BMT1010: INTRODUCTION TO BUSINESS

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BMT1010 - Introduction to Business

Compiled by

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Introduction to Business

TEXTBOOK INFORMATION

This is the Textbook for Introduction to Business OER (Open Educational Resource) which has been compiled by the OER Team in the Prince George's Community College Business and Entrepreneurship Department and made available through Libretexts

You will not need to purchase a textbook for this course.

COURSE DESCRIPTION

This course is a gateway course into the basics of business enterprise, its organization and its role in a free society. Emphasis is placed on business environments, marketing, and the use of technology in business. Students explore economic systems and conditions, the global environment, and components of business, such as corporate and social responsibility. Students are introduced to various components of human resources management such as structure, leadership, motivation, and teaming. Students learn about financial management in terms of assets, liabilities, and equity. (May also be taken as a continuing education course, MGT 585 Introduction to Business.)

COURSE LEARNING OUTCOMES:

Upon successful completion of this course, students will be able to:

1. Discuss the roles of various stakeholders such as consumers, employees, and business owners, in all aspect of business.
2. Identify the components of business.
3. Identify the factors of global business environment
4. Explain the advantages and disadvantages associated with various forms of business ownership.
5. Examine the role of Human Resources Management as it relates to structure, leadership, teaming, and professional development.
6. Match various marketing activities with different types of business organizations.
7. Explain the importance of using technology in various forms of business.
8. Recognize the relationships among assets, liabilities and equity.

Licensing

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

CHAPTER OVERVIEW

1: Module One - Role of Business

1.1: 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 1.1.1: 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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1.2: 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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1.3: 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 1.3.1: 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 1.3.2: 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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1.4: 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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1.5: 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 1.5.1: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 1.5.2: 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.

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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**

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1.6: 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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1.7: 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).

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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 1.7.1: 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.

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CHAPTER OVERVIEW

2: Module Two - Roles of Stakeholders

2.1: 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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2.2: What Is a Stakeholder?

Learning Objectives

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

Figure 2.2.1: 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.

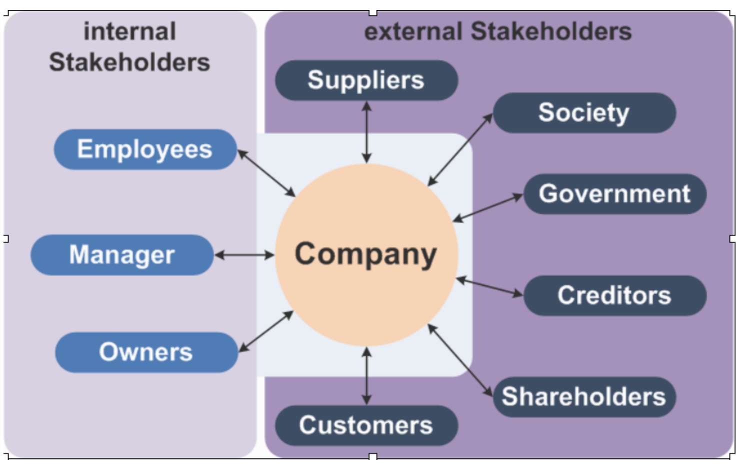

Figure 2.2.2: The picture shows the typical stakeholders of a company. The stakeholders are divided into internal and external stakeholders.

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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2.3: 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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2.4: 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 2.4.1: 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 2.4.2: 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 2.4.3: 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 2.4.4: 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 2.4.5: Business and its environment.

Practice Questions

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CHAPTER OVERVIEW

3: Module Three - Functional Components of Business

3.1: 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 3.1.1: 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.

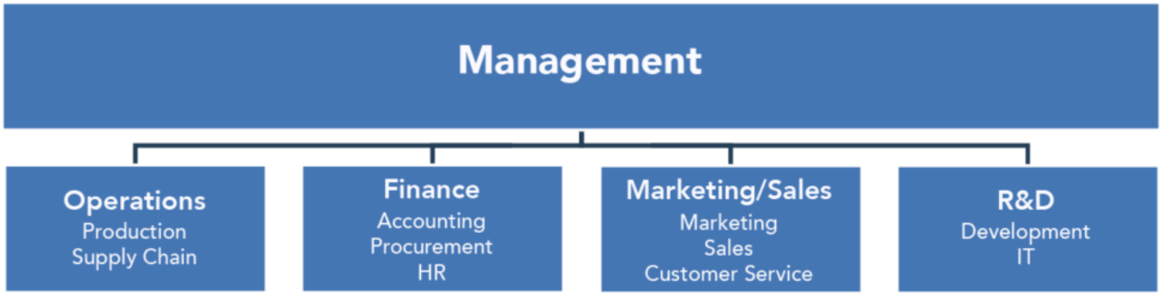

Figure 3.1.2: Copy and Paste Caption here.

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.

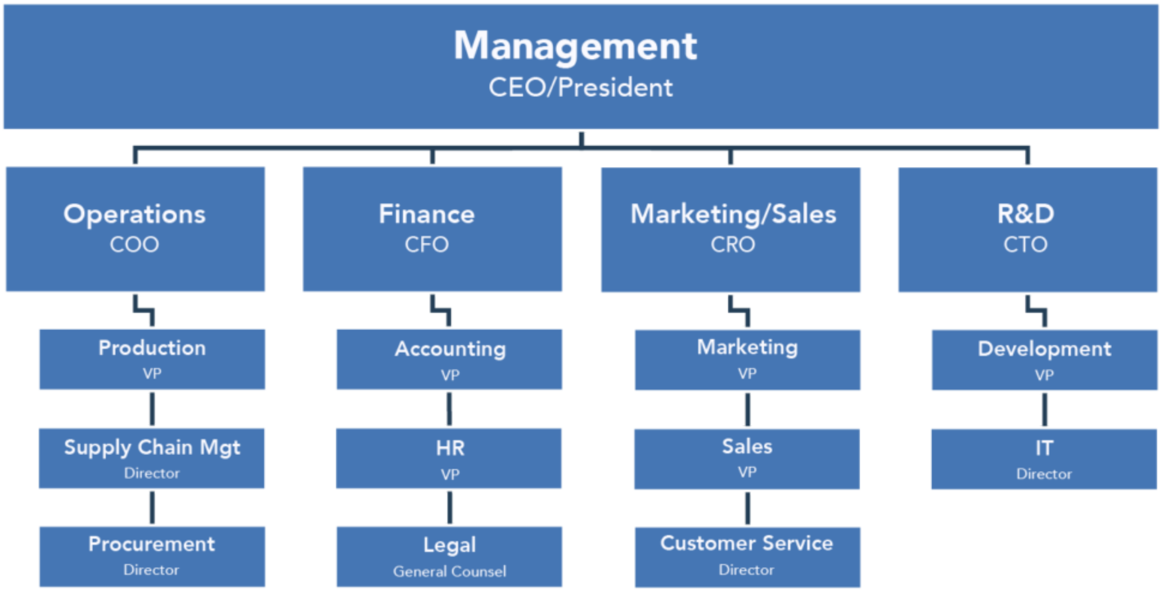

Figure 3.1.3: Key people within functional areas.

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.

? Practice Questions

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CHAPTER OVERVIEW

4: Module Four - Global Business Environment Factors

4.1: 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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4.2: 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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4.3: 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

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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. ↵

Contributors and Attributions

4.4: 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.

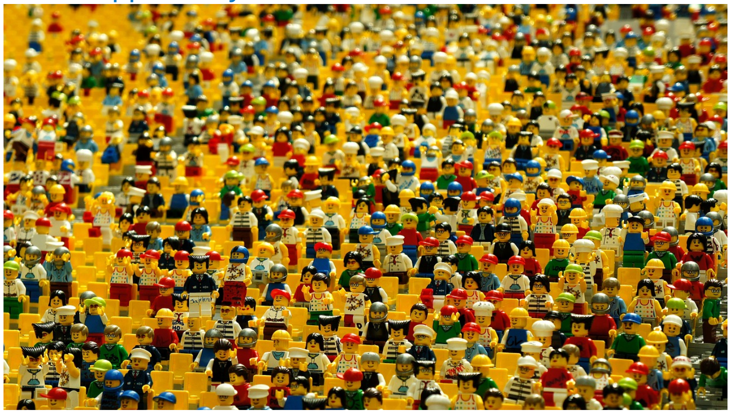
Contributors and Attributions

4.5: 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

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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. ↵

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4.6: 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.

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4.7: 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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4.8: 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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4.9: 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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4.10: 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 4.10.1: 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 4.10.2: 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

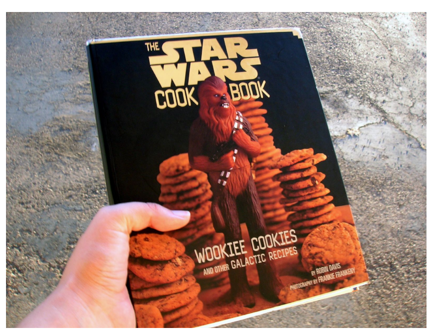

Figure 4.10.3:The Star Wars Cookbook

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 4.10.4: 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 4.10.5: 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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CHAPTER OVERVIEW

5: Module Five - Global Business Environment Factors

5.1: 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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5.2: 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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Contributors and Attributions

5.3: Political and Economic Differences

Learning Objectives

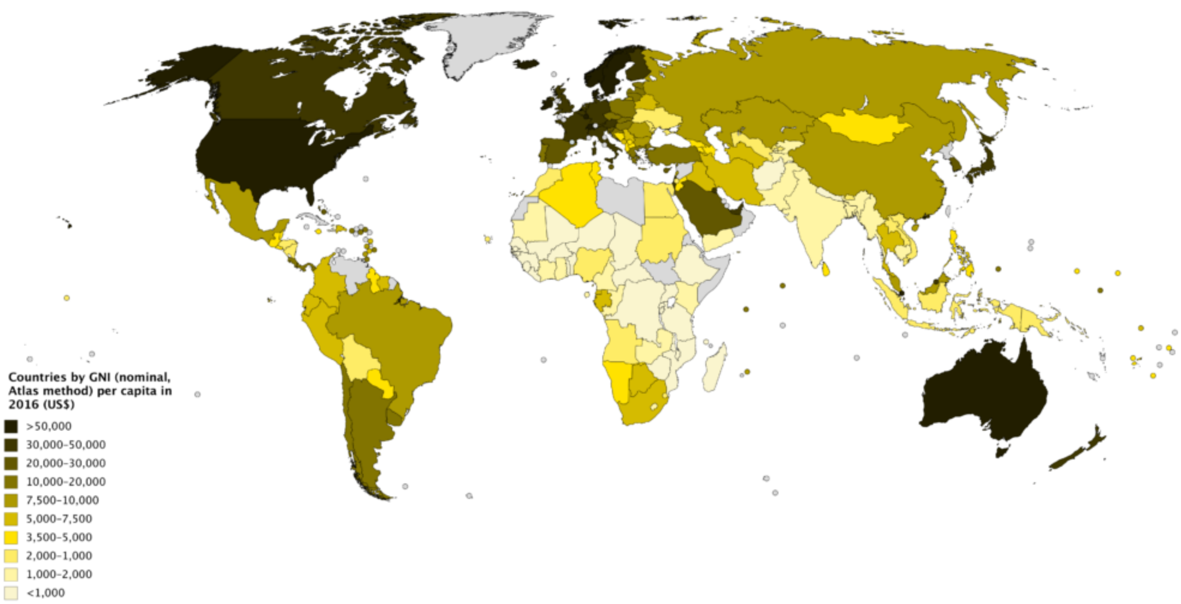
- Describe the impact of political and economic forces on global trade

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.

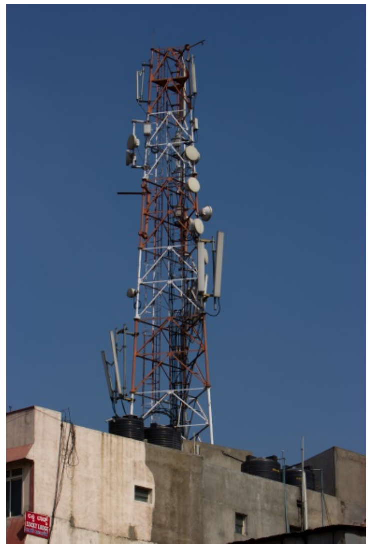


Figure 5.3.1: India has the world’s second-largest mobile-phone user base: 996.66 million users as of September 2015. Shown here is a rooftop mobile phone tower in Bangalore.

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

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1. "Conversion Rates - Exchange Rates - OECD Data." OECD. Accessed June 24, 2019. https://data.oecd.org/conversion/exchange-rates.htm. ↵

Contributors and Attributions

5.4: 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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5.5: 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

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5.6: 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).

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5.7: 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

5.8: The World Trade Organization (WTO)

Learning Objectives

- Describe the role of the WTO in promoting global trade

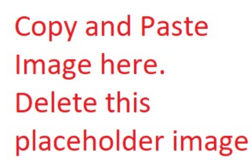

Figure 5.8.1: Copy and Paste Caption here. (Copyright; author via source)

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

5.9: The World Bank

Learning Objectives

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

Figure 5.9.1: 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

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5.10: 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

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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).

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5.11: Trade Agreements

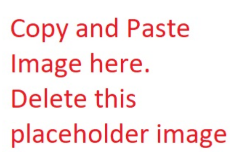
Learning Objectives

- 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].



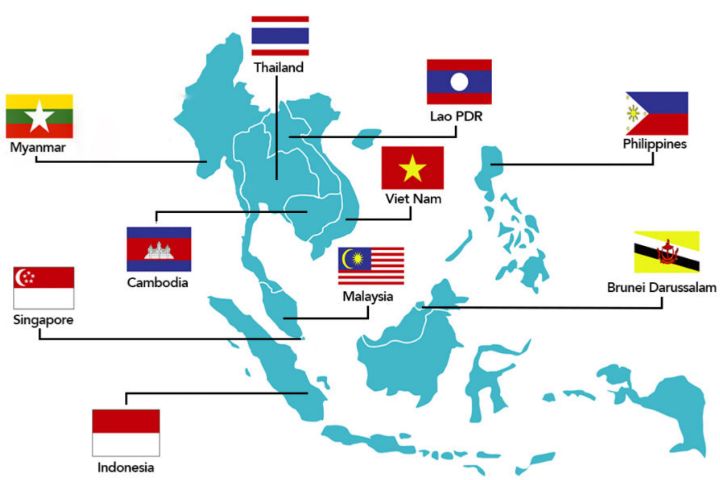


Figure 5.11.1: The Association of Southeast Asian Nations (ASEAN)

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

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

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- **9.21: Trade Agreements** has no license indicated.

5.12: 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.

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5.13: 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

5.14: 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 5.14.1: 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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5.15: 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.

CHAPTER OVERVIEW

6: Module Six- Forms of Business Ownership

6.1: 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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6.2: 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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6.3: 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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6.4: 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.

6.5: 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

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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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6.6: 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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6.7: 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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6.8: 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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6.9: C and S Corporations

Learning Objectives

- Summarize the differences between C and S corporations
- Discuss the advantages and disadvantages of corporations

Corporate Rights

Figure 6.9.1: 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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6.10: 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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2. "Benefit Corporations: Frequently Asked Questions." BLab. http://benefitcorp.net/sites/default/files/FAQs%20Directors%20and%20Officers_6_17.pdf↵

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6.11: 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.

Contributors and Attributions

6.12: 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

https://assessments.lumenlearning.co...essments/14385

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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6.13: 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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6.14: 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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6.15: 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

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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

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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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6.16: 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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6.17: 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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1. Kenton, Will. "Vertical Integration." Investopedia. August 21, 2019. http://www.investopedia.com/terms/v/verticalintegration.asp#ixzz4PRMbV5zm↵

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6.18: 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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CHAPTER OVERVIEW

7: Module Seven- Entrepreneurship

7.1: 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

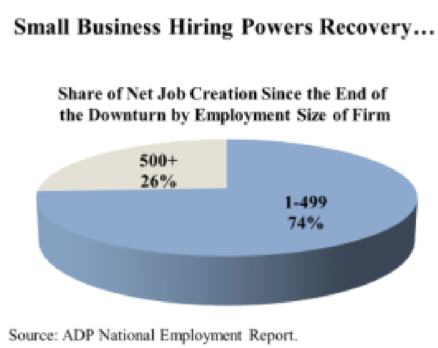
In addition, they complement the economic activity of large organizations by providing them with components, services, and distribution of their products.

