understand and predict consumer behavior.

You can view the transcript for "DATA MINING | The Checkout | ABC1" (opens in new window).

Practice Question

https://assessments.lumenlearning.co...essments/11098

Today businesses are treating the Internet as a massive data warehouse and are using data mining techniques to gather data about not just existing customers, but potential customers. Data mining tools such as Scrapy, Nutch and Splash allow businesses to learn more about customers, competitors, compare prices and even find new customers and sales targets. As the quantity of data businesses can collect continues to grow, having an effective data warehousing system that can be easily mined has become increasingly critical to business success.

Contributors and Attributions

33.10: Information and Business

Learning Objectives

- Explain how businesses use information.

We can summarize how businesses use information by saying, “businesses use information to gain a competitive advantage.”

Simply put a competitive advantage is what makes a business’s goods or services superior to all of a customer’s other choices. Internally, however, we can examine closer how information is used in both primary and support activities within the business.

Information and Primary Business Activities

The primary activities are the functions that directly impact the creation of a product or service. The goal of the primary activities is to add more value than they cost. The primary activities are:

- **Inbound logistics:** These are the functions performed to bring in raw materials and other needed inputs. Information can be used here to make these processes more efficient, such as with supply-chain management systems, which allow the suppliers to manage their own inventory.
- **Operations:** Any part of a business that is involved in converting the raw materials into the final products or services is part of operations. From manufacturing to business process management, information can be used to provide more efficient processes and increase innovation through flows of information.
- **Outbound logistics:** These are the functions required to get the product out to the customer. As with inbound logistics, information can be used here to improve processes, such as allowing for real-time inventory checks.
- **Sales/Marketing:** The functions that will entice buyers to purchase the products are part of sales and marketing. Information is critical to every aspect of sales and marketing. From online advertising to online surveys, information can be used to innovate product design and reach customers like never before. The company website can be a sales channel itself as we have seen with Amazon.
- **Service:** The functions a business performs after the product has been purchased to maintain and enhance the product’s value are part of the service activity. Service can be enhanced via technology as well, including support services through websites and mobile apps.

Information and Support Activities

The support activities are the functions in an organization that support, and cut across, all of the primary activities. The support activities are:

- **Firm infrastructure:** This includes organizational functions such as finance, accounting, and quality control, all of which depend on information; the use of ERP systems is a good example of the impact that information can have on these functions.
- **Human resource (HR) management:** This activity consists of recruiting, hiring, and other services needed to attract and retain employees. Using the Internet, HR departments can increase their reach when looking for candidates. There is also the possibility of allowing employees to use technology for a more flexible work environment.
- **Procurement:** The activities involved in acquiring the raw materials used in the creation of products and services are called procurement. Business-to-Business e-commerce can be used to improve the acquisition of materials.

This brief analysis sheds some light onto how businesses can use information to gain a competitive advantage. As you can see, the use of information cuts across the entire organization. Although the uses may vary from area to area one thing that is consistent is the use of accurate, timely information can improve business processes and thereby enhance the customer experience.

When the customer experience is enhanced, revenues rise, profits rise and business flourishes. Information is quickly becoming the lifeblood of business and its importance in the long-term success of an organization cannot be overstated.

Practice Question

https://assessments.lumenlearning.co...essments/11099

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33.11: Introduction to Information Networks

What you'll learn to do: compare the ways that businesses can manage information

Billions and billions of bits of data flood into an organization's information system, but how does that data get utilized effectively? The challenge lies not so much with the collection or storage of the data: today, it is possible to collect and even store vast amounts of information relatively cheaply. The main difficulty is figuring out the best and most efficient way to extract and manage the relevant data and resulting information. In this section you will learn how organizations use a variety of networks to manage their information.

Contributors and Attributions

33.12: The Internet and Cloud Computing

Learning Objectives

- Discuss how businesses can use the Internet to manage information

Once it's grown beyond just a handful of employees, an organization needs a way of sharing information. Imagine a flower shop with twenty employees. The person who takes phone orders needs access to the store's customer list, as do the delivery person and the bookkeeper. Now, the store may have one computer and everyone could share it. It's more likely, however, that there are a number of computers (several for salespeople, one for delivery, and one for bookkeeping). In this case, everyone needs to be sure that customer records have been updated on all computers every time that a change is required. Traditionally the business would install a network (LAN) to allow the various computers to talk to one another and share information. Today businesses are looking to the cloud to provide a network solution.

Cloud Computing

So, what is cloud computing? Watch the following video, which describes some of the uses and benefits of cloud computing.

You can view the transcript for "What Is the Cloud" (opens in new window).

The term "cloud computing" means performing computer tasks using services provided over the Internet. In cloud computing a company's data and applications are stored at an offsite data center that is then accessed via the Internet (the cloud). So when you hear or read that an individual or company is using the "cloud" or technology firms, such as IBM, Hewlett-Packard, and Salesforce.com, are offering cloud services, just substitute the word "Internet" for "cloud" and things will make sense.

You might be surprised to learn that you're already using the cloud—that is if you use Facebook (which is very likely—in fact, just mentioning Facebook here might prompt you to stop studying and check out your friends' pages). How do you know that Facebook is a cloud application? Remember the trick: just substitute the word "Internet" for "cloud." The Facebook computer application lets you store information about yourself and share it with others using the Internet.

Practice Question

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Advantages and Disadvantages of Cloud Computing

In making a decision whether or not to use cloud computing to store and share information, a business should consider some of its advantages and disadvantages.

Advantages

1. *Cost Savings*—By "renting" software rather than buying it the cloud can reduce. In most instances, the monthly fee to "use" software is generally less than the combined cost of buying, installing, and maintaining the software internally. On the hardware site, housing data in a service provider's facilities (such as Amazon or Google), rather than in-house, reduces the large outlay of cash needed to build and maintain data centers.
2. *Speed of Delivery*—Purchasing and installing software and data processing equipment can be time consuming. A cloud computing service provider can get applications up and running in a minimal time frame and often without interrupting normal business operations.
3. *Scalable*— As businesses grow it's often difficult to gauge the level of technology needs. If businesses overestimate their requirements, they end up paying for technology they don't need. If they underestimate, efficiency goes down, and the experience for customers may diminish. By using cloud computing businesses are able to have exactly what they need at their disposal at any point in time.
4. *Employees Can Be Mobile*—The use of cloud computing frees workers from their desks and allows them to work wherever they are. As applications move to the cloud, all that is needed for employees to connect to their "offices" is the Internet. This mobility benefit also makes it easier for employees to collaborate on projects and connect with others in the company.
5. *Information Technology Staff*— Finding experienced and knowledgeable information technology staff is a continuing problem for many businesses. By using cloud computing, businesses can reduce their human resource needs by shifting some of the work to outside vendors who have a staff of highly skilled individuals.

Disadvantages

Although the advantages of moving to a cloud environment outnumber the disadvantages, the following disadvantages are cause for concern:

1. *Disruption in Internet Service*— Since both applications and data are accessed via the Internet, if the Internet is unavailable because of a disruption this could create serious problems for a business.
2. *Security*—Many companies are reluctant to trust cloud service providers with their data because they're afraid it might become available to unauthorized individuals or criminals. This is a particular concern to business that collect and store sensitive client information.
3. *Service Provider System Crash*—Organizations considering moving to the cloud are often concerned about the possibility of a computer service crash at their service providers' facilities. If the service provider experiences an outage, then the business is in effect cut off from its data and operations.

Although there are some disadvantages, using cloud computing to manage information is the new normal for many businesses. In fact, according to Forbes magazine, the cloud computing market is estimated to grow to $411 billion by 2020. The global cloud computing services market size is driven by many factors. The most important factor, which is driving the market, is the cost effectiveness. With the deployment of cloud computing services, organizations can save more than 35% of the annual operating costs of their information systems. Clearly the future for the cloud is sky high!

Contributors and Attributions

33.13: Intranets and Extranets

Learning Objectives

- Discuss how businesses can use intranets and extranets to manage information

Intranets

Increasingly, businesses are relying on intranets to deliver tools such as collaboration, scheduling, customer relationship management tools, and project management to increase the productivity of the organization. An **intranet** is a private network accessible only to an organization's staff. Unlike the Internet, an internal intranet provides a wide range of information and services to employees of an organization but these tools and information are unavailable to the public. A company-wide intranet is an important focal point of internal communication and collaboration, and can provide a business with a single starting point to access both internal and external resources. Larger businesses allow users within their intranet to access the public Internet through firewall servers. Because businesses have the ability to screen both incoming and outgoing traffic, they are able to keep the security of the intranet intact. In its simplest form, an intranet is established with the technologies for local area networks (LANs) and wide area networks (WANs).

Some of the advantages and benefits a company can realize from establishing a robust intranet are as follows.

- **Workforce productivity**. Intranets can help users to locate and view information faster and use applications relevant to their roles and responsibilities.
- **Enhanced collaboration**. Information is easily accessible by all authorized users, which enables teamwork. Being able to communicate in real-time through integrated third party tools promotes the sharing of ideas and helps boost a business' productivity
- **Time Savings**. Intranets allow organizations to distribute information to employees on an *as-needed* basis in real time. Employees may link directly to relevant information as soon as the organization makes it available on the intranet.
- **Reduced Costs**. Users can view information and data via web-browser rather than maintaining physical documents such as procedure manuals, internal phone list and requisition forms. This can potentially save the business money on printing, duplicating documents, and the environment as well as document maintenance overhead.
- **Improved Communication**. Intranets can serve as powerful tools for communication within an organization. A great real-world example of where an intranet helped a company communicate is when Nestle had a number of food processing plants in Scandinavia. Their central support system had to deal with a large number of requests for information every day. When Nestle decided to invest in an intranet, they quickly realized the savings. In fact, the savings from the reduction in calls was substantially greater than the investment in the intranet[1].