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).

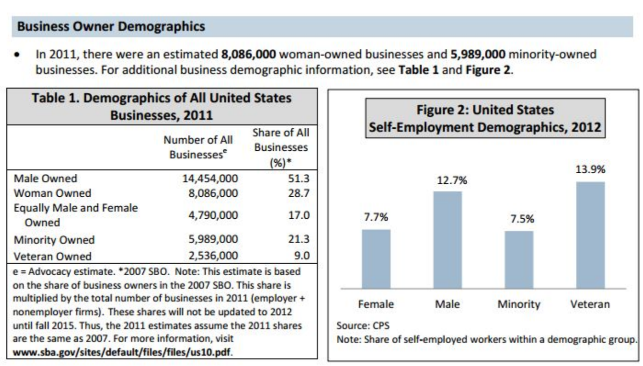
Small business owners are also particularly adept at finding new ways of doing old things. In 1994, for example, a young computer-science graduate working on Wall Street came up with the novel idea of selling books over the Internet. During the first year of operations, sales at Jeff Bezos's new company—Amazon.com—reached 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 7.1.2: 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.

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7.2: 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 7.2.1: 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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7.3: 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.

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7.4: 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).

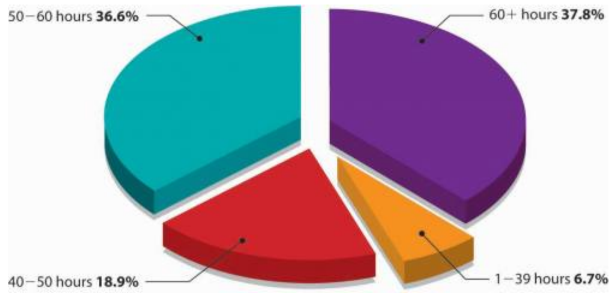

Figure 7.4.1: Copy and Paste Caption here. (Copyright; author via source)

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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7.5: 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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7.6: 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.

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7.7: 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	Kentucky	Ohio
Alaska	Louisiana	Oklahoma
Arizona	Maine	Oregon
Arkansas	Maryland	Pennsylvania
California	Massachusetts	Puerto Rico
Colorado	Michigan	Rhode Island
Connecticut	Minnesota	South Carolina
Delaware	Mississippi	South Dakota
District of Columbia	Missouri	Tennessee
Florida	Montana	Texas
Georgia	Nebraska	U.S. Virgin Islands
Guam	Nevada	Utah
Hawaii	New Hampshire	Vermont
Idaho	New Jersey	Virginia
Illinois	New Mexico	Washington
Indiana	New York	West Virginia
Iowa	North Carolina	Wisconsin
Kansas	North Dakota	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.

https://assessments.lumenlearning.com/assessments/194

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7.8: 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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7.9: 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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7.10: Why It Matters- Entrepreneurship

Why discuss the role of entrepreneurship in small business?

Figure 7.10.1: 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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7.11: 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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7.12: 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.

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7.13: 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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7.14: 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

7.15: 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

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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."

Contributors and Attributions

7.16: 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

https://assessments.lumenlearning.co...essments/11030

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. ↵
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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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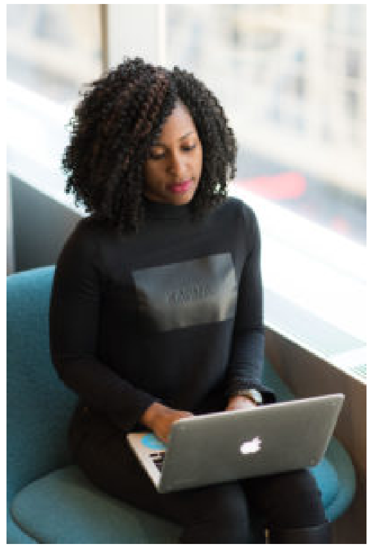
- **19.7: Types of Entrepreneurs** has no license indicated.

7.17: 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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7.18: 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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7.19: 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

https://assessments.lumenlearning.co...essments/11032

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7.20: 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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- **19.11: Why Some Ventures Fail** has no license indicated.

7.21: 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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7.22: 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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7.23: 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

https://assessments.lumenlearning.co...essments/11035

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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7.24: 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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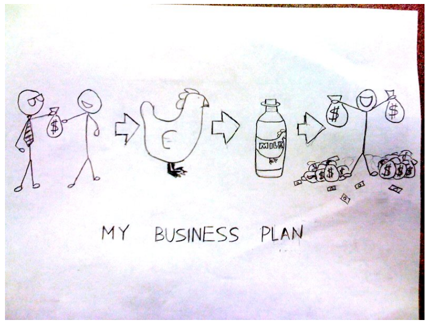
7.25: Create Your Business Plan

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

7.26: 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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CHAPTER OVERVIEW

8: Module Eight - Human Resources Theory

8.1: Why It Matters- Management

Why describe the primary functions, responsibilities, and skills of effective leadership and management?

You go out for dinner to your favorite restaurant for a special occasion—let's say graduation. It took a month or more to save up the money, and your date/spouse bought a new outfit just for this outing. Maybe, if you have children, you splurged and got a babysitter for the entire evening. Whatever the circumstances, you have planned an evening to remember. As the night progresses, things are not turning out as you hoped. The hostess has no record of your reservation, so there's a delay. When your waiter finally appears, he's grouchy and unhelpful. You place your order and anxiously await what Yelp* describes as a "5-star dining experience." By the time your food comes, you have devoured the bread on your table, a pack of mints rummaged from your purse, and you're eying the leftovers on the neighboring table. When your steak finally arrives, it's overcooked and sits beside a heap of steamed broccoli instead of the baked potato you ordered. You hate broccoli. So, who do you call?

No, not Ghostbusters! You want to speak to the *manager*, because the manager has the responsibility and authority to resolve the problem (or at least try). But managers do more than just listen to customers complain. As you will discover in this section, whether they interact with customers, employees, suppliers, contractors or the general public, managers and leaders play an important, multidimensional role in all business organizations.

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8.2: 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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8.3: Managerial Levels

Learning Objectives

- Differentiate between the functions of top managers, middle managers, and first-line managers

Figure 8.3.1: 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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8.4: 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.

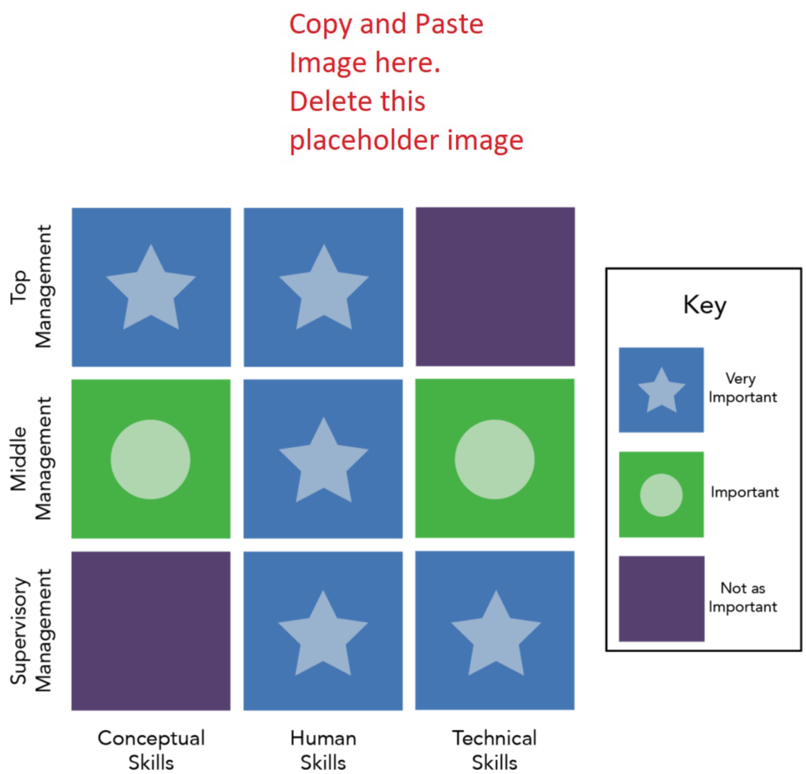

Figure 8.4.1: The Importance of Managerial Skills at Different Management Levels

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

8.5: 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.

8.6: 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 8.6.1: 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

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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

8.7: 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 8.7.1: 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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8.8: 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.

Contributors and Attributions

8.9: 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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8.10: 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.

Contributors and Attributions

8.11: 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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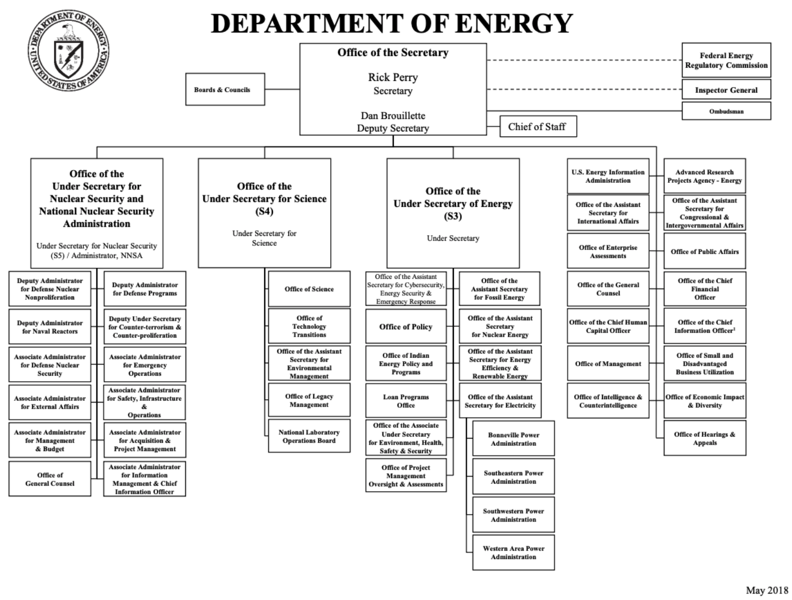
Types of Organizational Structure

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.

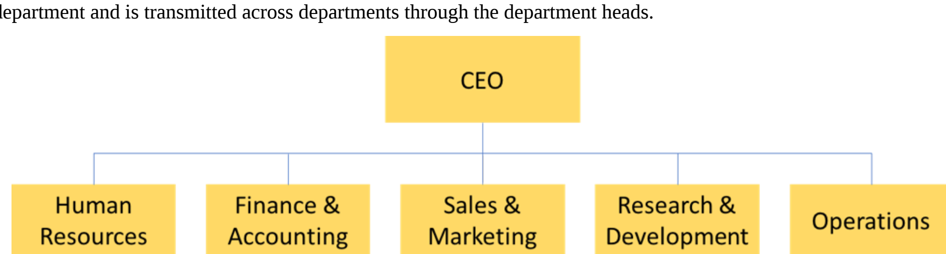


Figure 8.11.1: Functional structure organizational chart.

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.

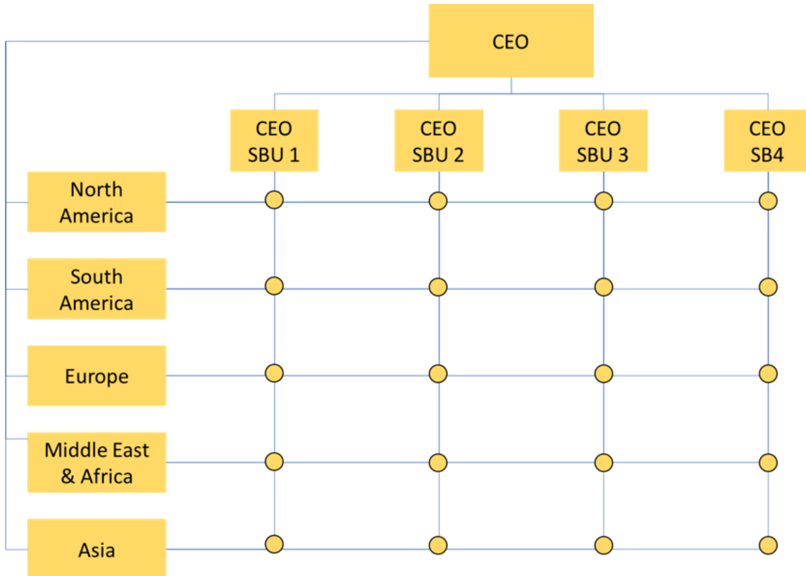


Figure 8.11.2: Matrix structure with geographic and product (SBU) structure.

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

https://assessments.lumenlearning.co...essments/14421

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1. Fayol, H. (1949). *General and Industrial Management* (C. Storrs, Trans.). London: Sir Isaac Pitman & Sons ↵

Contributors and Attributions

- Image: DOE Organization Chart. **Provided by**: US Department of Energy. **Located at**: https://www.energy.gov/leadership/organization-chart. **License**: *Public Domain: No Known Copyright*

8.12: 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.

Contributors and Attributions

8.13: 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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Contributors and Attributions

8.14: 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/. ↵

Contributors and Attributions

8.15: 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.

Contributors and Attributions

8.16: 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 8.16.1: 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:

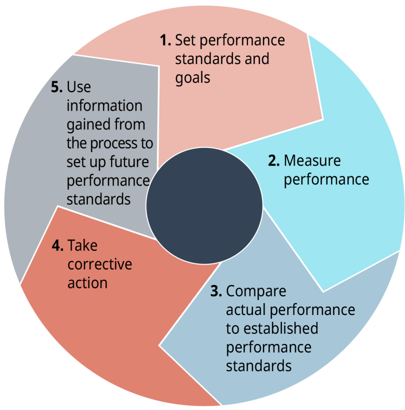

Figure 8.16.2: The control process

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.

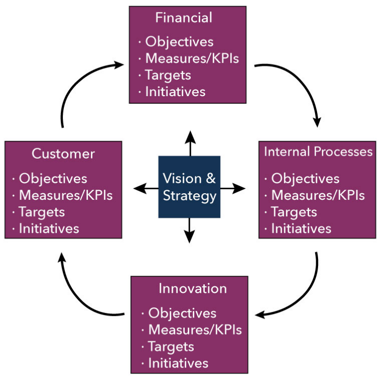

Figure 8.16.3: The balanced scorecard: On a standard balanced scorecard, each "perspective" reminds the user to articulate attributes necessary for an effective scorecard: the financial perspective, the customer's perspective, innovation, and internal processes, all of which come together to form an 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

https://assessments.lumenlearning.co...essments/14427

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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Contributors and Attributions

8.17: 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.

Contributors and Attributions

8.18: 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?

Contributors and Attributions

8.19: 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.

Contributors and Attributions

8.20: 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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8.21: 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

8.22: 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.

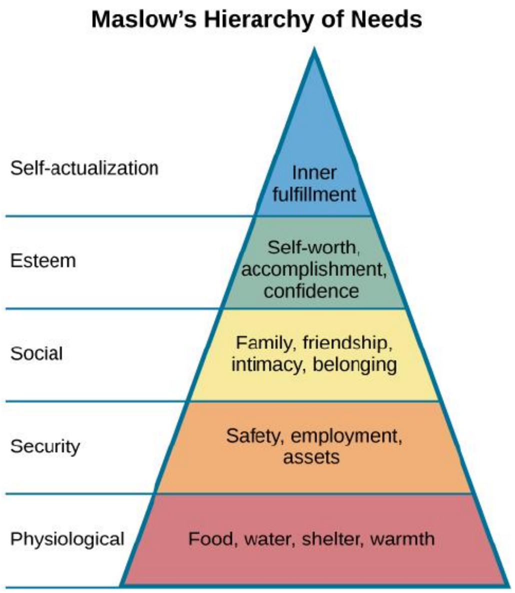

Figure 8.22.1: Maslow’s hierarchy of needs is illustrated here. In some versions of the pyramid, cognitive and aesthetic needs are also included between esteem and self-actualization. Others include another tier at the top of the pyramid for self-transcendence.