Extranets

In some cases organizations make the decision to allow external parties such as customers and suppliers to have access to their intranet. When these outside parties are provided access to a subset of the information accessible from an organization's intranet the intranet becomes an **extranet**. For example a large construction company may share drawings with architects or inspectors, photographs to their customers and loan documents to their bankers by implementing online applications that allow these external parties to access and even mark-up and make changes to documents. In essence, the company will use an extranet to manage project-related communications. One of the biggest advantages of establishing an extranet is that a business can share large quantities of data using EDI or electronic data interchange. Data such as invoice and order that were traditionally transmitted via paper can now instantly be shared among organizations. Some of the most sophisticated extranets are run by large retailers like Walmart and Target who constantly transmit data via their extranet to vendors and suppliers, ensuring that merchandise arrives when it is needed, where it is needed.

Like intranets, extranets have some distinct advantages for the organizations establishing them. Several of these benefits are explained below.

- **Build customer relationships.** Customers who are provided access to timely information about product availability, specifications and cost increase their efficiency. In business-to-business relationships, the more timely and accurate information a business makes available to their customers, the more likely they are to retain that business. Collaborate with other companies on joint development efforts

- **Reduced margin of error.** An extranet can reduce a company's margin of error thereby reducing or eliminating costly errors, especially with something as complex as processing orders from distributors and suppliers. Customers can be given access to their accounts to verify order history, account balances and payments.
- **Timely and accurate information.** On an extranet a business can instantly change, edit, and update sensitive information such as price lists or inventory information. Compared to typical paper-based publishing processes, an extranet offers a unique opportunity to quickly get information into the right hands before it's out-of-date.
- **Reduced inventory.** One of the greatest advantage of a business-to-business extranet is its impact on supply-chain management. By linking the inventory system directly to a supplier, businesses can process orders as soon as the system knows they are needed, thus reducing the stock a business keeps on hand and generally making the procurement process more efficient.
- **Flexibly.** A well designed extranet allows remote and mobile staff to access core business information 24 hours a day, irrespective of location. This allows employees to work remotely or respond to critical requests for information after normal working hours. As businesses expand globally, the ability to work across time zones is enhanced by the establishment of an extranet.

? PRactice Question

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Whether a company is managing an intranet or extranet, both systems can raise security issues. With increased access comes an increased opportunity for security breaches. In particular, the security of extranets can be a concern when hosting valuable or proprietary information. Unless sufficient security precautions are taken, data can be breached and altered, without either the sender or the receiver being aware of the interception. The growth in the complexity of networks has increased the possible points of attack, both from within organizations and from outside the company. Fortunately, the means of protecting against hackers have also expanded in line with the technology.

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1. McGovern, Gerry (November 18, 2002). "Intranet return on investment case studies".. Retrieved 2018-11-03 ↵

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33.14: Virtual Private Networks (VPNs)

Learning Objectives

- Discuss how businesses can use Virtual Private Networks (VPNs) to manage information

A **virtual private network** (**VPN**) extends a private network (intranet) across a public network Internet), and enables users to send and receive data across shared or public networks as if their computing devices were directly connected to the private network. Applications running across a VPN may therefore benefit from the functionality, security, and management of the private network while taking advantage of the flexibility of the Internet. In a business setting, remote-access VPNs allow employees to access their company's intranet from home or while traveling outside the office. Site-to-site VPNs allow employees in geographically separated offices to share one cohesive virtual network.

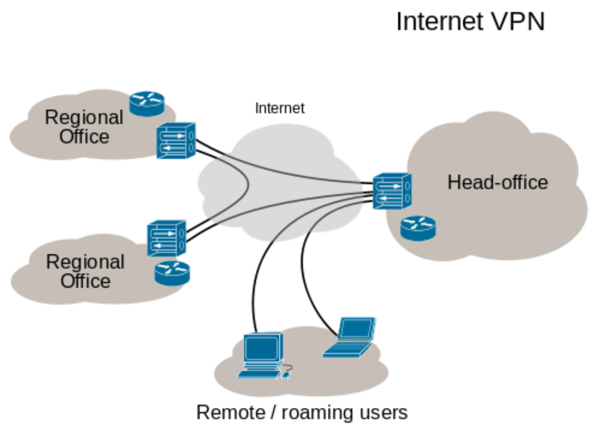

Figure 33.14.1: Internet VPN

To ensure security, the VPN connection is established using encryption protocols and VPN users use authentication methods, including passwords or certificates, to gain access to the VPN.

Although VPNs cannot make online connections completely secure, they can increase privacy and security. For example, to prevent disclosure of private information, VPNs typically allow only authenticated remote access using encryption techniques.

Some of the security advantages of a VPN include the following:

- even if the network traffic is accessed, an attacker would see only encrypted data
- sender authentication is required to prevent unauthorized users from accessing the VPN
- the VPN messaging is designed to detect instances of tampering with transmitted messages

As security concerns continue to grow in the digital age, more and more companies are emerging to serve the growing demand for VPN services. Which service a business chooses will be determined by its planned uses for the VPN.

Practice Question

https://assessments.lumenlearning.co...essments/11102

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33.15: Introduction to Current Issues in IT

What you'll learn to do: Identify security, privacy and ethical issues affected by information technology

Now that we have acknowledged the amount of data that business collects about people, what are the risks and challenges associated with keeping that information secure? Businesses stand to lose consumer confidence and respect if they allow unauthorized access to customer data. For this reason, businesses take information security and cyber-security seriously. Despite the importance of protecting customer data, breaches and hacks seem to be more and more common.

Is this a result of inadequate security measures on the part of the businesses, or are hackers getting better at accessing so-called "secure networks"? The answer is probably both. In this section you'll learn about some of the ongoing security issues businesses face in trying to safeguard their (and their customers') electronic communications and data.

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33.16: Security Issues in Information Technology

Learning Objectives

- Identify security issues associated with information technology.

Now that we have acknowledged the amount of data that business collects about people, what are the risks and challenges associated with keeping that information secure? Businesses stand to lose consumer confidence and respect if they allow unauthorized access to customer data. For this reason, businesses take information security and cyber-security seriously. Despite the importance of protecting customer data, breaches and hacks seem to be more and more common. Is this a result of inadequate security measures on the part of the businesses, or are hackers getting better at accessing so-called “secure networks”? The answer is probably both. In this section you’ll learn about some of the ongoing security issues businesses face in trying to safeguard their (and their customers’) electronic communications and data.

Information technology has presented businesses with opportunities undreamt of only a couple of decades ago. But it also has introduced some unprecedented challenges.

You can view the transcript for “Home Depot Security Breach” (opens in new window) or the text alternative for “Home Depot Security Breach” (opens in new window).

It has been estimated that businesses expend more than 5% of their annual IT budgets protecting themselves against disrupted operations and theft due to information theft . A February 2018 report by McAfee estimates that cyber-crime costs the world over $800 billion or 0.08% of global GDP. Among the reasons given for the growing cost of cyber-crime are:

- Quick adoption of new technologies by cyber-criminals
- The increased number of new users online (these tend to be from low-income countries with weak cyber-security)
- The increased ease of committing cyber-crime, with the growth of Cyber-crime-as-a-Service
- An expanding number of cyber-crime “centers” that now include Brazil, India, North Korea, and Vietnam
- A growing financial sophistication among top-tier cyber criminals that, among other things, makes monetization easier

According to the McAfee report, “Monetization of stolen data, which has always been a problem for cyber-criminals, seems to have become
less difficult because of improvements in cyber-crime black markets and the use of digital currencies[1].”

Cyber-crime can take on many faces from data breaches to malicious program that attack a company’s network and disrupt service or corrupt sensitive corporate data. We will examine just a few of the ways that criminals are using technology to wreak havoc on business operations.

Viruses and Malicious Programs

With the increased use of the Internet comes an increased risk of a business’s computer network being effected by malicious programs such as viruses. A computer virus is a piece of computer code that is inserted into another program and lies dormant until triggered by an unsuspecting user. This trigger can be as simple as opening a file attachment or downloading a file from the

Internet. Viruses range from the playful, simply displaying an image on the users' screen meant to be funny to extreme cases where data files are permanently erased. Most companies deploy anti-virus software across their network, but even the most sophisticated anti-virus software cannot keep up with the ever growing number of viruses and malicious programs out there. Motives for creating viruses can include seeking profit (e.g., with ransomware), desire to send a political message, personal amusement, to demonstrate that a vulnerability exists in software, for sabotage and denial of service, or simply because hackers wish to explore cyber-security issues. The consequences of such viruses and malicious programs can be catastrophic, effectively destroying a company's entire network and electronic records.

Phishing

One of the most prevalent cyber-attacks is the phishing scam. Phishing is when a scammer uses fraudulent emails or texts, or copycat websites to get you to share valuable personal information – such as account numbers, Social Security numbers, or your login IDs and passwords. Scammers use your information to steal your money or your identity or both. Scammers also use phishing emails to get access to your computer or network then they install programs like ransomware that can lock you out of important files on your computer.

Phishing scammers lure their targets into a false sense of security by spoofing the familiar, trusted logos of established, legitimate companies. Or they pretend to be a friend or family member. Phishing scammers make it seem like they need your information or someone else's, quickly – or something bad will happen. They might say your account will be frozen, you'll fail to get a tax refund, your boss will get mad, even that a family member will be hurt or you could be arrested. They tell lies to get to you to give them information.