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

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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.

Contributors and Attributions

8.23: 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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8.24: Intrinsic and Extrinsic Motivators

Learning Objectives

- Explain the difference between intrinsic and extrinsic motivators in Herzberg's two-factor theory

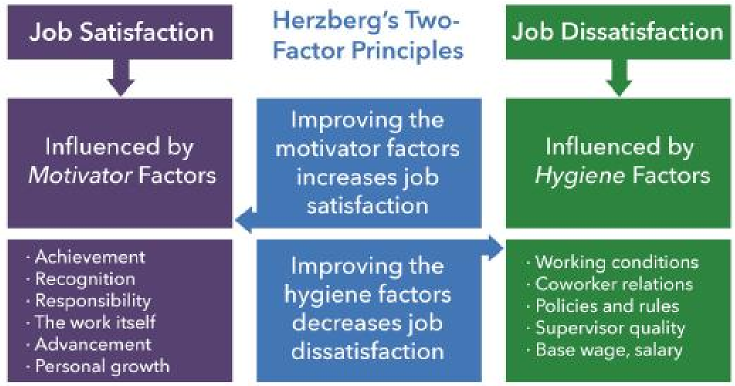
American psychologist **Frederick Herzberg** is regarded as one of the great original thinkers in management and motivational theory. Herzberg set out to determine the effect of attitude on motivation, by simply asking people to describe the times when they felt really good, and really bad, about their 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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8.25: 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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8.26: 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.

Contributors and Attributions

8.27: 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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8.28: 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.

Contributors and Attributions

8.29: Reinforcement Theory

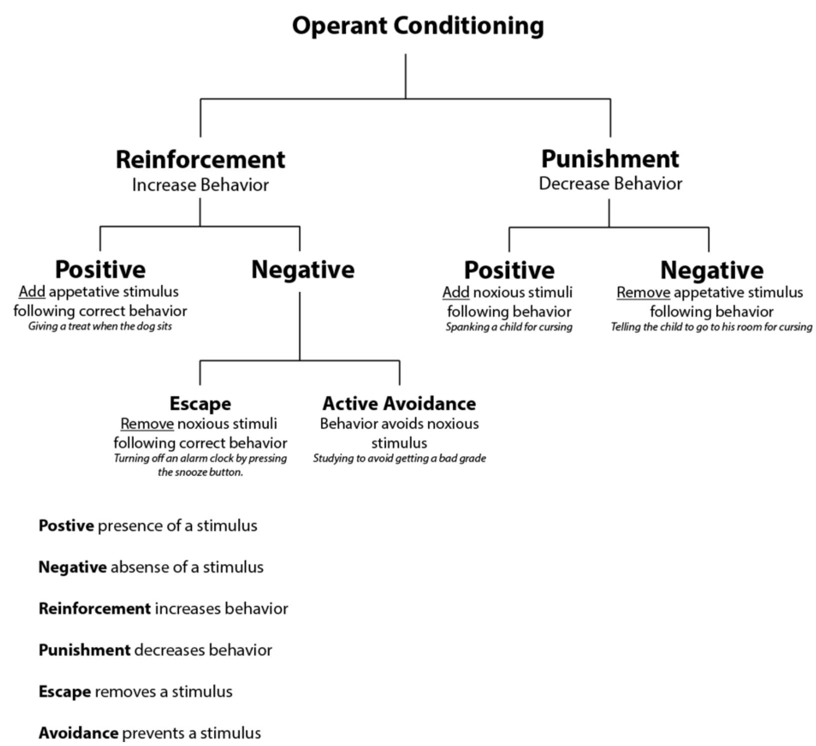
Learning Objectives

- 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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8.30: 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

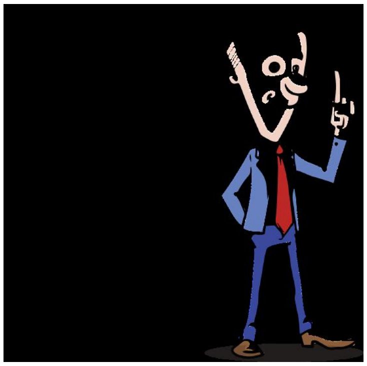
In this section, we approach motivation from the opposite—management versus employee—side of the equation. We will discuss three different theories (all developed by management professors): Douglas McGregor's contrasting Theory X and Theory Y and William Ouchi's cross-cultural Theory Z. As in prior sections, we'll discuss the underlying assumptions of each theory and the associated management approach or style and organizational impacts and implications.

Contributors and Attributions

8.31: 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.

Contributors and Attributions

8.32: 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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8.33: 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.

Contributors and Attributions

8.34: 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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8.35: Goal-Setting Theory

Learning Objectives

- Describe ways in which goal setting can improve employee performance

Goal Setting

Figure 8.35.1: 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 8.35.2: 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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8.36: 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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8.37: Putting It Together- Motivating Employees

Synthesis

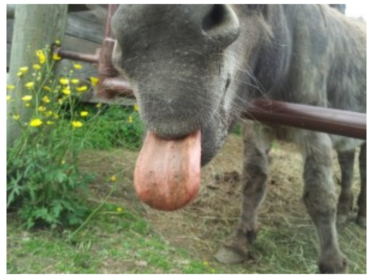

Figure 8.37.1: “You can’t make me.”

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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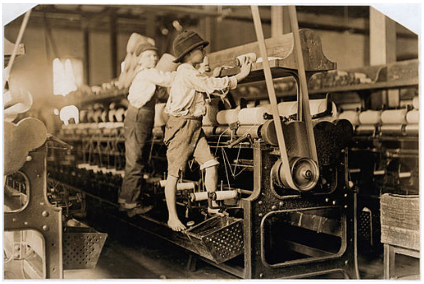
CHAPTER OVERVIEW

9: Module Nine - Human Resources Management

9.1: 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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9.2: 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.

Contributors and Attributions

9.3: 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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https://assessments.lumenlearning.co...essments/14511

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9.4: 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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9.5: 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 9.5.1: 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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https://assessments.lumenlearning.co...essments/14513

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

https://assessments.lumenlearning.co...essments/14515

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9.6: 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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9.7: 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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Contributors and Attributions

9.8: 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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1. Kulik, 2004 ↵
2. Heathfield, Use the Web for Recruiting: Recruiting Online ↵
3. Heathfield, Recruiting Stars: Top Ten Ideas for Recruiting Great Candidates ↵

Contributors and Attributions

9.9: 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

9.10: 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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9.11: Training and Professional Development

Learning Objectives

- Describe different approaches to employee training
- Describe different approaches to professional development

Figure 9.11.1: 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

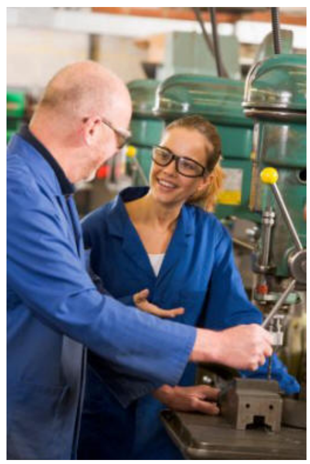
The need for training exists in every business. However the nature of training varies depending on the type of business and operations involved. For example, a manufacturing company may have a need for technical skills training while an insurance company may emphasize customer service training. So, how 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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9.12: 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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9.13: 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 9.13.1: 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 9.13.2: 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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9.14: 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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9.15: 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

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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

https://assessments.lumenlearning.co...essments/14524

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9.16: 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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9.17: 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.

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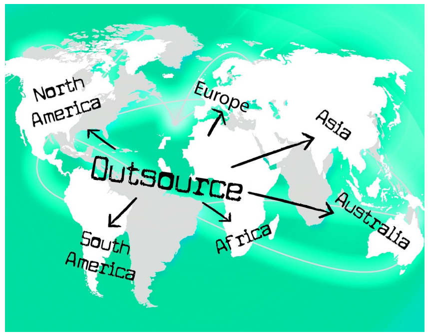
9.18: HR Challenges

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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1. Schramm, Jen. "The Big Issues Facing HR." SHRM. March 1, 2016. Accessed June 25, 2019. https://www.shrm.org/hr-today/news/hr-magazine/0316/pages/the-big-issues-facing-hr.aspx. ↵

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9.19: 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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CHAPTER OVERVIEW

10: Module Ten - The Functions of Marketing

10.1: 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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10.2: 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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10.3: 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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10.4: 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 10.4.1: 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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10.5: 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)

? PRactice Question

https://assessments.lumenlearning.co...essments/14477

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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10.6: 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.

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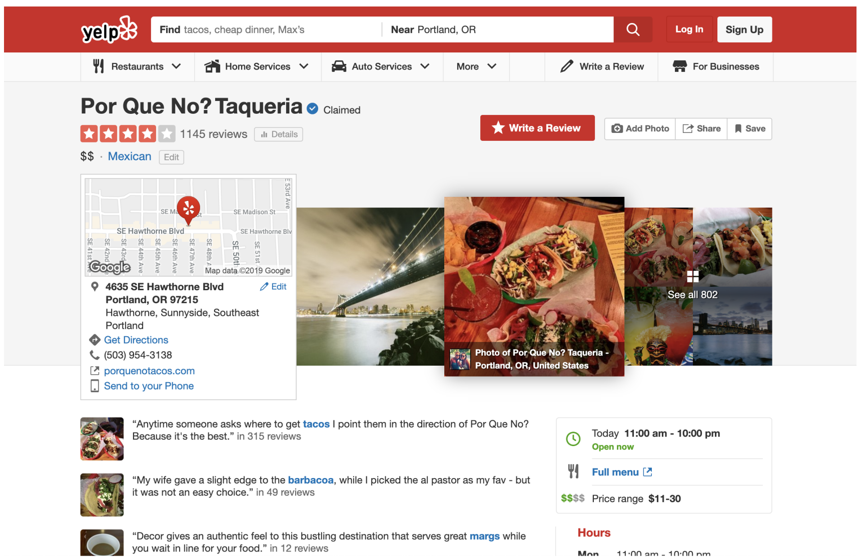

Additionally, smart marketers know that when people take a public stance on a product or issue, they tend to become more committed to that position. Thus, customer relationship management can become a virtuous cycle. As customers have more exposure and positive interaction with a company and its products, 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.

? Practice Question

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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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10.7: Influences on Consumer Decisions

Learning Objectives

- Explain the factors that influence customer decisions

What, Exactly, Influences a Purchasing Decision?

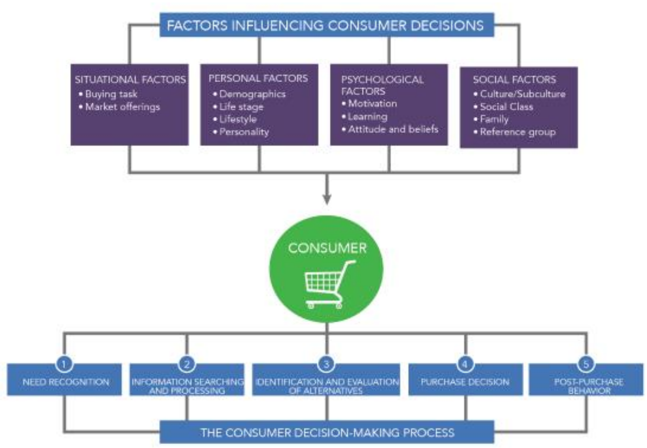
While a purchase decision-making process itself appears quite standardized, no two people make a decision in exactly the same way. People have many beliefs and behavioral tendencies—some controllable, some beyond our control. How all these factors interact with each other ensures that each of us is unique 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.



Practice Question

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- **28.7: Influences on Consumer Decisions** has no license indicated.

10.8: 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*.

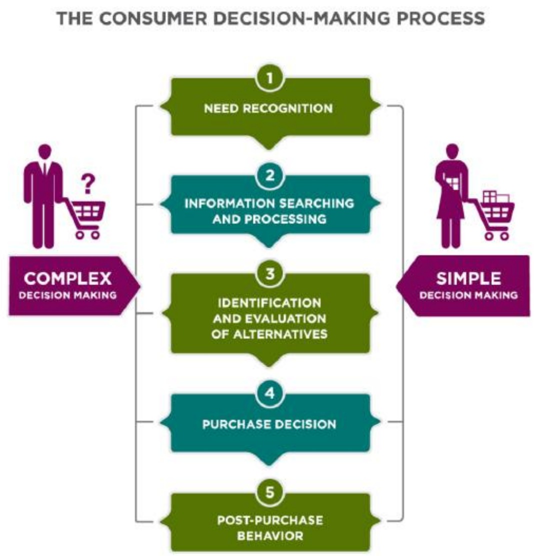

Figure 10.8.1

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.

Practice Question

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10.9: 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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10.10: 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 10.10.1. 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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10.11: 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

https://assessments.lumenlearning.co...essments/14482

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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10.12: 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 10.12.1: 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 10.12.1: 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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10.13: 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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10.14: 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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10.15: Components of the Marketing Mix

Learning Objectives

- Define product
- Define promotion
- Define place
- Define price

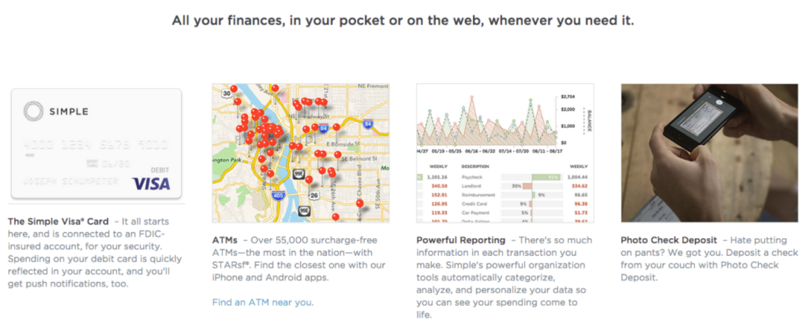
Product

Figure 10.15.1: 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

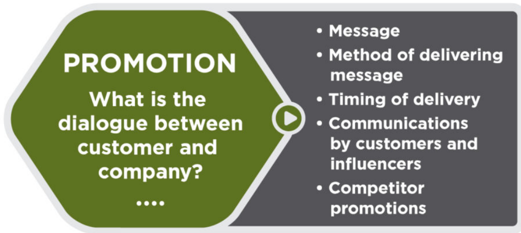


Figure 10.15.2: Promotion

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 10.15.3: Marketers often run social media campaigns, rewarding customers who “Like” the company on Facebook.

Place

Figure 10.15.4: 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 10.15.5: 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 10.15.6: 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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10.16: 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 10.16.1. 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.

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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 10.16.2. 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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10.17: 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 10.17.1: 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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10.18: 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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CHAPTER OVERVIEW

11: Module Eleven - The Marketing Mix

11.1: 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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11.2: 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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11.3: 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 11.3.1: 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

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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11.4: 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 11.4.1: 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 11.4.2: 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 11.4.3: 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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11.5: 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

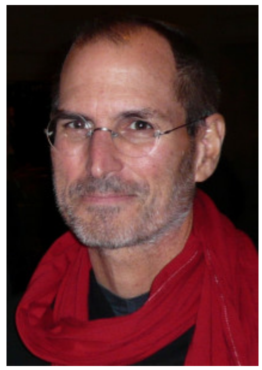

Figure 11.5.1: Steve Jobs, co-founder and long-time CEO of Apple

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 11.5.2: 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 11.5.4: 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 11.5.5: 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 11.5.6: 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

https://assessments.lumenlearning.co...essments/14493

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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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11.6: 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.

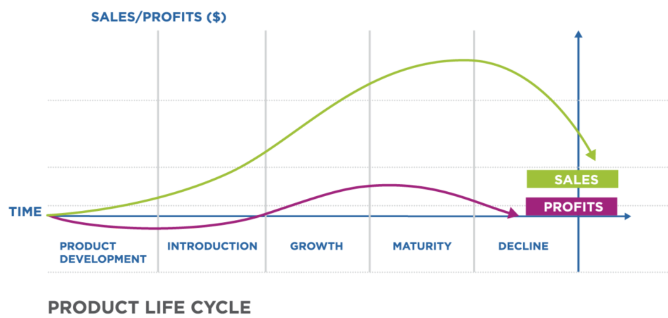

Figure 11.6.1: Product life cycle

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*

11.7: 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 11.7.1: 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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11.8: The New-Product Development Process

Learning Objectives

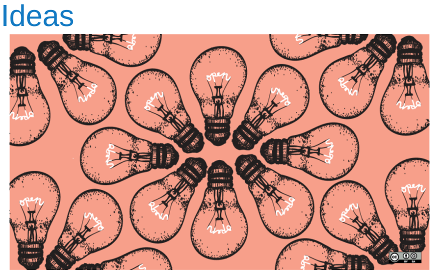
- Explain the stages of the new-product development process

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.

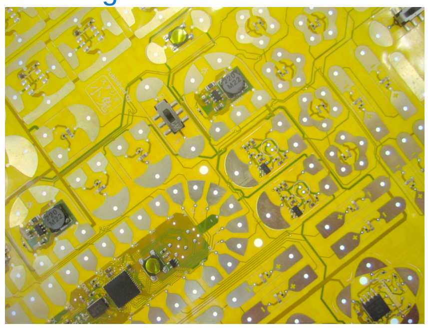
The key to the idea generation stage is to explore possibilities, knowing that most will not result in products that go to market.

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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11.9: 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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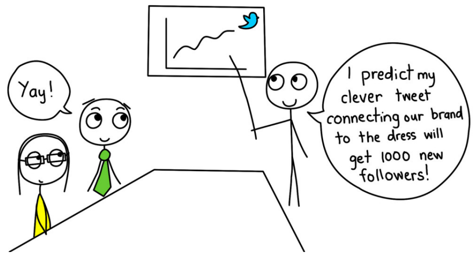
11.10: Integrated Marketing Communication (IMC) Definition

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 11.10.1: 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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11.11: Common Marketing Communication Methods

Learning Objectives

- Describe common marketing communication methods, including their advantages and disadvantages

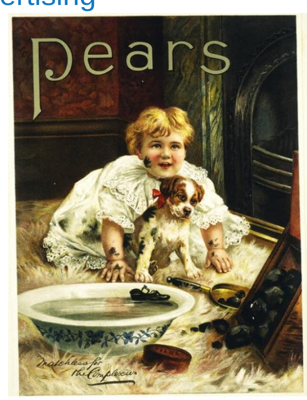
In a successfully operated campaign, all activities will be well-coordinated to build on one another to increase the overall impact. For example, a single campaign might include:

- **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**
>
> https://assessments.lumenlearning.co...essments/14499

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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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11.12: 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.

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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. ↵

Contributors and Attributions

11.13: 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.

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11.14: 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

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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.

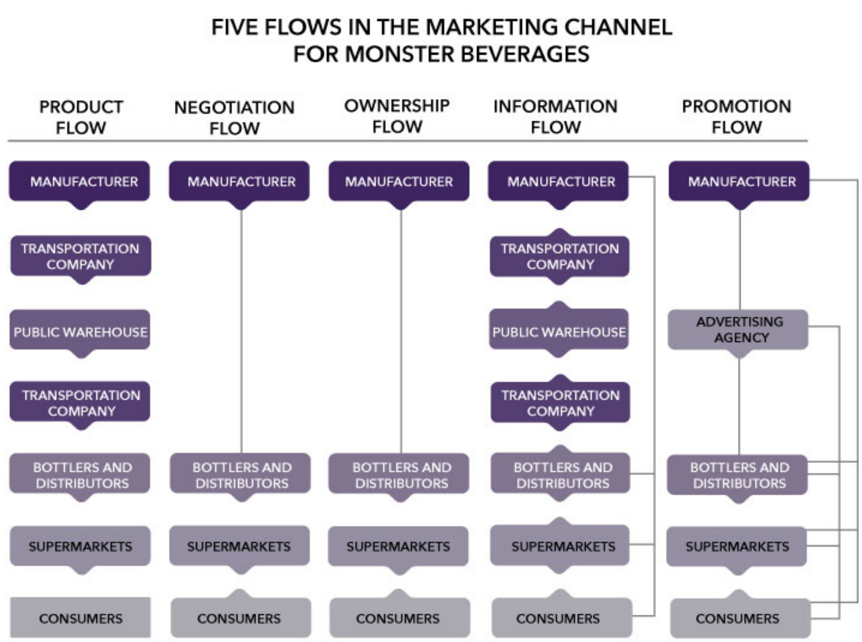

Figure 11.14.1: Flows for the Monster Energy drink (and many other energy drink brands)

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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Contributors and Attributions

11.15: 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**.

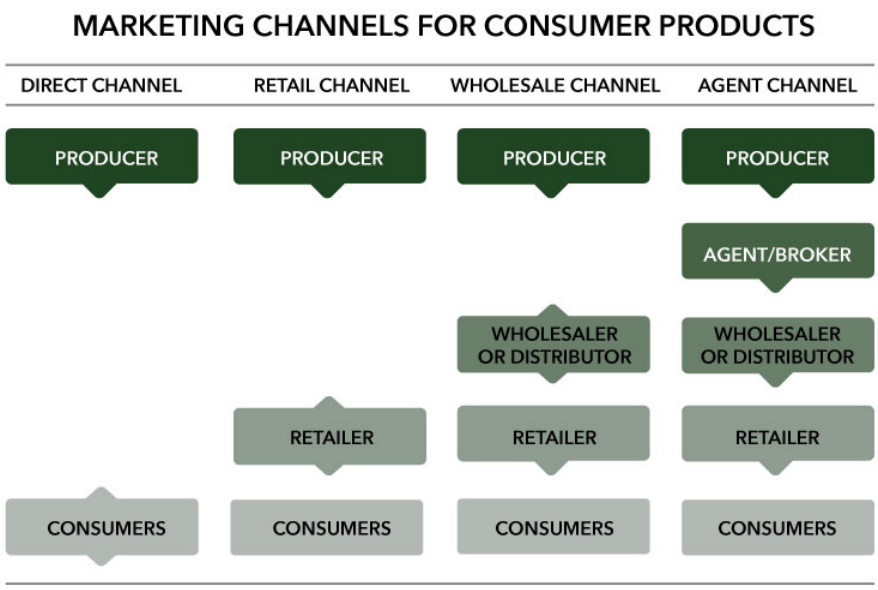

Figure 11.15.1: Marketing channels for consumer products

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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11.16: 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.

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11.17: 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]

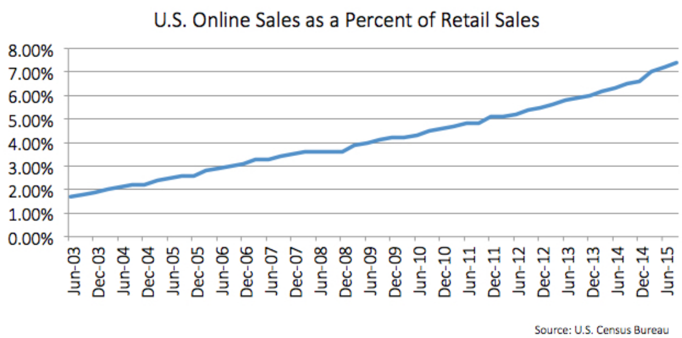

Figure 11.17.1: US online sales as a percent of retail sales

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

https://assessments.lumenlearning.co...essments/14504

1. Ruiz, Rebecca R. "Catalogs, After Years of Decline, Are Revamped for Changing Times." The New York Times. January 26, 2015. Accessed June 25, 2019. http://www.nytimes.com/2015/01/26/business/media/catalogs-after-years-of-decline-are-revamped-for-changing-times.html. ↵
2. Geller, Lois. "Why Are Printed Catalogs Still Around?" Forbes. October 16, 2012. Accessed June 25, 2019. http://www.forbes.com/sites/loisgeller/2012/10/16/why-are-printed-catalogs-still-around/#75a143e17fcb. ↵

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11.18: Supply Chains and Distribution Channels

Learning Objectives

- Differentiate between supply chains and distribution channels

What Is a Supply Chain?

Figure 11.18.1: 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).

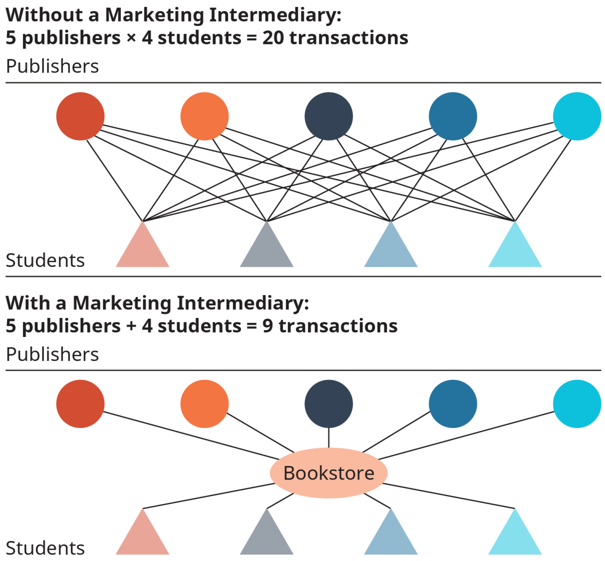

Figure 11.18.2: How Distribution Channels Reduce the Number of Transactions (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

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

https://assessments.lumenlearning.co...essments/14505

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.

Contributors and Attributions

11.19: 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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11.20: Customer Value and Price

Learning Objectives

- Explain pricing from the customer's viewpoint

Figure 11.20.1: 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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11.21: 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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11.22: 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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11.23: 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

1. Home Depot. "Pro Loyalty Program." Pro Xtra. Accessed June 25, 2019. http://www.homedepot.com/c/Pro_Xtra. ↵

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11.24: 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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CHAPTER OVERVIEW

12: Module Twelve - Importance of Technology for Businesses

12.1: 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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12.2: 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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12.3: 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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12.4: 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

https://assessments.lumenlearning.co...essments/11094

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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

12.5: 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

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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/. ↵

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12.6: 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.

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12.7: 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

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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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12.8: 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. ↵

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12.9: 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

12.10: 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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12.11: 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

12.12: 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!

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12.13: 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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12.14: 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.

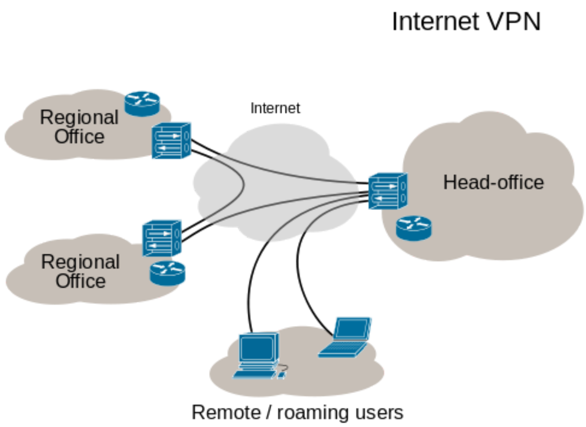

Figure 12.14.1: Internet VPN

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

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12.15: 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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12.16: 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

12.17: 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

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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. ↵

Contributors and Attributions

12.18: 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.

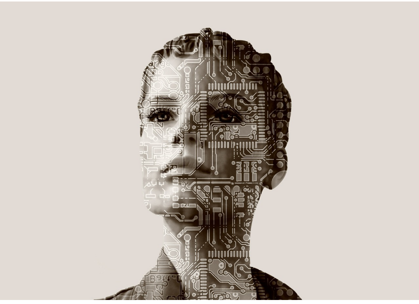
Ethical and Social Issues

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.

Contributors and Attributions

CHAPTER OVERVIEW

13: Module Thirteen - Business Accounting

13.1: Why It Matters- Accounting and Finance

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

Figure 13.1.1: 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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13.2: Learning Hacks- Don’t Bother Highlighting

THE HACK

Highlighting or underlining potentially important parts of a text is not a very effective study technique.

You would be better off spending your time on a more effective study technique, like taking practice tests.

The Story

You’ve probably bought a used textbook that looked like the one above – marked up endlessly with various colors of highlighters. Maybe you’ve even created one like this yourself! You would think that highlighting the important parts of what you’re reading would help emphasize to your brain that these are the things it should pay attention to. Unfortunately, this turns out not to be the case.

The Research

A group of researchers looked at highlighting along with several other study techniques to see which were most useful. In their research, they looked at studies of many kinds of students – from children to college students to Air Force trainees. They looked at research where students were studying texts about many different topics, including science, history, psychology, and geography. They looked at studies focused on highlighting short texts and studies focused on highlighting long texts. They looked at research where students were tested right after highlighting texts, and research where students weren’t tested until long after they had highlighted texts. After reviewing all this research, the authors summarized their findings by saying, “In most situations that have been examined and with most participants, highlighting does little to boost performance” (Dunlosky, p. 21).

As often happens in studies, the researchers found the occasional exception to this rule. For example, if students are explicitly taught how to highlight and are assigned highlighting practice and then given feedback on the quality of their highlighting, highlighting can improve learning. But they also found situations where highlighting actually hurts students’ learning. For example, highlighting has been shown to harm students’ performance on higher-level thinking problems, like questions that require students to make inferences.

In the end, the researchers rated highlighting as having “low utility” and recommended that students use their limited study time on study techniques that are more effective, like taking practice tests (which, after reviewing the research, they rated as “high utility”). So be sure to use the Show What You Know, Practice, and Self Check opportunities throughout this course!

The Source

Dunlosky, J., Rawson, K. A., Marsh, E. J., Nathan, M. J., & Willingham, D. T. (2013). Improving Students’ Learning With Effective Learning Techniques. Psychological Science in the Public Interest, 14(1), 4–58. doi:10.1177/1529100612453266

13.3: 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.