To protect yourself and your company's information, the U.S. Federal Trade Commission recommends the following precautions:

- **Be cautious about opening attachments or clicking on links in emails.** Even your friend or family members' accounts could be hacked. Files and links can contain malware that can weaken your computer's security.
- **Do your own typing.** If a company or organization you know sends you a link or phone number, don't click. Use your favorite search engine to look up the website or phone number yourself. Even though a link or phone number in an email may look like the real deal, scammers can hide the true destination.
- **Make the call if you're not sure.** Do not respond to any emails that request personal or financial information. Phishers use pressure tactics and prey on fear. If you think a company, friend or family member really does need personal information from you, pick up the phone and call them yourself using the number on their website or in your address book, not the one in the email.
- **Turn on two-factor authentication.** For accounts that support it, two-factor authentication requires both your password and an additional piece of information to log in to your account. The second piece could be a code sent to your phone, or a random number generated by an app or a token. This protects your account even if your password is compromised.
- **Back up your files to an external hard drive or cloud storage.** Back up your files regularly to protect yourself against viruses or a ransomware attack.
- **Keep your security up to date.** Use security software you trust, and make sure you set it to update automatically.

Even with these precautions in place, highly sophisticated phishing scams are successful in achieving their goal. The following 2018 statistics from Dashlane **(SOURCE: https://blog.dashlane.com/phishing-statistics/)** illustrate just how prolific phishing attacks are:

- According to PhishMe's Enterprise Phishing Resiliency and Defense Report, phishing attempts have grown 65% in the last year.
- According to Wombat Security State of the Phish, 76% of businesses reported being a victim of a phishing attack in the last year.
- According to the Verizon Data Breach Investigations Report, 30% of phishing messages get opened by targeted users and 12% of those users click on the malicious attachment or link.
- According to the SANS Institute, 95% of all attacks on enterprise networks are the result of successful spear phishing.
- According to Symantec, phishing rates have increased across most industries and organization sizes — no company or vertical is immune.
- According to the Webroot Threat Report, nearly 1.5 million new phishing sites are created each month.

Another way that cyber-criminals interrupt business operations is through DoS (Denial of Service attacks).

Denial of Service

A denial-of-service (DoS) attack occurs when legitimate users are unable to access information systems, devices, or other network resources due to the actions of a malicious cyber threat actor. Services affected may include email, websites, online accounts (e.g., banking), or other services that rely on the affected computer or network. A denial-of-service is accomplished by flooding the targeted host or network with traffic until the target cannot respond or simply crashes, preventing access for legitimate users. DoS attacks can cost an organization both time and money while their resources and services are inaccessible. In 2012, not one, not two, but a whopping six U.S. banks were targeted by a string of DoS attacks. The victims were no small-town banks either: They included Bank of America, JP Morgan Chase, U.S. Bancorp, Citigroup and PNC Bank.

These are just a few of the security issues associated with information technology. Such risks illustrate the need for increased cybersecurity to protect computer systems from theft or damage to their hardware, software or electronic data, as well as from disruption or misdirection of the services they provide. The field is of growing importance due to increasing reliance on computer systems, the Internet and wireless networks such as Bluetooth and Wi-Fi, and due to the growth of "smart" devices, including smartphones, televisions and the various devices that constitute the Internet of Things. Due to its complexity, both in terms of politics and technology, it is one of the major challenges of the contemporary world.

? Practice Question

https://assessments.lumenlearning.co...essments/11103

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1. Lewis, James. "Economic Impact of Cybercrime—No Slowing Down." McAfee. January 2018. Accessed June 25, 2019. csis-prod.s3.amazonaws.com/s3fs-public/publication/economic-impact-cybercrime.pdf. ↵

Contributors and Attributions

33.17: Ethical and Social Issues in Information Technology

Learning Objectives

- Identify privacy issues associated with information technology
- Identify ethical issues associated with information technology

As you'll recall, the industrial revolution of the nineteenth century gave rise to a number of unforeseen ethical and social issues—for instance, concerns about workplace safety, wages, discrimination, and child labor—which led to real changes in worker protections, labor practices, and law. Similarly, the technology revolution of the twentieth century—starting with the widespread use of the Internet and home computers—has spawned a new set of ethical and social concerns that people a hundred years ago couldn't have imagined: for example, how should personal information and online privacy be protected? Who gets to own the information about our habits and "likes"? Before the advent of the Internet, people thought about and controlled their personal information in very different ways. Today, many of us lead complex online lives, and we may not even realize how our personal information is being collected and used. Companies like Caesars can collect data on the purchasing patterns, personal preferences, and professional/social affiliations of their customers without their even knowing about it. In this section we'll explore some of the ethical and social issues related to network security, privacy, and data collection that businesses must address.

Technoethics

Ethical and social issues arising from the use of technology in all areas of our lives—and in business, in particular—have lead to the creation of a new branch of ethics: technoethics.

Technoethics (TE) is an interdisciplinary research area concerned with all moral and ethical aspects of technology in society. It draws on theories and methods from multiple knowledge domains (such as communications, social sciences information studies, technology studies, applied ethics, and philosophy) to provide insights on ethical dimensions of technological systems and practices for advancing a technological society.[1]

Technoethics views technology and ethics as socially embedded enterprises and focuses on discovering the ethical use of technology, protecting against the misuse of technology, and devising common principles to guide new advances in technological development and application to benefit society. Typically, scholars in technoethics have a tendency to conceptualize technology and ethics as interconnected and embedded in life and society. Technoethics denotes a broad range of ethical issues revolving around technology- from specific areas of focus affecting professionals working with technology to broader social, ethical, and legal issues concerning the role of technology in society and everyday life.[2]

Recent advances in technology and their ability to transmit vast amounts of information in a short amount of time has changed the way information is being shared amongst co-workers and managers throughout organizations across the globe. Starting in the 1980s with information and communications technologies (ICTs), organizations have seen an increase in the amount of technology that they rely on to communicate within and outside of the workplace. However, these implementations of technology in the workplace create various ethical concerns and in turn a need for further analysis of technology in organizations. As a result of this growing trend, a subsection of technoethics known as organizational technoethics has emerged to address these issues.

Technoethical perspectives are constantly changing as technology advances into areas unseen by creators and users engage with technology in new ways.

Technology, Business, and Your Data

Technology makes businesses more efficient, makes tasks faster and easier to complete, and ultimately creates value from raw data. However, as much as technology impacts the *way* that companies do business, it also raises important new issues about the employer-employee relationship. If you send personal emails from your office computer, do you have the right to expect that they're private? Does your employer have a legal and ethical right to "cyber-peek" at what you are doing with company assets? Twenty years ago this was not an issue; today it's a case before the Supreme Court.

You can view the transcript for “Cell Phone Privacy” (opens in new window).

Social Media

Employers want to use technology to help them screen applicants and verify information about their workforce, which is understandable. In the module on Human Resource Management you learned about the cost of recruiting, hiring, and training employees. However, what if the company believes that one of the quickest ways to gather information about an employee is to access their social media accounts? A company would never ask for your login credentials for Facebook, Twitter, InstaGram, LinkdIn . . . or would they? And if they did, is it legally and ethically justified? What would you do if you found yourself in the situation presented in the following video?

You can view transcript for “US Employers Banned from Asking for Social Media Logins” (opens in new window).

Information As a Business

The fact is that technology has put our information at the fingertips of businesses—there for the taking and, in some cases, the selling. Is it ethical for a business to collect data about a person and then sell that information to another business? Many organizations collect data for their own purposes, but they also realize that your data has value to others. As a result, selling data has become an income stream for many organizations. If you didn’t realize that your data was collected by Company A, it’s even less likely you knew that it was sold to Company B.

You can view the transcript for “Selling You As Data” (opens in new window) or the text alternative for “Selling You As Data (opens in new window).

We have discussed just a few of the emerging ethical issues surrounding business, technology, and personal data. We have yet to touch on security issues and the responsibility business has to protect your data once it has been collected.

? Practice Questions

https://assessments.lumenlearning.co...essments/11104

https://assessments.lumenlearning.co...essments/11105

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1. Luppicini, R. (2010). Technoethics and the evolving knowledge society. Hershey: Idea Group Publishing. ↵
2. Luppicini, R. (2010). Technoethics and the evolving knowledge society. Hershey: Idea Group Publishing. ↵

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33.18: Putting It Together- Using Technology to Manage Business Information

Summary

In this module you learned about the roles of data and information technology in business operations. Following is a summary of the key points we covered.

Data vs. Information

Technology has made it easy for businesses to gather facts about their customers and business operations. However, data are just facts and figures in their raw form. It's not until the data are processed—i.e., converted into information—that businesses can use them to improve their operations.

Managing Data

Being able to collect data is central to most businesses; however, all that data needs to be stored somewhere so users can retrieve it and use it. The creation of databases—virtual warehouses where data is stored—allows businesses to take the first step in managing and using data. Since the creation of "cloud computing," businesses have been able to store their data offsite but still access it from anywhere in the world. Businesses mine data in order to find valuable patterns and answers to questions.

Information in Networks

In order to make the greatest use of data, it must be shared. In business this means that data collected by marketing needs to be shared with other departments—finance, production, research, and development—via networks. Again, this is where businesses must make decisions about the best way to share data: through internal networks (LANS), wide-area networks, (WANS) or the cloud. Each has its own set of advantages and disadvantages.

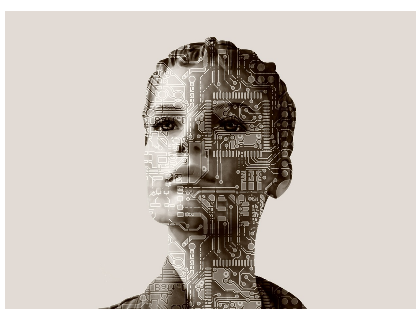
Ethical and Social Issues

Who owns your information? This question is at the heart of many of the ethical and social issues that arise when businesses collect data. The debate about how best to balance the benefits of information technology with the costs to personal privacy has led to a new field of study called technoethics.