13.4: 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. ↵

Contributors and Attributions

13.5: 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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13.6: 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

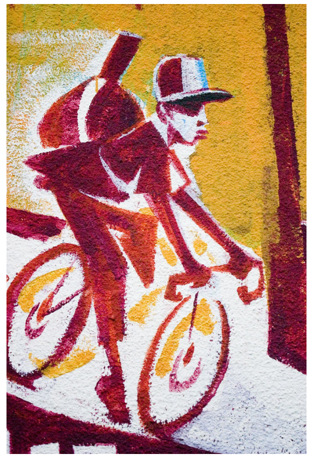
Financial statements are the means by which companies communicate their story. Together these statements represent the profitability and financial strength of a company. The financial statement that reflects a company’s profitability is the **income statement**. The **statement of owner’s equity**—also 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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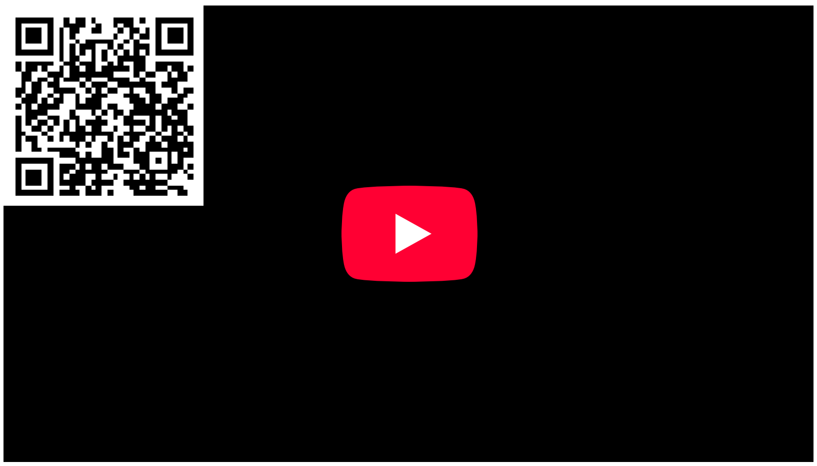
https://assessments.lumenlearning.co...essments/14533

https://assessments.lumenlearning.co...essments/14534

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

https://assessments.lumenlearning.co...essments/14535

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13.7: 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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13.8: 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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13.9: Finding the Break-Even Point

Learning Objectives

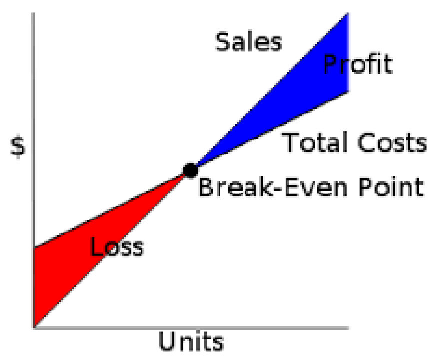
- Define the break-even point
- Differentiate between fixed and variable costs
- Calculate the break-even point
- Calculate the contribution margin
- Calculate the contribution margin ratio
- Calculate the margin of safety

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:

$$\begin{aligned} \text{BE units} &= \frac{\text{Fixed Costs}}{\text{Contribution Margin per unit}} \\ \text{BE units} &= \frac{\text{40,000 USD}}{\text{8 USD per unit}} \\ \text{BE units} &= \text{5,000 units} \end{aligned} \tag{13.9.1}$$

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.

$$\text{BE dollars} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Ratio}} \tag{13.9.2}$$

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:

$$\text{Contribution Margin Ratio} = \frac{\text{Contribution Margin per unit}}{\text{Selling Prince per unit}} \tag{13.9.3}$$

$$\frac{\text{USD 20 - USD 12}}{\text{USD 20}} = \frac{\text{USD 8}}{\text{USD 20}} = 0.40 \tag{13.9.4}$$

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:

$$\text{Contribution Margin Ratio} = \frac{\text{Total Contribution Margin}}{\text{Total Revenues}} \tag{13.9.5}$$

$$\frac{\text{USD 48,000}}{\text{USD 120,000}} = 0.40 \tag{13.9.6}$$

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:

$$\text{BE dollars} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Rate}} \tag{13.9.7}$$

$$\text{BE dollars} = \frac{\text{USD 40,000}}{0.40} = \text{USD 100,000} \tag{13.9.8}$$

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:

$$\text{BE units} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Ratio}} \tag{13.9.9}$$

$$\text{BE units} = \frac{\text{USD 50,000}}{0.40} = \text{USD 125,000} \tag{13.9.10}$$

[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:

$$\text{Margin safety} = \text{Current sales} - \text{Break-even sales} \tag{13.9.11}$$

$$= \text{USD } 120{,}000 - \text{USD } 100{,}000 \tag{13.9.12}$$

$$= \text{USD } 20{,}000 \tag{13.9.13}$$

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:

$$\text{Margin of Safety Rate} = \frac{\text{Current Sales} - \text{Break Even Sales}}{\text{Current Sales}} \tag{13.9.14}$$

$$\frac{\text{USD } 120{,}000 - \text{USD } 100{,}000}{\text{USD } 120{,}000} = 16.67\ \% \tag{13.9.15}$$

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

? Practice Question

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Contributors and Attributions

13.10: 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.

Contributors and Attributions

13.11: 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

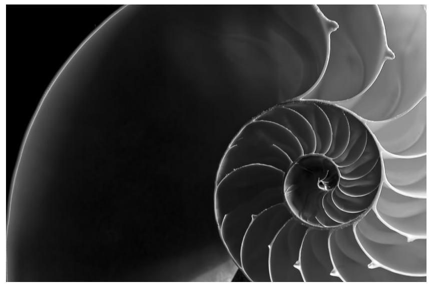
Financial ratios allow consumers of financial information to compare how companies are doing relative to their industry or even how they are faring from one period (month, quarter, year) to another. For the purposes of this course, you will be working with just a couple of these ratios—namely liquidity 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.

Contributors and Attributions

13.12: 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:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} \tag{13.12.1}$$

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:

$$\text{Acid Test Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} \tag{13.12.2}$$

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:

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \tag{13.12.3}$$

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:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}=\frac{\text{USD }13{,}022{,}000{,}000}{6{,}268{,}000{,}000}=2.08{:}1 \tag{13.12.4}$$

2. Acid-test ratio:

$$\frac{\text{Quick Assets}}{\text{Current Liabilities}}=\frac{\text{USD }9{,}119{,}000{,}000}{6{,}268{,}000{,}000}=1.45{:}1 \tag{13.12.5}$$

3. Inventory turnover:

$$\frac{\text{Net Sales}}{\text{Average Inventory}}=\frac{\text{USD }18{,}701{,}000{,}000}{2{,}111{,}000{,}000}=1.45{:}1 \tag{13.12.6}$$

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

- **32.11: Financial Ratio Analysis** has no license indicated.

13.13: 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

13.14: 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 13.14.1: 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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13.15: 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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13.16: 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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13.17: 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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13.18: 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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CHAPTER OVERVIEW

14: Module Fourteen - Stocks, Securities, Bonds, and the Risks

14.1: Stocks and Stock Markets

Learning Objectives

1. Explain the role of stock issuance and ownership in economic growth.
2. Contrast and compare the roles of the primary and secondary stock markets.
3. Identify the steps of stock issuance.
4. Contrast and compare the important characteristics of common and preferred stock.
5. Explain the significance of American Depository Receipts for U.S. investors.

Resources have costs, so a company needs money, or capital, which is also a resource. To get that start-up capital, the company could borrow or it could offer a share of ownership, or equity, to those who chip in capital.

If the costs of debt (interest payments) are affordable, the company may choose to borrow, which limits the company's commitment to its capital contributor. When the loan matures and is paid off, the relationship is over.

Figure 15.1.1 . © 2010 Jupiterimages Corporation

If the costs of debt are too high, however, or the company is unable to borrow, it seeks equity investors willing to contribute capital in exchange for an unspecified share of the company's profits at some time in the future. In exchange for taking the risk of no exact return on their investment, equity investors get a say in how the company is run.

Stock represents those shares in the company's future and the right to a say in how the company is run. The original owners—the inventor(s) and entrepreneur(s)—choose equity investors who share their ideals and vision for the company. Usually, the first equity investors are friends, family, or colleagues, allowing the original owners freedom of management. At that point, the corporation is privately held, and the company's stock may be traded privately between owners. There may be restrictions on selling the stock, often the case for a family business, so that control stays within the family.

If successful, however, eventually the company needs more capital to grow and remain competitive. If debt is not desirable, then the company issues more equity, or stock, to raise capital. The company may seek out an **angel investor**, **venture capital** firm, or **private equity** firm. Such investors finance companies in the early stages in exchange for a large ownership and management stake in the company. Their strategy is to buy a significant stake when the company is still "private" and then realize a large gain, typically when the company goes public. The company also may seek a buyer, perhaps a competitive or complementary business.

Alternatively, the company may choose to **go public**, to sell shares of ownership to investors in the public markets. Theoretically, this means sharing control with random strangers because anyone can purchase shares traded in the stock market. It may even mean losing control of the company. Founders can be fired, as Steve Jobs was from Apple in 1985 (although he returned as CEO in 1996).

Going public requires a profound shift in the corporate structure and management. Once a company is publicly traded, it falls under the regulatory scrutiny of federal and state governments, and must regularly file financial reports and analysis. It must broaden participation on the board of directors and allow more oversight of management. Companies go public to raise large amounts of capital to expand products, operations, markets, or to improve or create competitive advantages. To raise public equity capital, companies need to sell stock, and to sell stock they need a market. That's where the stock markets come in.

Primary and Secondary Markets

The private corporation's board of directors, shareholders elected by the shareholders, must authorize the number of shares that can be issued. Since issuing shares means opening up the company to more owners, or sharing it more, only the existing owners have the authority to do so. Usually, it authorizes more shares than it intends to issue, so it has the option of issuing more as need be.

Those **authorized shares** are then issued through an **initial public offering (IPO)**. At that point the company goes public. The IPO is a **primary market** transaction, which occurs when the stock is initially sold and the proceeds go to the company issuing the stock. After that, the company is publicly traded; its stock is outstanding, or publicly available. Then, whenever the stock changes hands, it is a **secondary market** transaction. The owner of the stock may sell shares and realize the proceeds. When most people think of "the stock market," they are thinking of the secondary markets.

The existence of secondary markets makes the stock a liquid or tradable asset, which reduces its risk for both the issuing company and the investor buying it. The investor is giving up capital in exchange for a share of the company's profit, with the risk that there will be no profit or not enough to compensate for the opportunity cost of sacrificing the capital. The secondary markets reduce that risk to the shareholder because the stock can be resold, allowing the shareholder to recover at least some of the invested capital and to make new choices with it.

Meanwhile, the company issuing the stock must pay the investor for assuming some of its risk. The less that risk is, because of the liquidity provided by the secondary markets, the less the company has to pay. The secondary markets decrease the company's cost of equity capital.

A company hires an investment bank to manage its initial public offering of stock. For efficiency, the bank usually sells the IPO stock to institutional investors. Usually, the original owners of the corporation keep large amounts of stock as well.

What does this mean for individual investors? Some investors believe that after an initial public offering of stock, the share price will rise because the investment bank will have initially underpriced the stock in order to sell it. This is not always the case, however. Share price is typically more volatile after an initial public offering than it is after the shares have been outstanding for a while. The longer the company has been public, the more information is known about the company, and the more predictable its earnings are and thus share price.M. B. Lowery, M. S. Officer, and G. W. Schwert, "The Variability of IPO Initial Returns," *Journal of Finance*, http://schwert.ssb.rochester.edu/ipovolatility.htm (accessed June 9, 2009).

When a company goes public, it may issue a relatively small number of shares. Its **market capitalization**—the total dollar value of its outstanding shares—may therefore be small. The number of individual shareholders, mostly institutional investors and the original owners, also may be small. As a result, the shares may be "thinly traded," traded infrequently or in small amounts.

Thinly traded shares may add to the volatility of the share price. One large shareholder deciding to sell could cause a decrease in the stock price, for example, whereas for a company with many shares and shareholders, the actions of any one shareholder would not be significant. As always, diversification—in this case of shareholders—decreases risk. Thinly traded shares are less liquid and more risky than shares that trade more frequently.

Common, Preferred, and Foreign Stocks

A company may issue **common stock** or **preferred stock**. Common stock is more prevalent. All companies issue common stock, whereas not all issue preferred stock. The differences between common and preferred have to do with the investor's voting rights, risk, and dividends.

Common stock allows each shareholder voting rights—one vote for each share owned. The more shares you own, the more you can influence the company's management. Shareholders vote for the company's directors, who provide policy guidance for and hire the management team that directly operates the corporation. After several corporate scandals in the early twenty-first century, some shareholders have become more active in their voting role.

Figure 15.1.2 . © 2010 Jupiterimages Corporation

Common stockholders assume the most risk of any corporate investor. If the company encounters financial distress, its first responsibility is to satisfy creditors, then the preferred shareholders, and then the common shareholders. Thus, common stocks provide only residual claims on the value of the company. In the event of bankruptcy, in other words, common shareholders get only the residue—whatever is left after all other claimants have been compensated.

Common shareholders share the company's profit after interest has been paid to creditors and a specified share of the profit has been paid to preferred shareholders. Common shareholders may receive all or part of the profit in cash—the dividend. The company is under no obligation to pay common stock dividends, however. The management may decide that the profit is better used to expand the company, to invest in new products or technologies, or to grow by acquiring a competitor. As a result, the company may pay a cash dividend only in certain years or not at all.

Shareholders investing in preferred stock, on the other hand, give up voting rights but get less risk and more dividends. Preferred stock typically does not convey voting rights to the shareholder. It is often distributed to the "friends and family" of the original founders when the company goes public, allowing them to share in the company's profits without having a say in its management. As noted above, preferred shareholders have a superior claim on the company's assets in the event of bankruptcy. They get their original investment back before common shareholders but after creditors.

Preferred dividends are more of an obligation than common dividends. Most preferred shares are issued with a fixed dividend as **cumulative preferred shares**. This means that if the company does not create enough profit to pay its preferred dividends, those dividends ultimately must be paid before any common stock dividend.

For the individual investor, preferred stock may have two additional advantages over common stock:

1. Less volatile prices
2. More reliable dividends

As the company goes through its ups and downs, the preferred stock price will fluctuate less than the common stock price. If the company does poorly, preferred stockholders are more likely to be able to recoup more of their original investment than common shareholders because of their superior claim. If the company does well, however, preferred stockholders are less likely to share more in its success because their dividend is fixed. Preferred shareholders thus are exposed to less risk, protected by their superior claim and fixed dividend. The preferred stock price reflects less of the company's volatility.

Because the preferred dividend is more of an obligation than the common dividend, it provides more predictable dividend income for shareholders. This makes the preferred stock less risky and attractive to an investor looking for less volatility and more regular dividend income.

Figure 15.3 summarizes the differences between common stock and preferred stock.

Common versus Preferred Stock	Common Stock	Preferred Stock
Voting Rights	Yes	Usually not
Downside Risk	More	Less
Upside Risk	More	Less or None
Reliability of Investment Income	Less	More
Price Volatility	More	Less

Figure 15.1.3 : Stock Comparisons

As an investment choice, preferred stock is more comparable to bonds than to common stock. Bonds also offer less volatility and more reliable income than common stock (see Chapter 16). If there is a difference in the tax rate between dividend income (from preferred stock) and interest income (from bonds), you may find a tax advantage to investing in preferred stock instead of bonds.

Corporations often issue and trade their stocks on exchanges or in markets outside their home country, especially if the foreign market has more liquidity and will attract more buyers. Many foreign corporations issue and trade stock on the New York Stock Exchange (NYSE) or on the National Association of Securities Dealers Automated Quotations (NASDAQ), for example.

Investing in foreign shares is complicated by the fact that stock represents ownership, a legal as well as an economic idea, and because foreign companies operate in foreign currencies. To get around those issues and make foreign shares more tradable, the **American Depository Receipt (ADR)** was created in 1927. U.S. banks buy large amounts of shares in a foreign company and then sell ADRs (each representing a specified number of those shares) to U.S. investors. Individual shares of the stock are called American Depository Shares, or ADSs.

The ADR is usually listed on a major U.S. stock exchange, such as the New York Stock Exchange, or is quoted on the NASDAQ. One ADR can represent more or less than one share of the foreign stock, depending on its price and the currency exchange rate, so that the bank issuing the ADR can "price" it according to the norms of U.S. stock markets.

ADRs lower transaction costs for U.S. investors investing in foreign corporations. Because they are denominated in U.S. dollars, they lower exchange rate or currency risk for U.S. investors. They also lower your usual risks with investing overseas, such as lack of information and too much or too little regulatory oversight.

In return for marketing their shares in the lucrative U.S. market, foreign companies must provide U.S. banks with detailed financial reports. This puts available foreign corporate information on par with that of U.S. companies. Because they are issued and sold in the United States on U.S. exchanges, ADRs fall under the regulatory control of the Securities and Exchange Commission (SEC) and other federal and state regulatory agencies, which also lowers your risk.

Summary

- Companies go public to raise capital to finance growth by selling equity shares in the public markets.
- A primary market transaction happens between the original issuer and buyer.
- Secondary market transactions are between all subsequent sellers and buyers.
- The secondary market lowers risk and transaction costs by increasing liquidity.
- Shares are authorized and issued and then become outstanding or publicly available.
- Equity securities may be common or preferred stock, differing by

- the assignment of voting rights,
  - dividend obligations,
  - claims in case of bankruptcy,
  - risk.
- Common stocks have less predictable income, whereas most preferred stocks have fixed-rate cumulative dividends.
- ADRs represent foreign shares traded in U.S. markets, lowering risks, such as currency risks, and transaction costs for U.S. investors.