Information Security and Cybersecurity

With big data comes big responsibility. This responsibility is about keeping customer and employee data safe from the threat of cyber criminals and illicit users. Large data security breaches have become more prevalent in recent years, and businesses are constantly working to find better and more effective ways to protect their data.

Synthesis



Each of us can be represents by hundreds of data points about our daily activities, our likes and dislikes, shopping habits, income, zip code, mobile phone use, age, gender, marital status, and so on—the list is nearly endless. We are in many respects the sum of the data collected about us. How businesses use that information will continue to evolve as technology changes. It's clear, though, that collecting, storing, managing, and using our data are vital components of virtually all business operations. The issues associated with the use of data and information technology are evolving just as quickly. Society now finds itself torn between the benefits that data can provide and the toll it takes on individual privacy. Most people believe that the organizations collecting our data have a responsibility to protect it against unauthorized access and use. Regardless of whether you pursue a career in business or not, the topics you learned about in this module will apply to you as a citizen, an employee, and an individual. As technology and data collection methods become ever more sophisticated and complex, the burden is on all of us—consumers and businesses alike—to devise effective ways of managing and controlling them.

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33.19: Discussion- Wanda on the Web

In order to prepare for this assignment, READ the information contained in the document "Salty Pawz: A Case Study in Business."

General Discussion Instructions

You are required to post to this discussion THREE TIMES, on THREE DIFFERENT DAYS. Please refer to the Discussion Grading Rubric for detail regarding how your performance will be assessed. ***NOTE:*** *Please be certain to read the entire discussion assignment since in some instances there is* ***more than one question*** *you need to discuss, respond to, or address. Be sure that you have answered the* ***entire*** *question!*

Post 1: Initial Post

Instructions

This posting should be a minimum of one short paragraph and a maximum of two paragraphs. Word totals for this post should be in the **100–200 words** range. Whether you agree or disagree, explain why with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate.

Scenario

Wanda subscribes to services through Google and Facebook that allow her to track and capture data about the people who visit her website and her Facebook page. She is hoping to get information about who visits, how long they stay, what they click on, and other key information she can use to improve her marketing and even expand her product lines.

She is a little nervous since there have been so many instances of data breaches in the news and wonders if she should even risk collecting and storing customer data. On the other hand, she really needs to get as much information as she can about her customers. She figures that if people are using the Internet and the possibility of their information being compromised is just the price of living in a digital age. Or is it?

For Discussion

1. What are Wanda's ethical and social responsibilities about the data she collects and uses?
2. How can Wanda protect herself and her business from cyber-crimes that would have a negative impact on her business?
3. How concerned are you about the security of your personal information on the Internet? Does it impact what you do online in terms of shopping, sharing information, or other activities?

Posts 2 & 3: Respond to Classmates' Posts

After you have created your initial post, look over the discussion posts of your classmates and give at least two thoughtful responses to two different classmates (one per classmate) as outlined in the Discussion Grading Rubric.

A response posting should be a minimum of one short paragraph. Word totals for these posts should be in the **75–100** words range. Whether you agree or disagree, **explain why** with supporting evidence and concepts from the readings or a related experience. Include a reference, link, or citation when appropriate. The goal of your response posts is to **extend discussions already taking place or pose new possibilities or opinions not previously voiced**. Your goal should be to motivate the group discussion and present a creative approach to the topic.

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33.20: Assignment- Policy at Salty Pawz

Much of the success of Salty Pawz is the result of Wanda using the Internet and e-commerce to build her business. She considers herself relatively “tech savvy” and has contacted a local company about installing a LAN in her new location. She will rely heavily on cloud computing, and intends to have everything from customer orders to inventory managed through the LAN. She feels certain that taking this approach will keep Salty Pawz competitive and on the cutting edge of whatever new developments in technology come along in the near future.

The one part of her technology plan that she is less comfortable with is the access that her employees will have to almost all of the information about the business. One disgruntled employee, and she could lose years of customer data, sales records, and product information. At a recent seminar she attended about e-commerce, the presenter talked at length about the importance of having a solid “Acceptable Use Policy” for the computers and network. Guess who she has come to in order to have this policy drafted? You guessed it!

Your Task

Prepare an “Acceptable Use Policy” for Salty Pawz that outlines for employees what their rights and responsibilities are as they relate to the use, access, and security of the Salty Pawz local area network. Be very specific in your drafting of this policy, since the future of Wanda’s business could be at stake.

Sample Grading Rubric

Sample Rubric

Criteria	Not Evident: 0%	Developing: 55%	Proficient: 80%	Distinguished: 100%	Weight
Policy identifies specific rights of employees as related to the use of company computing.	0 points	16.5 points	24 points	30 points	30%
Policy identifies specific responsibilities of employees as related to the use of company computing.	0 points	16.5 points	24 points	30 points	30%
Policy identifies the areas of use, access and security as related to the use of company computing.	0 points	16.5 points	24 points	30 points	30%
Articulation of response (citations, grammar, spelling, syntax, or organization that negatively impact readability and articulation of main ideas).	0 points	5.5 points	8 points	10 points	10%

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SECTION OVERVIEW

33.21: Readings- Information Technology and Business

33.21.1: Reading- Data vs. Information

Data vs. Information

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.

Information Systems

To gather and process data into information and distribute it to people who need it, organizations develop an information system (IS)—the combination of technologies, procedures, and people who collect and distribute the information needed to make decisions and coordinate and control company-wide activities. In most large organizations, the IS is operated by a senior management team that includes a chief information officer (CIO) who oversees information and telecommunications systems. There may also be a chief technology officer who reports to the CIO and oversees IT planning and implementation. As for information managers, their tasks include the following:

- Determining the information needs of members of the organization
- Collecting the appropriate data
- Applying technology to convert data into information
- Directing the flow of information to the right people

Differences in Information Needs

The job is complicated by the fact that information needs vary according to different levels, operational units, and functional areas. Consider, for instance, the following information needs of managers at several levels:

- *Top managers* need information for planning, setting objectives, and making major strategic decisions.
- *Middle managers* need information that helps them allocate resources and oversee the activities under their control.
- *First-line managers* require information that helps them supervise employees, oversee daily operations, and coordinate activities.

Figure 1, “Information Needs and Flows,” illustrates a hypothetical hierarchy of information needs at Caesars. The president, for example, needs information to determine whether profitability is up or down or if the organization is facing any new competitive threats. At the vice-presidential level, executives need information that will help them in controlling and planning for specific areas of operations. The VP of casino operations, for example, might need to know which operations are most profitable—slots, table games, or other gaming activities. The VP of hotel operations might want to know whether room revenues are going up or down.

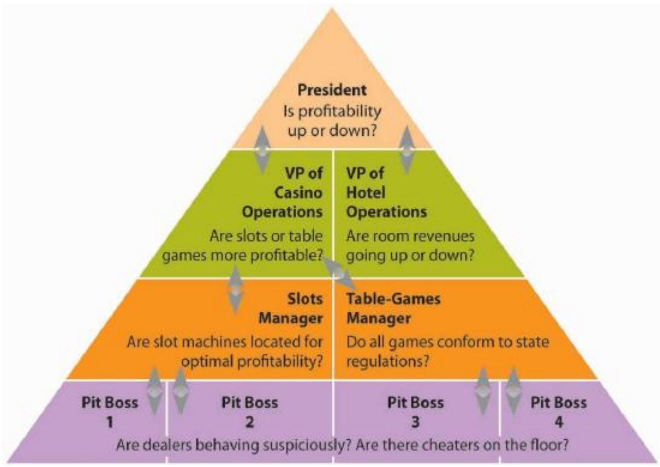

Figure 33.21.1.1: Information Needs and Flows

The information needs of middle-level and lower-level managers are different still. The slot-machine manager might want to know whether the placement of machines on the casino floor affects profitability. The poker manager might want to know whether all table games comply with state regulations. At a lower level, the pit manager (who’s in charge of table games in a particular area) needs to know whether there’s a card-counter at his blackjack table or whether a dealer’s activities are suspicious.

Even at a given level, information needs can vary. A manager on the hotel side of the business, for instance, doesn’t care much about profitability at the poker tables, while a pit manager doesn’t have much use for hotel housekeeping reports. The reports that an accountant needs would hardly be the same as those needed by a human resources manager.

The Need to Share Information

Having stressed the differences in information needs, we should pause to remind ourselves that the managerial levels, operations, and functions of every organization are intertwined, to a greater or lesser degree. If you’ll glance again at Figure 1 above, you’ll be reminded that organizations need to share information, that information must flow, and that it must flow in both directions, bottom-up and top-down. At Caesars, for instance, both casino and hotel managers are concerned about security, which is also of interest to managers in different functional areas. Information supplied by the security group is obviously vital to managers in the gaming areas, but HR managers also need it to screen potential employees. Marketing information is clearly important to both casino and hotel operations: to maximize overall profits, the company uses marketing data to fill hotel rooms with customers who spend big in the casinos.[1]

Caesars’s information needs entail more than allowing individuals in a given casino to share information; information has to be shared among all of Caesars’s thirty-nine casinos. Thus, Caesars relies on an *integrated IT system* that allows real-time communication among all its properties. Installing the system (in the mid-1990s) was complicated, and not everyone in the organization liked the idea. Some managers felt that information sharing threatened their independence. Others, including some in the IT group, doubted that a large number of separate IT systems could be adequately integrated. To get everyone on board, John Bushy, then senior VP of information technology, pledged that he wouldn’t cut his hair until the system was up and running. By the time it was operational in 1997, Bushy had hair down to his shoulders, but it was worth it: Caesars’s ability to share real-time information across all its properties has been a major factor in the company’s success. Caesars’s new system cut costs by $20 million a year, increased brand recognition, and increased the number of customers playing at more than one Caesars property by 72 percent.[2]

Enterprise Systems

Many large and mid-size companies rely on a highly integrated system called an enterprise resource planning (ERP) system to channel information to multiple users. To understand what an ERP system does, forget about the P for *planning* (it really doesn't have much to do with planning) and the R for *resource* (it's an imprecise term). Focus on the E for *enterprise*.[3] An ERP system integrates the computer needs of all activities *across the enterprise* into a single system that serves all users. Such broad integration isn't a simple task, and you wouldn't be the first person to wonder whether it wouldn't be easier to give each department its own computer system. Salespeople, for example, need a system that tracks sales and generates sales reports. Meanwhile, manufacturing personnel don't need to track sales but do need to track inventory. What's the problem with stand-alone computer systems? Quite simply, users in various departments can't share information or communicate with each other.

What If You Don't Have ERP?

Imagine that you're a sales manager for a fairly large manufacturing company that produces and sells treadmills. Like every other department in the organization, you have your own computer system. A local sporting-goods store orders one hundred treadmills through a regional sales representative. It's your job to process the order. It wouldn't be much of a problem for you to go into your computer and place the order. But how would you know if the treadmills were actually in stock and when they could be delivered? How would you know if the customer's credit was any good? You could call the warehouse and ask if the treadmills are in stock. If they are, you'd tell the warehouse manager that you're placing an order and hope that the treadmills are still in stock by the time your order gets there two days later. While you're at it, you'd better ask for an expected delivery date. As a final precaution, you should probably call the finance department and ask about your customer's credit rating. So now you've done your job, and it can hardly be your fault that because the cost of manufacturing treadmills has gone up, accounting has recommended an immediate price increase that hasn't shown up in your computer system yet.

What If You Do Have ERP?

Wouldn't it be easier if you had an ERP system like the one illustrated below in Figure 2, "ERP System"—one that lets you access the same information as every other department? Then you could find out if there were one hundred treadmills in stock, the expected delivery date, your customer's credit rating, and the current selling price—without spending most of the day exchanging phone calls, e-mails, text messages, and faxes. You'd be in a better position to decide whether you can give your customer credit, and you could promise delivery (at a correct price) on a specified date. *Then*, you'd enter the order into the system. The information that you entered would be immediately available to everyone else. The warehouse would know what needs to be shipped, to whom, and when. The accounting department would know that a sale had been made, the dollar amount, and where to send the bill. In short, everyone would have up-to-date information, and no one would have to reinput any data.

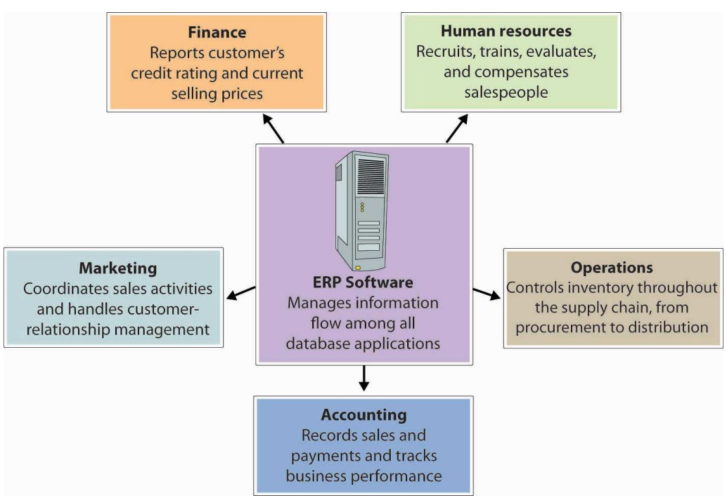

Figure 33.21.1.1: ERP System

KEY TAKEAWAYS

- **Data** are unprocessed facts. **Information** is data that have been processed or turned into some useful form.
- To gather and process data into information and distribute it to people who need it, an organization develops an **information system (IS)**—the combination of technologies, procedures, and people who collect and distribute the information needed to make decisions and to coordinate and control company-wide activities.
- In most large organizations, the information system is operated by a senior management team that includes a **chief information officer (CIO)** who oversees information and telecommunications systems.
- There may also be a **chief technology officer** who reports to the CIO and oversees IT planning and implementation.
- The tasks of **information managers** include the following:
  - Determining the information needs of people in the organization
  - Collecting the appropriate data
  - Applying technology to convert data into information
  - Directing the flow of information to the right people
- The job is complicated by the fact that information needs vary according to different levels, operational units, and functional areas.
- In addition, information must be shared. To channel information to multiple users, large and mid-size companies often rely on a highly integrated system called an **enterprise resource planning (ERP) system**.
- An ERP system integrates the computer needs of all business activities *across the enterprise* into a single computer system that serves all users.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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33.21.2: Reading- Managing Data

Managing 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?

Data and Databases

To answer such questions, let's go back to our Caesars example. As we've seen, Caesars collects a vast amount of data. Its hotel system generates data when customers make reservations, check in, buy food and beverages, purchase stuff at shops, attend entertainment events, and even relax at the spa. In the casino, customers apply for rewards programs, convert cash to chips (and occasionally chips back to cash), try their luck at the tables and slots, and get complimentary drinks. Then, there are the data generated by the activities of the company itself: employees, for instance, generate payroll and benefits data, and retail operations generate data every time they buy or sell something. Moreover, if we added up all these data, we'd have only a fraction of the amount generated by the company's gaming operations.

How does Caesars handle all these data? First of all, it captures and stores them in several databases—electronic collections of related data that can be accessed by various members of the organization. Think of databases as filing cabinets that can hold massive amounts of organized information, such as revenues and costs from hotel activities, casino activities, and events reservations at each of Caesars facilities.

Warehousing and Mining Data

What if Caesars wants to target customers who generate a lot of revenue, by using a program designed to entice return visits? How would it identify and contact these people? Theoretically, it could search through the relevant databases—those that hold customer-contact information (such as name and address) and information about customer activity in the company's hotels, casinos, and entertainment venues. It would be a start, perhaps, but it wouldn't be very efficient. First of all, it would be time-consuming. Plus, what if the same data weren't stored in a similar fashion in each database? In that case, it would be quite hard to combine the data in a meaningful way. To address this problem, Caesars managers will rely on a system like the one illustrated in Figure 1, "The Data Mining Process," which calls for moving all the relevant data into a data warehouse—a centralized database in which data from several databases are consolidated and organized so that they can be easily analyzed.

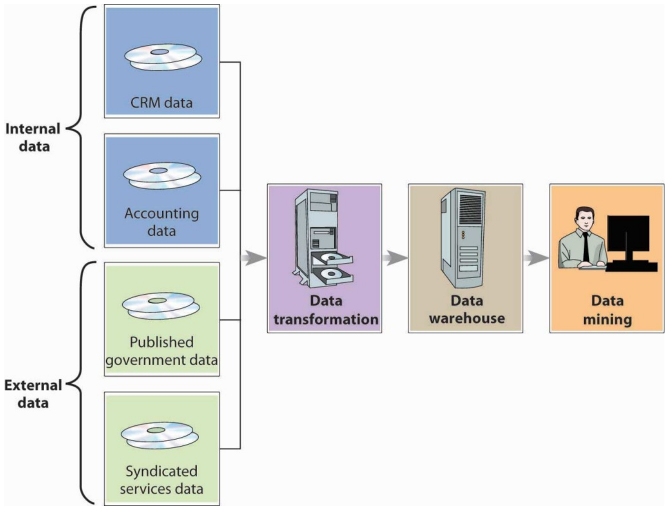

Figure 33.21.2.1: The Data Mining Process

Data Mining

With the data in one central location, management can find out everything it needs to about a particular group of customers. It can also use the data to address some pretty interesting questions. Why do people come to our casinos? How can we keep customers coming back? How can we increase the number of visits per customer? How can we increase the amount they spend on each visit? What incentives (such as free dinners, hotel rooms, or show tickets) do our customers like most? To come up with answers to these questions, they'll perform a technique called data mining—the process of searching and analyzing large amounts of data to reveal patterns and trends that can be used to predict future behavior.

Data Mining and Customer Behavior

By data-mining its customer-based data warehouse, Caesars's management can discover previously unknown relationships between the general behavior of its customers and that of a certain group of customers (namely, the most profitable ones). Then, it can design incentives to appeal specifically to those people who will generate the most profit for the company.

To get a better idea of how data mining works, let's simplify a description of the process at Caesars. First, we need to know how the casino gathered the data to conduct its preliminary analysis. Most customers who play the slots use a Caesars player's card that offers incentives based on the amount of money that they wager on slot machines, video poker, and table games. To get the card, a customer must supply some personal information, such as name, address, and phone number. From Caesars's standpoint, the card is extremely valuable because it can reveal a lot about the user's betting behavior: actual wins and losses, length of time played, preferred machines and coin denominations, average amount per bet, and—most important—the speed with which coins are deposited and buttons pushed. Caesars's primary data source was *internal*—generated by the company itself rather than provided by an outside source—and drew on a marketing database developed for *customer relationship management* (CRM).