Exercises

1. See the video "Woz-Bing!" of Steve Wozniak, cofounder of Apple, Inc., (along with Steve Jobs and Ron Wayne) at finance.yahoo.com/tech-ticker...-Co-Founder-a- %22Big-Fan%22-of-Microsofts-New-Search-Engine. In this Yahoo! video Wozniak talks about Bing, a new search engine launched in 2009 as Microsoft's answer to Google. How does the discussion of this new technology relate to understanding the role of stock investing in an economy? What factors would you consider when deciding which investments in new technology to include in your stock portfolio? Record your thoughts in My Notes or your personal finance journal.
2. What is a venture capitalist? Watch noted venture capitalist (or VC) and entrepreneur Guy Kawasaki at http://www.youtube.com/watch?v=1etQC2-Vg_s. What three top pieces of advice does he give to new ventures seeking equity investment? According to http://www.investorwords.com/212/angel_investor.html, what is an angel investor?
3. Explore Hoover's at www.hoovers.com/global/ipoc/. What information about IPOs can be found there? Click on a recently listed IPO. Read about the company and click on its stock ticker symbol. What was the price per share when the company was first listed on the stock exchange? How many shares were sold? What is its price today? Where did the proceeds from the IPO sale of shares go, and where will the proceeds from sales on the secondary markets go?

14.2: Videos

Understanding the Stock Market: The Nasdaq, S&P, and the Dow Jones Industrial Averages

Investing in the stock market "Warren Buffett"

14.3: Bonds and Bond Markets

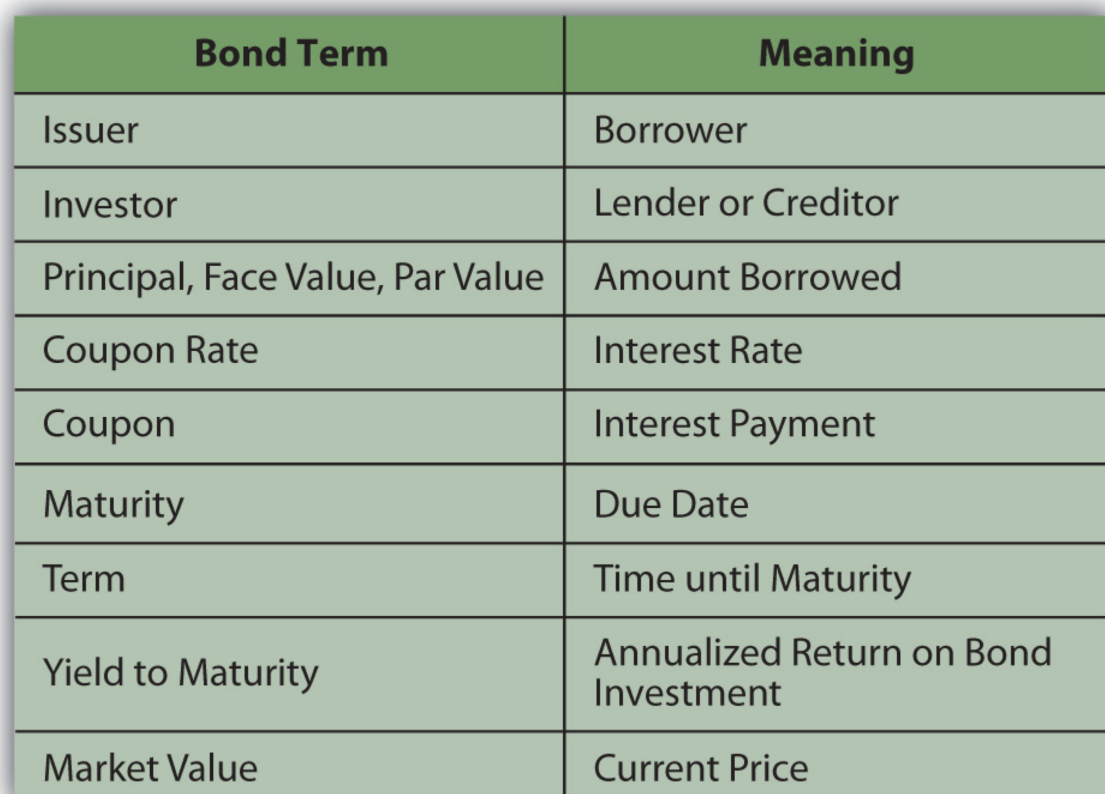
Learning Objectives

1. Identify bond features that can determine risk and return.
2. Differentiate the roles of various U.S. government bonds.
3. List the types and features of state and municipal bonds.
4. Compare and contrast features of the corporate bond markets, the markets for corporate stock, and the markets for government bonds.
5. Explain the role of rating agencies and the process of bond rating.

Bonds are a relatively old form of financing. Formalized debt arrangements long preceded corporate structure and the idea of equity (stock) as we know it. Venice issued the first known government bonds of the modern era in 1157,Isadore Barmash, *The Self-Made Man* (Washington, DC: Beard Books, 2003), 55. while private bonds are cited in British records going back to the thirteenth century.George Burton Adams, *The Constitutional History of England* (London: H. Holt, 1921), 93. Venice issued bonds to raise funds to finance a Crusade against Constantinople, which included expansion of a shipyard attached to the Venetian Arsenal. (Go to http://en.Wikipedia.org/wiki/Venetian_Arsenal to view images.)

Bonds

In addition to financing government projects, bonds are used by corporations to capitalize growth. Bonds are also a legal arrangement, couched in conditions, obligations, and consequences. As a result of their legal and financial roles, bonds carry a quaint and particular vocabulary. Bonds come in all shapes and sizes to suit the needs of the borrowers and the demands of lenders. Figure 16.1 lists the descriptive terms for basic bond features.



Bond Term	Meaning
Issuer	Borrower
Investor	Lender or Creditor
Principal, Face Value, Par Value	Amount Borrowed
Coupon Rate	Interest Rate
Coupon	Interest Payment
Maturity	Due Date
Term	Time until Maturity
Yield to Maturity	Annualized Return on Bond Investment
Market Value	Current Price

Figure 16.1.1 : Basic Bond Features

The **coupon** is usually paid to the investor twice yearly. It is calculated as a percentage of the **face value**—amount borrowed—so that the annual coupon = coupon rate × face value. By convention, each individual bond has a face value of $1,000. A corporation issuing a bond to raise $100 million would have to issue 100,000 individual bonds (100,000,000 divided by 1,000). If those bonds pay a 4 percent coupon, a bondholder who owns one of those bonds would receive a coupon of $40 per year (1,000 × 4%), or $20 every six months.

The **coupon rate** of interest on the bond may be fixed or floating and may change. A floating rate is usually based on another interest benchmark, such as the U.S. **prime rate**, a widely recognized benchmark of prevailing interest rates.

A **zero-coupon bond** has a coupon rate of zero: it pays no interest and repays only the principal at maturity. A "zero" may be attractive to investors, however, because it can be purchased for much less than its face value. There are **deferred coupon bonds** (also called **split-coupon bonds** and issued below par), which pay no interest for a specified period, followed by higher-than-normal interest payments until maturity. There are also **step-up bonds** that have coupons that increase over time.

The face value, the principal amount borrowed, is paid back at maturity. If the bond is **callable**, it may be redeemed after a specified date but before maturity. A borrower typically "calls" its bonds after prevailing interest rates have fallen, making lower-cost debt available. Borrowers can borrow new, cheaper debt and pay off the older, more expensive debt. As an investor (lender), you would be paid back early, which sounds great, but because interest rates have fallen, you would have trouble finding another bond investment that would pay as high a rate of return.

A **convertible bond** is a corporate bond that may be converted into common equity at maturity or after some specified time. If a bond were converted into stock, the bondholder would become a shareholder, assuming more of the company's risk.

The bond may be secured by collateral, such as property or equipment, sometimes called a **mortgage bond**. If unsecured, or secured only by the "full faith and credit" of the borrower (the borrower's unconditional commitment to pay principal and interest on the debt), the bond is a **debenture**. Most bonds are issued as debentures.

A bond specifies if the borrower has more than one bond issue outstanding or more than one set of lenders to repay, which establishes the bond's seniority in relation to previously issued debt. This "pecking order" determines which lenders will be paid back first in case of default on the debt or bankruptcy. Thus, when the borrower does not meet its coupon obligations, investors holding **senior debt** as opposed to **subordinated debt** have less risk of default.

Bonds may also come with **covenants** or conditions on the borrower. Covenants are usually attached to corporate bonds and require the company to maintain certain performance goals during the term of the loan. Those goals are designed to lower **default risk** for the lender. Examples of typical covenants are

- dividend limits,
- debt limits,
- limits on sales of assets,
- maintenance of certain liquidity ratios or minimum cash balances.

Corporations issue corporate bonds, usually with maturities of ten, twenty, or thirty years. Corporate bonds tend to be the most "customized," with features such as callability, conversion, and covenants.

The U.S. government issues **Treasury bills** for short-term borrowing, **Treasury notes** for intermediate-term borrowing (longer than one year but less than ten years), and **Treasury bonds** for long-term borrowing for more than ten years. The federal government also issues **Treasury Inflation-Protected Securities (TIPS)**. TIPS pay a fixed coupon, but the principal adjusts with inflation. At maturity, you are repaid either the original principal or the inflation-adjusted principal, whichever is greater.

State and municipal governments issue revenue bonds or general obligation bonds. A **revenue bond** is repaid out of the revenue generated by the project that the debt is financing. For example, toll revenue may secure a debt that finances a highway. A **general obligation bond** is backed by the state or municipal government, just as a corporate debenture is backed by the corporation.

Interest from state and **municipal bonds** (also called "munis") may not be subject to federal income taxes. Also, if you live in that state or municipality, the interest may not be subject to state and local taxes. The tax exemption differs from bond to bond, so you should be sure to check before you invest. Even if the interest is not taxable, however, any gain (or loss) from the sale of the bond is taxed, so you should not think of munis as "tax-free" bonds.

Foreign corporations and governments issue bonds. You should keep in mind, however, that foreign government defaults are not uncommon. Mexico in 1994, Russia in 1998, and Argentina in 2001 are all recent examples. Foreign corporate or sovereign debt also exposes the bondholder to currency risk, as coupons and principal will be paid in the foreign currency. Figure 16.2 shows a summary of bonds and their issuers.

	Government				Corporate
	U.S. Treasury	State	Municipality	Foreign	
Short-Term (< 1 year)	Treasury Bills				Commercial Paper
Intermediate-Term (1–10 years)	Treasury Notes	Revenue Bonds or General Obligation Bonds	Revenue Bonds or General Obligation Bonds	Sovereignty Bonds	Bonds
Long-Term (> 10 years)	Treasury Bonds	Revenue Bonds or General Obligation Bonds	Revenue Bonds or General Obligation Bonds	Sovereignty Bonds	Bonds

Figure 16.1.2 : Bond Issuers and Terms

Bond Markets

The volume of capital traded in the bond markets is far greater than what is traded in the stock markets. All sorts of borrowers issue bonds: corporations; national, state and municipal governments; and government agencies. Even small towns issue bonds to finance capital expenditures such as schools, fire stations, and roads. Each kind of bond has its own market.

Private placement refers to bonds that are issued in a private sale rather than through the public markets. The investors in privately placed bonds are institutional investors such as insurance companies, endowments, and pension funds.

U.S. Treasury bonds are issued to the primary market through auctions. Participants, usually dealers or institutional investors, bid for the bonds, but no one participant is allowed to buy enough shares to monopolize the secondary market. Individuals can also buy Treasuries directly from the U.S. Treasury through its online service, called TreasuryDirect (http://www.treasurydirect.gov/).TreasuryDirect, http://www.treasurydirect.gov/ (accessed June 13, 2009).

Corporate bonds are traded in over-the-counter transactions through brokers and dealers. Because the details of each bond issue may vary—maturity, coupon rate, callability, convertibility, covenants, and so on—it is hard to directly compare bond values the way stock values are compared. As a result, the corporate bond markets are less transparent to the individual investor.

To provide guidance, **rating agencies** provide bond ratings; that is, they "grade" individual bond issues based on the likelihood of default and thus the risk to the investor. Rating agencies are independent agents that base their ratings on the financial stability of the company, its business strategy, competitive environment, outlook for the industry and the economy—any factors that may affect the company's ability to meet coupon obligations and pay back debt at maturity.

Ratings agencies such as Fitch Ratings, A. M. Best, Moody's, and Standard & Poor's (S&P) are hired by large borrowers to analyze the company and rate its debt. Moody's also rates government debt. Ratings agencies use an alphabetical system to grade bonds (shown in Figure 16.3) based on the highest-to-lowest rankings of two well-known agencies.

Standard & Poor's	Moody's	Grade	Meaning
AAA	Aaa	Investment	Risk is almost zero
AA	Aa	Investment	Low risk
A	A	Investment	Risk if economy declines
BBB	Baa	Investment	Some risk; more if economy declines
BB	Ba	Speculative	Risky
B	B	Speculative	Risky; expected to get worse
CCC	Caa	Speculative	Probable bankruptcy
CC	Ca	Speculative	Probable bankruptcy
C	C	Speculative	In bankruptcy or default
D		Speculative	In bankruptcy or default

Figure 16.1.3 : Bond Ratings

A plus sign (+) following a rating indicates that it is likely to be upgraded, while a minus sign (−) following a rating indicates that it is likely to be downgraded.

Bonds rated BBB or Baa and above are considered **investment grade bonds**, relatively low risk and "safe" for both individual and institutional investors. Bonds rated below BBB or Baa are speculative in that they carry some default risk. These are called **speculative grade bonds**, **junk bonds**, or **high-yield bonds**. Because they are riskier, speculative grade bonds need to offer investors a higher return or yield in order to be "priced to sell."

Although the term "junk bonds" sounds derogatory, not all speculative grade bonds are "worthless" or are issued by "bad" companies. Bonds may receive a speculative rating if their issuers are young companies, in a highly competitive market, or capital intensive, requiring lots of operating capital. Any of those features would make it harder for a company to meet its bond obligations and thus may consign its bonds to a speculative rating. In the 1980s, for example, companies such as CNN and MCI Communications Corporation issued high-yield bonds, which became lucrative investments as the companies grew into successful corporations.

Default risk is the risk that a company won't have enough cash to meet its interest payments and principal payment at maturity. That risk depends, in turn, on the company's ability to generate cash, profit, and grow to remain competitive. Bond-rating agencies analyze an issuer's default risk by studying its economic, industry, and firm-specific environments and estimate its current and future ability to satisfy its debts. The default risk analysis is similar to equity analysis, but bondholders are more concerned with cash flows—cash to pay back the bondholders—and profits rather than profits alone.

Bond ratings can determine the coupon rate the issuer must offer investors to compensate them for default risk. The higher the risk, the higher the coupon must be. Ratings agencies have been criticized recently for not being objective enough in their ratings of the corporations that hire them. Nevertheless, over the years bond ratings have proven to be a reliable guide for bond investors.

Summary

- Bond features that can determine risk and return include
  - coupon and coupon structure,
  - maturity, callablility, and convertibility,
  - security or debenture,
  - seniority or subordination,
  - covenants.
- The U.S. government issues Treasury
  - bills for short-term borrowing,
  - notes for intermediate-term borrowing,
  - bonds for long-term borrowing,
  - TIPS, which are inflation-protected.
- State and municipal governments issue
  - revenue bonds, secured by project revenues, or
  - general obligation bonds, secured by the government issuer.
- State and municipal government muni bonds may or may not have tax advantages for certain investors.
- Corporate bonds may be issued through the public bond markets or through private placement.
- U.S. government bonds are issued through auctions managed by the Federal Reserve.
- The secondary bond market offers little transparency because of the differences among bonds and the lower volume of trades.
- To help provide transparency, rating agencies analyze default risk and rate specific bonds.