What does the casino do with the data that it's mined? Caesars was most interested in "first trippers"—first-time casino customers. In particular, it wanted to know which of these customers should be enticed to return. By analyzing the data collected from player's-card applications and from customer's actual play at the casino (even if for no more than an hour), Caesars could develop a profile of a profitable customer. Now, when a first-timer comes into any of its casinos and plays for a while, Caesars can instantly tell whether he or she fits the profitable-customer profile. To lure these people back for return visits, it makes generous offers of free or reduced-rate rooms, meals, entertainment, or free chips (the incentive of choice for Caesars's preferred customers). These customers make up 26 percent of all Caesars's customers and generate 82 percent of its revenues. Surprisingly, they're not the wealthy high rollers to whom Caesars had been catering for years. Most of them are regular working people or retirees with available time and income and a fondness for slots. They generally stop at the casino on the way home from work or on a weekend night and don't stay overnight. They enjoy the thrill of gambling, and you can recognize them because they're the ones who can't push the button or pump tokens in fast enough.

KEY TAKEAWAYS

- Organizations capture and store data in **databases**—electronic collections of related data that can be accessed by various people in the organization.
- To facilitate data analysis, IS managers may move data from various databases into a **data warehouse**—a centralized database in which data are consolidated and organized for efficient analysis.
- To come up with answers to a huge range of questions, managers perform a technique called **data mining**—the process of searching and analyzing large amounts of data to reveal patterns and trends that can be used to predict future behavior.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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33.21.3: Reading- Computer Networks and Cloud Computing

Computer Networks and Cloud Computing

Once it's grown beyond just a handful of employees, an organization needs a way of sharing information. Imagine a flower shop with twenty employees. The person who takes phone orders needs access to the store's customer list, as do the delivery person and the bookkeeper. Now, the store may have one computer and everyone could share it. It's more likely, however, that there are a number of computers (several for salespeople, one for delivery, and one for bookkeeping). In this case, everyone needs to be sure that customer records have been updated on all computers every time that a change is required.

Networks

Likewise, many companies want their personal computers to run their own software and process data independently. But they also want people to share databases, files, and printers, and they want them to share applications software that performs particular tasks, including word processing, creating and managing spreadsheets, designing graphical presentations, and producing high-quality printed documents (*desktop publishing*).

The solution in both cases is *networking*—linking computers to one another. The two major types of networks are distinguished according to geographical coverage:

- A local area network (LAN) links computers that are in close proximity—in the same building or office complex. They can be connected by cables or by wireless technology. Your university might have a LAN system that gives you access to resources, such as registration information, software packages, and printers. Figure 1, "Local Area Network (LAN)," below, illustrates a LAN that's connected to another network by means of a *gateway*—a processor that allows dissimilar networks to communicate with one another
- Because a wide area network (WAN) covers a relatively large geographical area, its computers are connected by telephone lines, wireless technology, or even satellite.

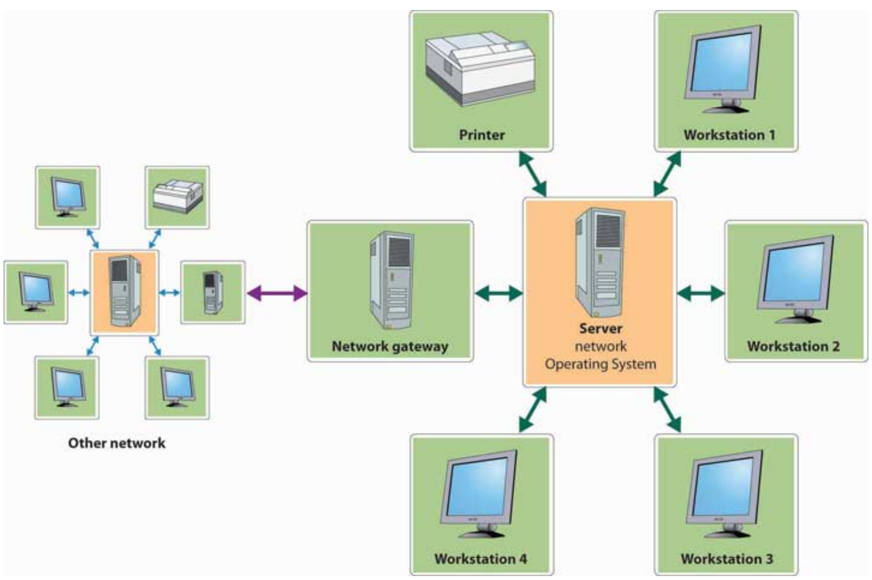

Figure 33.21.3.1: Local area network

Like the one above in Figure 1, "Local Area Network (LAN)," some networks are client-server systems, which include a number of client machines (the ones used by employees for data input and retrieval) and a server (which stores the database and the programs used to process the data). Such a setup saves time and money and circulates more-accurate information.

Cloud Computing

What is cloud computing? Watch the following video, which describes some of the uses and benefits of cloud computing.

A cloud is a “visible mass of condensed water vapor floating in the atmosphere, typically high above the ground.” The term “cloud computing” means performing computer tasks using services provided over the Internet. So how do you connect the two definitions? When IT professionals diagrammed computer systems, they used a cloud symbol to represent the Internet. So when you hear or read that an individual or company is using the “cloud” or technology firms, such as IBM, Hewlett-Packard, and Salesforce.com, are offering cloud services, just substitute the word “Internet” for “cloud” and things will make sense.

You might be surprised to learn that you’re already using the cloud—that is if you use Facebook (which is very likely—in fact, just mentioning Facebook here might prompt you to stop studying and check out your friends’ pages). How do you know that Facebook is a cloud application? Remember the trick: just substitute the word “Internet” for “cloud.” The Facebook computer application lets you store information about yourself and share it with others using the Internet.

Business Applications

Think about the functional areas of business you’ve explored in this text: accounting, finance, human resources, management, marketing, operations, and product design. Now imagine you’re Katrina Lane, senior vice president and chief technology officer for Caesars Entertainment, who is responsible for the information technology needed to handle multiple tasks in all these functional areas. You’re sitting at your desk when Gary Loveman, chief executive officer of Caesars, walks in and gives you the news. Caesars just purchased the Planet Hollywood Casino and Resort in Las Vegas and will open up two new casinos in Ohio in 2012. This is good news for the company, but it means a lot of work for you and your staff.

You wonder whether this might be the time to outsource some of your computing tasks to a technology firm specializing in cloud computing. You remember an example that really makes sense. Right now, whenever Microsoft comes out with a new version of Word, Caesars has to pay $350 per PC for the latest version. Wouldn’t it make more sense to rent the use of the Microsoft Word program from a cloud vendor for say $5 a month (or $60 a year)? Given that the average time between new releases of Word is two years, your total cost per PC would be $120 (2 × $60)—a savings of about $230 per PC ($350 − $120). Your employees wouldn’t mind; instead of working offline, they would just login to the Internet and work with their online version using the files that were saved for them. And the members of your IT staff would be pleased that they wouldn’t need to install the new version of Word on all your PCs.

The As-A-Service Group

Companies can contract for various cloud computing services. The Microsoft Word example discussed previously is classified as software as a service (SaaS). This type of service gives companies access to a large assortment of software packages without having to invest in hardware or install and maintain software on its own computers. The available software, which includes e-mail and collaboration systems and customer relationship management programs, can be customized and used by an individual client or shared among several clients. A second type of service is called infrastructure as a service (IaaS). Instead of providing users with software, a technology firm offering infrastructure as a service provides hardware, including servers, central processing units, network equipment, and disk space. The most successful IaaS provider is Amazon Web Services. The company rents computer power and storage to users who access their data via the Internet. The last as-a-service model is called platform as a service (PaaS). Those offering platform as a service provide services that enable users to develop customized web applications. Because they don't have to start from scratch but rather build on existing platforms made available by the service provider, the web applications can be developed quickly.

Advantages and Disadvantages of Cloud Computing

In making your final decision (as the pretend chief technology officer for Caesars) you should consider these advantages and disadvantages of cloud computing:

Advantages

Shifting some of Caesars's IT functions to the cloud would produce a number of advantages:

1. *Cost Savings*—By "renting" software rather than buying it, Caesars can reduce its costs. The monthly fee to "use" the software is generally less than the combined cost of buying, installing, and maintaining the software internally. On the hardware site, housing Caesars's data in a service provider's facilities, rather than in-house, reduces the large outlay of cash needed to build and maintain data centers.
2. *Speed of Delivery*—Purchasing and installing software and data processing equipment can be time consuming. A cloud computing service provider could get Caesars's applications up and running in only a few weeks.
3. *Scalable*—Caesars is constantly expanding both in the number of casinos it owns and geographically. In this ever-changing environment, it's difficult to gauge the level of our technology needs. If we overestimate our requirements, we end up paying for technology we don't need. If we underestimate, efficiency goes down, and the experience for our customers diminishes. By using cloud computing we are able to have exactly what we need at our disposal at any point in time.
4. *Employees Can Be Mobile*—The use of cloud computing will free workers from their desks and allow them to work wherever they are. As applications move to the cloud, all that is needed for our employees to connect to their "offices" is the Internet. This mobility benefit also makes it easier for employees to collaborate on projects and connect with others in the company.
5. *Information Technology Staff*—Although our current staff is extremely qualified and dedicated, finding experienced and knowledgeable staff is a continuing problem particularly in the casino industry which suffers from historically high turnover. By using cloud computing, we reduce our human resource needs by shifting some of our work to outside vendors who are able to hire and keep well qualified individuals (in part because IT professionals enjoy working for technology companies).

Disadvantages

Although the advantages of moving to a cloud environment outnumber the disadvantages, the following disadvantages are cause for concern:

1. *Disruption in Internet Service*—If Caesars moves some of its applications to the cloud, its employees can work on these applications on any device and in any location as long as they have an Internet connection. But what if the Internet is unavailable because of a disruption? Depending on the length of the disruption, this could create serious problems for Caesars.
2. *Security*—Many companies are reluctant to trust cloud service providers with their data because they're afraid it might become available to unauthorized individuals or criminals. This is a particular problem for Caesars, which collects and stores sensitive client information and has to constantly be on the lookout for fraudulent activity of staff and customers.
3. *Service Provider System Crash*—Organizations considering moving to the cloud are justifiably concerned about the possibility of a computer service crash at their service providers' facilities. It looks like this concern was warranted. In April of 2011, Amazon Web Service (a leading cloud services provider) experienced an outage in one of its large web-connected data centers. The outage crashed its system and brought down the Web sites of a number of companies, including the location-based social network, Foursquare. It took more than thirty-six hours to get all seventy or so of the crashed sites up and running.

Go or No Go?

So, pretend chief technology officer for Caesars, what's your decision: will you get on the cloud or stay on the ground? If you are curious about what the real chief technology officer did, she took the high road and transferred a number of applications to Salesforce.com's Web-based Force.com's cloud applications service.

KEY TAKEAWAYS

- Once an organization has grown to more than a few employees, it needs to network individual computers to allow them to share information and technologies.
- A **client-server system** links a number of client machines (for data input and retrieval) with a server (for storing the database and the programs that process data).
- Many companies want personal computers to run their own software and process data independently.
- But they also want individuals to share databases, files, printers, and **applications software** that perform particular types of work (word processing, creating and managing spreadsheets, and so forth).
- There are two systems that can satisfy both needs.
  1. A **local area network (LAN)** links computers in close proximity, connecting them by cables or by wireless technology.
  2. A **wide area network (WAN)** covers a relatively large geographical area and connects computers by telephone lines, wireless technology, or satellite.
- The term “**cloud computing**” means performing computer tasks using services provided over the Internet.
- The **software as a service (SaaS)** category of cloud computing gives companies access to a large assortment of software packages without having to invest in hardware or install and maintain software on its own computers.
- A technology firm offering **infrastructure as a service** provides users with hardware, including servers, central processing units, network equipment, and disk space.
- Those offering the **platform as a service** category of cloud computing provide services that enable users to develop customized web applications.
- Shifting IT functions to the cloud produces a number of advantages, including cost savings, speedy delivery of software, scalability (you pay for only what you need), employee mobility, and a reduction in information technology staff.
- The following disadvantages of cloud computing are cause for concern: disruption in internet service, security issues, and unreliability of service provider systems.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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33.21.4: Reading- Ethical and Social Issues

Technoethics

Ethical and social issues arising from the use of technology in all areas of our lives—and in business, in particular—have lead to the creation of a new branch of ethics: technoethics.

Technoethics (TE) is an interdisciplinary research area concerned with all moral and ethical aspects of technology in society. It draws on theories and methods from multiple knowledge domains (such as communications, social sciences information studies, technology studies, applied ethics, and philosophy) to provide insights on ethical dimensions of technological systems and practices for advancing a technological society.[1]

Technoethics views technology and ethics as socially embedded enterprises and focuses on discovering the ethical use of technology, protecting against the misuse of technology, and devising common principles to guide new advances in technological development and application to benefit society. Typically, scholars in technoethics have a tendency to conceptualize technology and ethics as interconnected and embedded in life and society. Technoethics denotes a broad range of ethical issues revolving around technology- from specific areas of focus affecting professionals working with technology to broader social, ethical, and legal issues concerning the role of technology in society and everyday life.[2]

Recent advances in technology and their ability to transmit vast amounts of information in a short amount of time has changed the way information is being shared amongst co-workers and managers throughout organizations across the globe. Starting in the 1980s with information and communications technologies (ICTs), organizations have seen an increase in the amount of technology that they rely on to communicate within and outside of the workplace. However, these implementations of technology in the workplace create various ethical concerns and in turn a need for further analysis of technology in organizations. As a result of this growing trend, a subsection of technoethics known as organizational technoethics has emerged to address these issues.

Technoethical perspectives are constantly changing as technology advances into areas unseen by creators and users engage with technology in new ways.

Technology, Business, and Your Data

Technology makes businesses more efficient, makes tasks faster and easier to complete, and ultimately creates value from raw data. However, as much as technology impacts the *way* that companies do business, it also raises important new issues about the employer-employee relationship. If you send personal emails from your office computer, do you have the right to expect that they're private? Does your employer have a legal and ethical right to "cyber-peek" at what you are doing with company assets? Twenty years ago this was not an issue; today it's a case before the Supreme Court.

Social Media

Employers want to use technology to help them screen applicants and verify information about their workforce, which is understandable. In the module on Human Resource Management you learned about the cost of recruiting, hiring, and training employees. However, what if the company believes that one of the quickest ways to gather information about an employee is to access their social media accounts? A company would never ask for your login credentials for Facebook, Twitter, InstaGram, LinkdIn . . . or would they? And if they did, is it legally and ethically justified? What would you do if you found yourself in the situation presented in the following video?

Information As a Business

The fact is that technology has put our information at the fingertips of businesses—there for the taking and, in some cases, the selling. Is it ethical for a business to collect data about a person and then sell that information to another business? Many organizations collect data for their own purposes, but they also realize that your data has value to others. As a result, selling data has become an income stream for many organizations. If you didn't realize that your data was collected by Company A, it's even less likely you knew that it was sold to Company B.

We have discussed just a few of the emerging ethical issues surrounding business, technology, and personal data. We have yet to touch on security issues and the responsibility business has to protect your data once it has been collected.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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1. Luppicini, R. (2010). Technoethics and the evolving knowledge society. Hershey: Idea Group Publishing. ↵
2. Luppicini, R. (2010). Technoethics and the evolving knowledge society. Hershey: Idea Group Publishing. ↵

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33.21.5: Reading- Security Issues in Electronic Communication

Security Issues in Electronic Communication

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. 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. 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. The battle against technology crime is near the top of the FBI’s list of priorities, behind only the war against terrorism and espionage. 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.

Data Security

In some ways, life was simpler for businesspeople before computers. Records were produced by hand and stored on paper. As long as you were careful to limit access to your records (and remembered to keep especially valuable documents in a safe), you faced little risk of someone altering or destroying your records. In some ways, storing and transmitting data electronically is a little riskier. Let’s look at two data-security risks associated with electronic communication: *malicious programs* and *spoofing*.

Malicious Programs

Some people get a kick out of wreaking havoc with computer systems by spreading a variety of destructive programs. Once they’re discovered, they can be combated with antivirus programs that are installed on most computers and that can be updated daily. In the meantime, unfortunately, they can do a lot of damage, bringing down computers or entire networks by corrupting operating systems or databases.

Viruses, Worms, and Trojan Horses

The cyber vandal’s repertory includes “viruses,” “worms,” and “Trojan horses.” Viruses and worms are particularly dangerous because they can copy themselves over and over again, eventually using up all available memory and closing down the system. Trojan horses are viruses that enter your computer by posing as some type of application. Some sneak in by pretending to be virus-scanning programs designed to rid your computer of viruses. Once inside, they do just the opposite.

Spoofing

It's also possible for unauthorized parties to gain access to restricted company Web sites—usually for the purpose of doing something illegal. Using a technique called "spoofing," culprits disguise their identities by modifying the address of the computer from which the scheme has been launched. Typically, the point is to make it look as if an incoming message has originated from an authorized source. Then, once the site's been accessed, the perpetrator can commit fraud, spy, or destroy data. You could, for example, spoof a manufacturing firm with a false sales order that seems to have come from a legitimate customer. If the spoof goes undetected, the manufacturer will incur the costs of producing and delivering products that were never ordered (and will certainly never be paid for).

Every day, technically savvy thieves (and dishonest employees) steal large sums of money from companies by means of spoofing or some other computer scheme. It's difficult to estimate the dollar amount because many companies don't even know how much they've lost.

Revenue Theft

In addition to the problems of data security faced by every company that stores and transmits information electronically, companies that sell goods or provide services online are also vulnerable to activities that threaten their revenue sources. Two of the most important forms of computer crime are *denial of service* and *piracy*.

Denial of Service

A denial-of-service attack does exactly what the term suggests: it prevents a Web server from servicing authorized users. Consider the following scenario. Dozens of computers are whirring away at an online bookmaker in the offshore gambling haven of Costa Rica. Suddenly a mass of blank incoming messages floods the company's computers, slowing operations to a trickle. No legitimate customers can get through to place their bets. A few hours later, the owner gets an e-mail that reads, "If you want your computers to stay up and running through the football season, wire $40,000 to each of 10 numbered bank accounts in Eastern Europe."

You're probably thinking that our choice of online gambling as an example of this scheme is a little odd, but we chose it because it's real: many companies in the online-gambling industry suffer hundreds of such attacks each year. Because most gambling operations opt to pay the ransom and get back to business as usual, denial of service to businesses in the industry has become a very lucrative enterprise.

Online gambling operations are good targets because they're illegal in the United States, where they can't get any help from law-enforcement authorities. But extortionists have been known to hit other targets, including Microsoft and the Recording Industry Association of America. The problem could become much more serious if they start going after e-commerce companies and others that depend on incoming orders to stay afloat.

Piracy

Technology makes it easier to create and sell intellectual property, but it also makes it easier to steal it. Because digital products can be downloaded and copied almost instantly over the Internet, it's a simple task to make perfect replicas of your favorite copyright-protected songs, movies, TV shows, and computer software, whether for personal use or further distribution. When you steal such materials, you're cheating the countless musicians, technicians, actors, programmers, and others involved in creating and selling them. Theft cuts into sales and shrinks corporate profits, often by staggering amounts. Entertainment-industry analysts estimate that $30 billion worth of songs were illegally downloaded in the five year period ending in 2009. The software industry estimates that the global market for pirated software reached $59 billion in 2010.