Exercises

1. Explore the homepages of S&P at www2.standardandpoors.com/por...0,0,0,0,0.html and Moody's at www.moodys.com. Access to bond ratings at these sites requires registration, but other information is readily available. For example, how does S&P explain that its rating system does not directly measure default risk? Next, read Moody's explanation of its performance as a rating agency at www.moodys.com/cust/content/c...t.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/2001700000407258.pdf. What do the data generally show about the relationship between ratings and defaults on corporate bonds? What examples of defaults on municipal bonds does Moody's give as examples of the effects of financial stress on city governments? According to Moody's, how do municipal bonds compare to corporate bonds as investments? To find more information about bonds and investor tools for choosing bonds and calculating bond value, go to http://www.bondsonline.com.
2. What is your state's bond rating? A keyword search ("[state name] bond rating") will bring up current articles on this subject in the news media. What state government activities or expenditures do the bond issues finance? What factors have caused your state's bond rating to be increased or decreased recently? How does your state's bond rating compare with ratings of other states in your region? Now find the current bond rating for your city or town. In My Notes or your personal finance journal, write an explanation of why you might or might not invest in your city or town and state at this time. In general, why might you want to invest in municipal bonds? What role would bonds play in your investment portfolio?

14.4: Investments in Bonds

A company may invest in the bonds of another corporation if it has no immediate need for its cash, just like it can invest in another corporation's stock. An investor in bonds is lending money to another corporation. A separate account that mentions the unique name of the corporation for each bond investment is used.

For example, a company might invest in the bonds of three other corporations and use *Investment in ABC Bonds*, *Investment in Home Depot Bonds*, and *Investment in Delta Airlines Bonds* as their three distinct asset account names.

There are five possible journal entries related to investing in bonds, as follows:

1. Purchase the bonds investment
2. Record the semi-annual interest receipts
3. Amortize the discount or premium
4. Adjust to fair value
5. Sell the bonds investment

Investments in bonds are accounted for in three different ways, depending on how long the investor intends to hold the investment. Bonds are classified as one of three types of securities.

- The debt is classified as (a) **held-to-maturity** when the investor has the intent and ability to hold the bond full term.
- The debt is classified as (b) **trading** when the intent is to sell it in the short term for profit and own it less than one year.
- The debt is classified as (c) **available-for-sale** when it is neither held-to- maturity nor trading.

The investment in bonds accounts appear in the assets section of the balance sheet. Those that are classified as trading securities to be sold or traded within one year are current assets. Held-to-maturity and available-for-sale securities that are intended to be owned for more than one year are categorized as long-term investments.

Bonds have a face value, which is the amount that will be repaid on the maturity date. In the example that follows, the face amount is $5,000,000. In addition, the bond investment will show a contract rate, which is the percent of interest that will be paid annually to investors. In the example, the interest rate is 8%. Bonds also are in effect for a stated period of time and have a maturity date. In the example, the term of the bonds is four years, so the maturity date is December 31, 2021. On that date, investors are repaid the face amount of the bond investment.

4.10.1 Held-to-Maturity Securities

Bond investments are classified as held-to-maturity when the investor has the intent and ability to hold the bond full term. Two versions of the journal entries related to investing in held-to-maturity bond securities are illustrated side by side in the journal entries that follow. The transactions on the left illustrate transactions for bond investments purchased at a discount. On the right are journal entries for bonds purchased at a premium. Explanations are included.

Held-to-maturity bond securities appear under the Long-Term Investments caption in the assets section of the balance sheet. They are reported at their amortized cost, as explained below. They are not adjusted to fair value.

1A. Purchase the Bond Investment of Held-to-Maturity Securities

Bonds may be purchased for their face amount. They may also be purchased at either a discount or a premium; that is, for less or more than the face amount, respectively. If the contract interest rate that the issuing corporation is offering is less than the going market rate, investors purchase the bonds at a discount (for less than face amount). If the contract interest rate that the issuing corporation is offering is more than the going market rate, investors purchase the bonds at a premium (for more than face amount).

The following bonds are purchased on January 1, 2018.

At a Discount (market rate is lower) 1/1/2018 Your Corporation purchases $5,000,000 of four-year, 6% ABC Co. bonds for $4,700,000. (The bond investment is purchased at a discount of $300,000).						**At a Premium (market rate is higher)** 1/1/2018 Your Corporation purchases $5,000,000 of four-year, 6% ABC Co. bonds for $5,300,000. (The bond investment is purchased at a premium of $300,000).				
	Accoun t		**Debit**	**Credit**			**Accoun t**		**Debit**	**Credit**

▲	Investment in ABC Stock		4,700,000				▲	Investment in ABC Bonds		5,300,000		
▼	Cash			4,700,000			▼	Cash			5,300,000	
▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▼ *Cash* is an **asset** account that is **decreasing.**							▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▼ *Cash* is an **asset** account that is **decreasing.**					
Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock							**Investment in ABC Stock**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
		4,700,000		4,700,000					5,300,000		5,300,000	

2A. Record Interest for Semi-Annual Interest Receipts for Held-to-Maturity Securities

The corporation that issued the bond securities pays interest to the investor semi-annually, or every six months. The issuing company pays semi-annual interest on June 30 and December 31 each year. The amount is determined by multiplying the face amount of the bonds by half of the annual contract rate.

At a Discount (market rate is lower) EVERY SIX MONTHS Your Corporation records semi-annual interest received and discount amortized.						**At a Premium (market rate is higher)** EVERY SIX MONTHS Your Corporation records semi-annual interest received and premium amortized.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Cash		15,000			▲	Cash		15,000	
▲	Investment Revenue			15,000		▲	Interest Revenue			15,000
▲ *Cash* is an **asset** account that is **increasing.**						▲ *Cash* is an **asset** account that is **increasing.**				
▲ *Interest Revenue* is a **revenue** account that is **increasing.**						▲ *Interest Revenue* is a **revenue** account that is **increasing.**				
Cash and Interest Revenue amounts = ($5,000,000 x 6%) / 2 Cash and Interest Revenue amounts = ($5,000,000 x 6%) / 2										

The investment account balances are not affected by the receipt of the interest. This transaction is recorded every six months as the cash is received for the interest revenue for as long as the investment is held.

3A. Amortization of Discount or Premium for Held-to-Maturity Securities just prior to Financial Statements

If bonds are purchased at a discount or premium, there is a difference between the amount paid for the investment and the face amount. That difference is accounted for over time as Interest Revenue rather than recorded as Interest Revenue all at once at the time of purchase. This process is called amortization; it is similar to depreciation but for non-physical assets. Assume that the investor prepares financial statements at the end of each calendar year. The straight-line method will be used to amortize the discount or premium amount at the end of each year, which involves dividing the discount or premium amount by the number of years in the term of the bond.

At a Discount (market rate is lower) EVERY YEAR END Your Corporation records semi-annual interest received and discount amortized.							**At a Premium (market rate is higher)** EVERY YEAR END Your Corporation records semi-annual interest received and premium amortized.					
	Account		**Debit**	**Credit**					**Account**		**Debit**	**Credit**
▲	Investment in ABC Bonds		75,000				▼		Interest Revenue		75,000	
▲	Investment Revenue			75,000			▼		Interest in ABC Bonds			75,000
▲ *Cash* is an **asset** account that is **increasing.**							▼ *Interest Revenue* is a **revenue** account that is **decreasing.**					
▲ *Interest Revenue* is a **revenue** account that is **increasing.**							▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**					
Investment amortization amount = ($5,000,000 - $4,700,000) / 4 years = $75,000							Investment amortization amount = ($5,000,000 - $5,300,000) / 4 years = $75,000					

The journal entry above is repeated every year end for a total of four years in the term of the bond.
The ledgers that follow show the change over time in the carrying amount of the bond investment as the discount or premium is amortized every year.
With each entry in the investment account's ledger, the running debit balances moves closer and closer to the face amount of the bonds. The debit balance of an investment purchased at a discount continuously increases. The debit balance of an investment purchased at a premium continuously decreases.

Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock							**Investment in ABC Stock**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
1/1/18		4,700,000		4,700,000			1/1/18		5,300,000		5,300,000	
12/31/18		75,000		4,775,000			12/31/18		75,000		5,225,000	
12/31/19		75,000		4,850,000			12/31/19		75,000		5,150,000	
12/31/20		75,000		4,925,000			12/31/20		75,000		5,075,000	
12/31/21		75,000		5,000,000			12/31/21		75,000		5,000,000	

4A. Adjust to Fair Value - Not Applicable for Held-to-Maturity Securities

Held-to-maturity investments are not adjusted to fair value over time since the intent is not to sell them at a gain or loss prior to the maturity date of the bonds. Therefore, there is no journal entry to adjust held-to-maturity investments to fair value.

5A. Alternative #1 - Sell the Bonds Investment of Held-to-Maturity Securities on Maturity Date

Investors receive the full face amount on the maturity date. Held-to-maturity securities are typically repaid on the maturity date, so this is the more common transaction for the repayment.

At a Discount (market rate is lower) 12/31/21 ABC Co. redeems the bonds and pays back the face amount of $5,000,000 to Your Corporation after the full term of the bond.					
	Account		**Debit**	**Credit**	
▲	Cash		5,000,000		
▼	Investment in ABC Bonds			5,000,000	
▲ *Cash* is an **asset** account that is **increasing.**					
▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**					
Ledger account balance:					
Investment in ABC Stock					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
1/1/18		4,700,000		4,700,000	
12/31/18		75,000		4,775,000	
12/31/19		75,000		4,850,000	
12/31/20		75,000		4,925,000	
12/31/21		75,000		5,000,000	
12/31/21			5,000,000		0

At a Premium (market rate is higher) 12/31/21 ABC Co. redeems the bonds and pays back the face amount of $5,000,000 to Your Corporation after the full term of the bond.					
	Account		**Debit**	**Credit**	
▲	Cash		5,000,000		
▼	Interest in ABC Bonds			5,000,000	
▲ *Cash* is an **asset** account that is **increasing.**					
▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**					
Ledger account balance:					
Investment in ABC Stock					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
1/1/18		5,300,000		5,300,000	
12/31/18			75,000	5,225,000	
12/31/19			75,000	5,150,000	
12/31/20			75,000	5,075,000	
12/31/21			75,000	5,000,000	
12/31/21			5,000,000	0	

5A. Alternative #2 - Sell the Bonds Investment of Held-to-Maturity Securities Prior to Maturity Date

Investors may receive more or less than the face amount of the bond if they sell the investment prior to the maturity date. A gain or loss on the sale may occur. The examples that follow show a bond purchased at a discount that is sold for a gain and a bond purchased at a premium that is sold at a loss. The gain and loss may be reversed for a premium and discount, respectively, as well.

Held-to-maturity securities are typically repaid on the maturity date, so this is the less common transaction for the repayment.

At a Discount (market rate is lower) 12/31/20 Your Corporation sells the bond after three full years for $4,945,000 when the carrying amount of the investment is $4,925,000.		**At a Premium (market rate is higher)** 12/31/20 Your Corporation sells the bond after three full years for $5,055,000 when the carrying amount of the investment is $5,075,000.

	Account		Debit	Credit				Account		Debit	Credit	
▲	Cash		4,945,000				▲	Cash		5,055,000		
▼	Gain on Sale of Investment			20,000			▼	Loss on Sale of Investment		20,000		
▼	Investment in ABC Bonds			4,925,000			▼	Interest in ABC Bonds			5,075,000	
▲ *Cash* is an **asset** account that is **increasing.** ▲ *Gain on Sale of Investment* is a **revenue** account that is **increasing.** ▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**							▲ *Cash* is an **asset** account that is **increasing.** ▲ *Loss on Sale of Investment* is a **revenue** account that is **increasing.** ▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**					
Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock							**Investment in ABC Stock**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
1/1/18		4,700,000		4,700,000			1/1/18		5,300,000		5,300,000	
12/31/18		75,000		4,775,000			12/31/18			75,000	5,225,000	
12/31/19		75,000		4,850,000			12/31/19			75,000	5,150,000	
12/31/20		75,000		4,925,000			12/31/20			75,000	5,075,000	
12/31/20			4,925,000	0			12/31/20			5,075,000	0	
Ledger account balance:							**Ledger account balance:**					
Gain on Sale of Investment							**Loss on Sale of Investment**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
12/31/20			20,000		20,000		12/31/20		20,000		20,000	

4.10.2 Purchasing Bond Investments with Accrued Interest and Partial-Year Amortization

In the previous held-to-maturity examples, the investments were purchased on January 1 and sold on December 31. Each year the investor owned the bond securities for the full 12 months of the calendar year.

This, obviously, is not always the case. Bond investments may be purchased and sold any time during the year. Assuming that the investing corporation prepares annual financial statements on December 31 each calendar year, the corporation may need to pro-rate the amounts received for semi-annual interest and amounts amortized to adjust for a partial year of ownership.

The examples below show a comparison of full-year transactions on the left and partial-year transactions on the right.

1. Purchase Bonds as a Long-Term Investment

Full Year 1/1/2018 Your Corporation purchases $5,000,000 of four-year, 6% ABC Co. bonds for $4,700,000. (The bond investment is purchased at a discount of $300,000).						**Partial Year** 3/1/2018 Your Corporation purchases $5,000,000 of four-year, 6% ABC Co. bonds for $4,700,000. (The bond investment is purchased at a discount of $300,000).				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Investment in ABC Bonds		4,700,000			▲	Interest in ABC Bonds		4,700,000	
▼	Cash			4,700,000		▼	Interest Revenue		5,000	
						▼	Cash			4,705,000
▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▼ *Cash* is an **asset** account that is **decreasing.**						▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▼ *Interest Revenue* is a **revenue** account that is **decreasing.** ▼ *Cash* is an **asset** account that is **decreasing.**				

Interest is paid each year on June 30 and December 31. Since Your Corporation will be the owner of the bond on June 30, Your will receive the full six-month payment of $15,000 ($5,000,000 x 3%). However, Your is only entitled to one- third of it, or $5,000, since the investor only owned the bond four months (March, April, May, and June) during the six-month period. The party Your purchased the bond from is entitled to the other two months' worth, or $5,000.

Therefore, at the time of the closing on the bond on March 1, Your Corporation advances the seller his $5,000 portion of the $15,000 interest payment that will be paid on June 30. As you see from the transaction that follows, Your receives the full $15,000 from the company that issued the bond on June 30, and Your keeps it all—$10,000 is for the four months when Your owned the bond, and the other $5,000 is to reimburse Your for the amount it paid the seller on March 1.

2. Receive Semi-Annual Interest Payment on 6/30/18 and 12/31/18

Full Year EVERY SIX MONTHS Your Corporation records semi-annual interest received.						**Partial Year** EVERY SIX MONTHS Your Corporation records semi-annual interest received.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Cash		15,000			▲	Cash		15,000	
▲	Interest Revenue			15,000		▲	Interest Revenue			15,000
▲ *Cash* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** Cash and Interest Revenue amounts = ($5,000,000 x 6%) / 2						▲ *Cash* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** Cash and Interest Revenue amounts = ($5,000,000 x 6%) / 2				
Full Year EVERY YEAR END Your Corporation amortizes the discount on the investment.						**Partial Year** EVERY YEAR END Your Corporation amortizes the premium on the investment.				

	Account		Debit	Credit			Account		Debit	Credit
▲	Investment in ABC Bonds		75,000			▲	Investment in ABC Bonds		62,500	
▲	Interest Revenue			75,000		▲	Interest Revenue			62,500
▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** ($5,000,000 - $4,700,000) / 4 years = $75,000						▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** ($5,000,000 - $4,700,000) / 4 years = $75,000 x 10/12 = 62,500				

The investor can only amortize the discount over the period it owns the bonds. In this partial-year case, the investor can amortize 10 months out of 12 months in the year (March through December).

4.10.3 Selling Bond Investments with Accrued Interest and Partial-Year Amortization

An investor must also pro-rate interest and amortization amounts if it sells the investment during a calendar year.

The examples below show a comparison of full-year transactions on the left and partial-year transactions on the right.