So, what's being done to protect the victimized companies? Actually, quite a lot, even though it's a daunting task, both in the United States and abroad. In 1998, Congress passed the Digital Millennium Copyright Act, which outlaws the copying of copyright-protected music (unless you're copying legally acquired music for your own use). The penalties are fairly stiff: up to three years in prison and $250,000 in fines. To show that it means business, the music industry is also hauling offenders into court, but legal action is costly and prosecuting teenage music lovers doesn't accomplish much. Some observers believe that the best solution is for the industry to accelerate its own efforts to offer its products online. Initial attempts seem to be working: people who are willing to obey copyright laws have downloaded more than ten billion songs from the iTunes site alone.

Firewalls

Builders install firewalls (or fireproof walls) in structures to keep a fire that starts in one part of a building from entering another part. Companies do something similar to protect their computer systems from outside intruders: they install virtual firewalls—

software and hardware systems that prevent unauthorized users from accessing their computer networks.

You can think of the firewall as a gatekeeper that stands at the entry point of the company's network and monitors incoming and outgoing traffic. The firewall system inspects and screens all incoming messages to prevent unwanted intruders from entering the system and causing damage. It also regulates outgoing traffic to prevent employees from inappropriately sending out confidential data that shouldn't leave the organization.

Risks to Customers

Many people still regard the Internet as an unsafe place to do business. They worry about the security of credit-card information and passwords and the confidentiality of personal data. Are any of these concerns valid? Are you really running risks when you shop electronically? If so, what's being done to make the Internet a safer place to conduct transactions? Let's look a little more closely at the sort of things that tend to bother some Internet users (or, as the case may be, nonusers), as well as some of the steps that companies are taking to convince people that e-commerce is safe.

Credit-Card Theft

One of the more serious barriers to the growth of e-commerce is the perception of many people that credit-card numbers can be stolen when they're given out over the Internet. Though virtually every company takes considerable precautions, they're not entirely wrong. Cyber criminals, unfortunately, seem to be tirelessly creative. One popular scheme involves setting up a fraudulent Internet business operation to collect credit-card information. The bogus company will take orders to deliver goods—say, Mother's Day flowers—but when the day arrives, it will have disappeared from cyberspace. No flowers will get delivered, but even worse, the perpetrator can sell or use all the collected credit-card information.

Password Theft

Many people also fear that Internet passwords—which can be valuable information to cyber criminals—are vulnerable to theft. Again, they're not altogether wrong. There are schemes dedicated entirely to stealing passwords. In one, the cyber thief sets up a Web site that you can access only if you register, provide an e-mail address, and select a password. The cyber criminal is betting that the site will attract a certain percentage of people who use the same password for just about everything—ATM accounts, e-mail, employer networks. Having finagled a password, the thief can try accessing other accounts belonging to the victim. So, one day you have a nice cushion in your checking account, and the next you're dead broke.

Invasion of Privacy

If you apply for a life-insurance policy online, you may be asked to supply information about your health. If you apply for a mortgage online, you may be asked questions about your personal finances. Some people shy away from Internet transactions because they're afraid that such personal information can be stolen or shared with unauthorized parties. Once again, they're right: it does happen.

How Do "Cookies" Work?

In addition to data that you supply willingly, information about you can be gathered online without your knowledge or consent. Your online activities, for example, can be captured by something called a *cookie*. The process is illustrated below in Figure 1, "How Cookies Work." When you access a certain Web site, it sends back a unique piece of information to your browser, which proceeds to save it on your hard drive. When you go back to the same site, your browser returns the information, telling the site who you are and confirming that you've been there before. The problem is not that the cookie can identify you in the same way as a name or an address. It is, however, linked to other information about you—such as the goods you've bought or the services you've ordered online. Before long, someone will have compiled a profile of your buying habits. The result? You'll soon be bombarded with advertisements targeted to your interests. For example, let's suppose you check out the Web site for an online diet program. You furnish some information but decide that the program is not for you. The next time you log on, you may be greeted by a pop-up pushing the latest miracle diet.

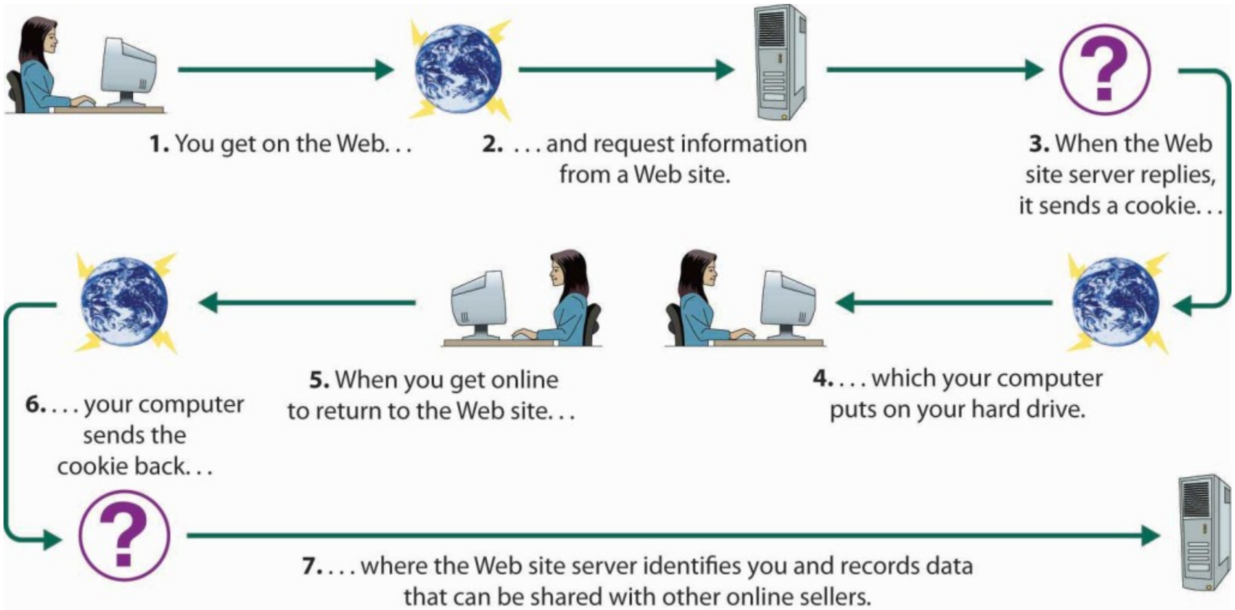

Figure 33.21.5.1: How Cookies Work

Cookies aren't the only form of online espionage. Your own computer, for example, monitors your Internet activities and keeps track of the URLs that you access.

Shoring up Security and Building Trust

So, what can companies do to ease concerns about the safety of Internet transactions? First, businesses must implement internal controls for ensuring adequate security and privacy. Then, they must reassure customers that they're competent to safeguard credit-card numbers, passwords, and other personal information. Among the most common controls and assurance techniques, let's look at *encryption* and *seals of assurance*.

Encryption

The most effective method of ensuring that sensitive computer-stored information can't be accessed or altered by unauthorized parties is encryption—the process of encoding data so that only individuals (or computers) armed with a secret code (or key) can decode it. Here's a simplified example: You want to send a note to a friend on the other side of the classroom, but you don't want anyone else to know what it says. You and your friend could devise a code in which you substitute each letter in the message with the letter that's two places before it in the alphabet. So you write A as C and B as D and so on. Your friend can decode the message, but it'll look like nonsense to anyone else. This is an oversimplification of the process. In the real world, it's much more complicated: data are scrambled using a complex code, the key for unlocking it is an algorithm, and you need certain computer hardware to perform the encryption/decryption process.

Certificate Authorities

The most commonly used encryption system for transmitting data over the Internet is called *secure sockets layer* (SSL). You can tell whether a Web site uses SSL if its URL begins with *https* instead of *http*. SSL also provides another important security measure: when you connect to a site that uses SSL (for example, your bank's site), your browser will ask the site to authenticate itself—prove that it is who it says it is. You can be confident that the response is correct if it's verified by a certificate authority—a third-party (such as VeriSign) that verifies the identify of the responding computer and sends you a digital certificate of authenticity stating that it trusts the site.

KEY TAKEAWAYS

- Though a source of vast opportunities, **e-commerce**—conducting business over the Internet—also presents some unprecedented challenges, particularly in the area of security.
  - *Malicious programs*, such as viruses and worms, can wreak havoc with computer systems.
  - Unauthorized parties may gain access to restricted company Web sites in order to steal funds or goods.

- **Firewalls**—software and hardware systems that prevent unauthorized users from accessing computer networks—help to reduce the risks of doing business online.
- Companies that do business online are also vulnerable to illegal activities.
  - A *denial-of-service attack*, for example, prevents a Web server from servicing authorized users; the culprit demands a ransom to stop the attack.
  - Companies that use the Internet to create and sell intellectual property (such as songs, movies, and software) face the problem of *piracy*.
  - The theft of digital products, which can be downloaded and copied almost instantly over the Internet, not only cheats the individuals and organizations that create them, but also reduces sales and shrinks corporate profits.
- Finally, online businesses 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.
- One effective method for protecting computer-stored information is **encryption**—the process of encoding data so that only individuals (or computers) armed with a secret code (or key) can decode it.
  - A commonly used encryption scheme is a *secure sockets layer* (SSL), which directs the user's browser to ask a site to authenticate itself.
  - Often, the user receives a digital certificate of authenticity, verifying that a third-party security provider called a **certificate authority** has identified a computer.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Glossary

corporate stakeholder | A corporate stakeholder is that which can affect or be affected by the actions of the business as a whole.

Glossary

Sample Word 1 | Sample Definition 1

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