Full Year On January 1, 2016, Your Corporation had purchased $5,000,000 of four-year, 6% ABC Co. bonds for $4,700,000. (The bond investment was purchased at a discount of $300,000). Your amortized the discount on 12/31 at the end of 2016 and 2017. The carrying amount on the investment on December 31, 2017 is $4,850,000 ($4,700,000 + $75,000 for 2016 + $75,000 for 2017). It is now December 31, 2018 and Your Corporation amortizes the discount to date in 2018 and sells the investment for $4,875,000. 12/31/18 Your Corporation amortizes the discount on the investment for 2018, just before the sale.						**Partial Year** On January 1, 2016, Your Corporation had purchased $5,000,000 of four-year, 6% ABC Co. bonds for $4,700,000. (The bond investment was purchased at a discount of $300,000). Your amortized the discount on 12/31 at the end of 2016 and 2017. The carrying amount on the investment on December 31, 2017 is $4,850,000 ($4,700,000 + $75,000 for 2016 + $75,000 for 2017). It is now April 30, 2018 and Your Corporation amortizes the discount to date in 2018 and sells the investment for $4,875,000. 4/30/18 Your Corporation amortizes the additional discount on the investment for 2018, just before the sale.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Investment in ABC Bonds		75,000			▲	Investment in ABC Bonds		25,000	
▲	Interest Revenue			75,000		▲	Interest Revenue			25,000
▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** ($5,000,000 - $4,700,000) / 4 years = $75,000						▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** ($5,000,000 - $4,700,000) / 4 years = $75,000 x 4/12 = 25,000				

Ledger account balance:							Ledger account balance:					
Investment in ABC Stock							**Investment in ABC Stock**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
1/1/16		4,700,000		4,700,000			1/1/16		4,700,000		4,700,000	
12/31/16		75,000		4,775,000			12/31/16		75,000		4,775,000	
12/31/17		75,000		4,850,000			12/31/17		75,000		4,850,000	
12/31/18		75,000		4,925,000			4/30/18		25,000		4,825,000	

In the case of the partial year where the investment was sold on April 30, 2018, the seller receives two-thirds of the $15,000 bond interest amount that the issuing company will pay on June 30. This is because the seller owned the investment four months during the six-month interest period. The buyer pays this $10,000 to the seller at the closing and the buyer is reimbursed on June 30 when he receives and keeps the full $15,000 interest payment.

Full Year 12/31/18 Your Corporation sells the bond after three full years for $4,875,000 when the carrying amount of the investment is $4,925,000.						**Partial Year** 4/30/18 Your Corporation sells the bond after two years and four months for $4,875,000 when the carrying amount of the investment is $4,825,000.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Cash		4,885,000			▲	Cash		4,885,000	
▲	Loss on Sale of Investment		50,000			▲	Gain on Sale of Investment			50,000
▼	Investment in ABC Bonds			4,925,000		▼	Investment in ABC Bonds			4,825,000
▲	Interest Revenue			10,000		▲	Interest Revenue			10,000
▲ *Cash* is an **asset** account that is **increasing.** ▲ *Loss on Sale of Investment* is a loss that is **increasing.** ▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.**						▲ *Cash* is an **asset** account that is **increasing.** ▲ *Gain on Sale of Investment* is a gain that is **increasing.** ▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.**				

Ledger account balance:							Ledger account balance:					
Investment in ABC Stock							**Investment in ABC Stock**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**

1/1/16		4,700,000		4,700,000			1/1/16		4,700,000		4,700,000	
12/31/16		75,000		4,775,000			12/31/16		75,000		4,775,000	
12/31/17		75,000		4,850,000			12/31/17		75,000		4,850,000	
12/31/18		75,000		4,925,000			4/30/18		25,000		4,825,000	
12/31/18			4,925,000	0			4/30/18			4,825,000	0	
Ledger account balance:							**Ledger account balance:**					
Loss on Sale of Investment							**Gain on Sale of Investment**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
12/31/18		50,000		50,000			4/30/18			50,000		50,000

4.10.4 Trading Securities

A bond investment is classified as trading when the investor intends to sell it quickly within one year. Trading bond securities appear in the current assets section on the balance sheet at their fair value. Unrealized gains or losses due toa difference between cost and fair value are reported on the investor's income statement as a component of **comprehensive income** in the *Unrealized Holding Gain/Loss – Net Income* account.

AVAILABLE-FOR-SALE SECURITIES

A bond investment is classified as **available-for-sale** when it is neither held- to-maturity nor trading. Available-for-sale bond securities typically appear under the **Long-Term Investments** caption in the assets section of the balance sheet at their fair value. Unrealized gains or losses due to a difference between cost and fair value are reported on the investor's balance sheet in the stockholders' equity section under the caption **Other Accumulated Comprehensive Income** in the *Unrealized Holding Gain/Loss – Available-for-Sale Securities* account.

Two versions of the transactions related to investing in bonds are illustrated side by side in the journal entries that follow. The transactions on the left illustrate transactions for bond investments classified as trading securities. On the right are transactions for bonds classified as available-for-sale securities. Explanations are included.

1. Purchase the Bond Investment of Trading or Available-for-Sale Securities

Notice in this example that the bonds are purchased on July 1, halfway through the calendar year.

Trading Securities 7/1/2018 Your Corporation purchases $5,000,000 of four-year, 6% ABC Co. bonds for their face amount. The investment is classified as a trading security since the investor expects to sell it in approximately 9 months.						**Available-for-Sale Securities** 7/1/2018 Your Corporation purchases $5,000,000 of four-year, 6% ABC Co. bonds for their face amount. The investment is classified as an available-for-sale security since the expected sale date is uncertain.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**

▲	Investment in ABC Bonds		5,000,000			▲	Investment in ABC Bonds		5,000,000	
▼	Cash			5,000,000		▼	Cash		5,000,000	
▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▼ *Cash* is an **asset** account that is **decreasing.**						▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▼ *Cash* is an **asset** account that is **decreasing.**				

Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock							**Investment in ABC Stock**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
7/1/18		5,000,000		5,000,000			7/1/18		5,000,000		5,000,000	

2. Record Interest for Simi-Annual Interest Receipts

The corporation that issued the bond securities pays interest to the investor semi-annually, or every six months. The issuing company pays semi-annual interest on June 30 and December 31 each year. The semi-annual amount is determined by multiplying the face amount of the bonds by half of the annual contract rate.

Trading Securities 12/31/2018 Your Corporation records semi-annual interest received.						**Available-for-Sale Securities** 12/31/2018 Your Corporation records semi-annual interest received.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Cash		15,000			▲	Cash		15,000	
▲	Interest Revenue			15,000		▲	Interest Revenue			15,000
▲ *Cash* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** Cash and Interest Revenue amounts = ($5,000,000 x 6%) / 2						▲ *Cash* is an **asset** account that is **increasing.** ▲ *Interest Revenue* is a **revenue** account that is **increasing.** Cash and Interest Revenue amounts = ($5,000,000 x 6%) / 2				

The investment account balance is not affected by the receipt of the interest. This transaction is recorded every six months as the cash is received for the interest revenue for as long as the investment is held.

3. Amortization of Discount or Premium for Trading or Available-for-Sale Securities

There is no discount or premium for either security since the bonds were purchased at their face amounts.

4. Adjust Trading or Available-for-Sale Securities to Fair Value just prior to Financial Statements

Trading securities and available-for-sale securities are adjusted to fair value at least once annually. In these examples, that adjustment will occur on December 31, 2018, just before the financial statements are prepared for the year.

Trading Securities 12/31/18 The fair value of the trading securities is $5,010,000.						Available-for-Sale Securities 12/31/18 The fair value of the available-for-sale securities is $5,010,000.				
	Account		Debit	Credit			Account		Debit	Credit
▲	Investment in ABC Bonds		10,000			▲	Investment in ABC Bonds		10,000	
▲	Unrealized Holding Gain/Loss — Net Income			10,000		▲	Unrealized Holding Gain/Loss — Available-for-Sale			10,000
▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▲ *Unrealized Holding Gain/Loss – Net Income* is a gain account that is **increasing.** Amount = $5,010,000 fair value - $5,000,000 cost						▲ *Investment in ABC Bonds* is an **asset** account that is **increasing.** ▲ *Unrealized Holding Gain/Loss – Available-for-Sale* is a gain that is **increasing.** Amount = $5,010,000 fair value - $5,000,000 cost				

Ledger account balance:							Ledger account balance:					
Investment in ABC Stock (trading)							**Investment in ABC Stock (available-for-sale)**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
7/1/18		5,000,000		5,000,000			7/1/18		5,000,000		5,000,000	
12/31/18		10,000		5,010,000			12/31/18		10,000		5,010,000	

Ledger account balance:							Ledger account balance:					
Unrealized Holding Gain/Loss — Net Income							**Unrealized Holding Gain/Loss — Available-For-Sale**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
12/31/18		10,000		10,000			12/31/18		10,000		10,000	

The following table includes financial statements with select accounts for a company that holds debt investments.

Comprehensive Income Statement		**Balance Sheet**	
Revenues	$XXX,XXX	ASSETS	
Expenses	XXX,XXX	Current assets:	
Income from operations	$XXX,XXX	Trading securities	$XXX,XXX
Other income and expenses:		Long-term investments:	
Investment Income	XXX,XXX	Available-for-sale securities	XXX,XXX
Gain on sale of investment [3]	XXX,XXX	Held-to-maturity securities	XXX,XXX
Loss on sale of investment [3]	(XXX,XXX)		
		LIABILITIES	
Net income	$XXX,XXX		
		STOCKDOLERS' EQUITY	
Other comprehensive income:		Common Stock	XXX,XXX
Unrealized holding gain/loss on investments [1]	XXX,XXX	Retained Earnings	XXX,XXX
		Other accumulated comprehensive income:	
Comprehensive income	$XXX,XXX	Unrealized holding gain/loss on available-for-sale securities [2]	XXX,XXX

[1] *related to trading securities*

[2] *related to available-for-sale securities*

[3] *related to held-to-maturity securities*

After financial statements are prepared, income statement accounts are closed to Retained Earnings.

Income statement accounts, such as *Unrealized Holding Gain/Loss – Net Income*, are closed to *Retained Earnings* after the financial statements are prepared. *Unrealized Holding Gain/Loss – Available-for-Sale Securities* is a balance sheet account and therefore is not closed.

Trading Securities 12/31/18 Close the income statement account.						**Available-for-Sale Securities**				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▼	Unrealized Holding Gain/Loss — Net Income		10,000							
▲	Retained Earnings			10,000						

▼ *Unrealized Holding Gain/Loss - Net Income* is a gain set to zero by **decreasing.** ▲ *Retained* Earnings is a stockholders' equity account that is **increasing.**		NO JOURNAL ENTRY.

Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock (trading)							**Investment in ABC Stock (available-for-sale)**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
7/1/18		5,000,000		5,000,000			7/1/18		5,000,000		5,000,000	
12/31/18		10,000		5,010,000			12/31/18		10,000		5,010,000	

Ledger account balance:							**Ledger account balance:**					
Unrealized Holding Gain/Loss — Net Income							**Unrealized Holding Gain/Loss — Available-For-Sale**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
12/31/18		10,000		10,000			12/31/18		10,000		10,000	
12/31/18			10,000	0								

5. Sell the Bonds Investment of Trading Securities or Available-for-Sale Securities

The trading securities are sold on March 31, 2019. The available for sale securities are sold on October 31, 2019.

The first step in the sale of each of the debt securities is to bring the carrying amount of the investment to its fair value on the date of the sale. This may also impact the amount of unrealized holding gain or loss balance.

Trading Securities 3/31/19 Your Corporation sells the bond trading securities when the fair value is $5,008,000.						**Available-for-Sale Securities** 10/31/19 Your Corporation sells the bond available-for-sale securities when the fair value is $5,008,000.				
	Account		**Debit**	**Credit**			**Account**		**Debit**	**Credit**
▲	Unrealized Holding Gain/Loss — Net Income		2,000			▲	Unrealized Holding Gain/Loss – Available-for-Sale		2,000	
▼	Retained Earnings			2,000		▼	Investment in ABC Bonds			2,000

▲ *Unrealized Holding Gain/Loss – Net Income* is a loss account that is **increasing.** ▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.** Amount = $5,008,000 fair value - $5,010,000 carrying amount		▲ *Unrealized Holding Gain/Loss – Net Income* is a loss account that is **increasing.** ▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.** Amount = $5,008,000 fair value - $5,010,000 carrying amount

Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock (trading)							**Investment in ABC Stock (available-for-sale)**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
7/1/18		5,000,000		5,000,000			7/1/18		5,000,000		5,000,000	
12/31/18		10,000		5,010,000			12/31/18		10,000		5,010,000	
3/31/19			2,000	5,008,000			10/31/19			2,000	5,008,000	

Ledger account balance:							**Ledger account balance:**					
Unrealized Holding Gain/Loss — Net Income							**Unrealized Holding Gain/Loss — Available-For-Sale**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
3/31/19		2,000		2,000			12/31/18		10,000		10,000	
12/31/18		10,000		10,000			10/31/19		2,000		8,000	
12/31/18			10,000	0								
3/31/19		2,000		2,000								

The second step in the sale of available-for-sale securities is to transfer the unrealized gain/loss amount from the balance sheet account to the Gain (or Loss) on Sale of Investment account on the income statement so it can be included in the net income amount for the year.

There is no such transfer for trading securities since the *Unrealized Holding Gain/Loss – Net Income* account is already an income statement account.

Trading Securities 3/31/19 Your Corporation sells the bond trading securities when the fair value is $5,008,000.					**Available-for-Sale Securities** 10/31/19 Your Corporation sells the bond available-for-sale securities when the fair value is $5,008,000. Transfer the unrealized gain.			
	Account	**Debit**	**Credit**			**Account**	**Debit**	**Credit**

					▲	Unrealized Holding Gain/Loss - Available-for-Sale	8,000	
					▲	Gain on Sale of Investment		2,000
NO JOURNAL ENTRY.					▲ *Unrealized Holding Gain/Loss – Net Income* is set to zero by **decreasing.** ▲ *Gain on Sale of Investment* is a gain that is **increasing.** Amount = $5,008,000 fair value - $5,010,000 carrying amount			

Ledger account balance:							**Ledger account balance:**					
Investment in ABC Stock (trading)							**Investment in ABC Stock (available-for-sale)**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
7/1/18		5,000,000		5,000,000			7/1/18		5,000,000		5,000,000	
12/31/18		10,000		5,010,000			12/31/18		10,000		5,010,000	
3/31/19			2,000	5,008,000			10/31/19			2,000	5,008,000	
Ledger account balance:							**Ledger account balance:**					
Unrealized Holding Gain/Loss — Net Income							**Unrealized Holding Gain/Loss — Available-For-Sale**					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**		**Date**	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
3/31/19		2,000		2,000			12/31/18		10,000		10,000	
12/31/18		10,000		10,000			12/1/19		2,000		8,000	
12/31/18			10,000	0			10/31/19			8,000	0	
3/31/19		2,000		2,000								
							Ledger account balance:					
							Gain on Sale of Investment					
							Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
							10/31/19		8,000		8,000	

The third step is to receive the cash from the sale of the investment at fair value.

Trading Securities
3/31/19 Your Corporation sells the bond trading securities when the fair value is $5,008,000.

	Account	Debit	Credit
▲	Cash	5,008,000	
▼	Investment in ABC Bonds		5,008,000

▲ *Cash* is an **asset** account that is **increasing.**
▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**

Available-for-Sale Securities
10/31/19 Your Corporation sells the bond available-for-sale securities when the fair value is $5,008,000.

	Account	Debit	Credit
▲	Cash	5,008,000	
▼	Investment in ABC Bonds		5,008,000

▲ *Cash* is an **asset** account that is **increasing.**
▼ *Investment in ABC Bonds* is an **asset** account that is **decreasing.**

Ledger account balance:

Investment in ABC Stock (trading)

Date	Item	Debit	Credit	Debit	Credit
7/1/18		5,000,000		5,000,000	
12/31/18		10,000		5,010,000	
3/31/19			2,000	5,008,000	
3/31/19		5,008,000		0	

Ledger account balance:

Investment in ABC Stock (available-for-sale)

Date	Item	Debit	Credit	Debit	Credit
7/1/18		5,000,000		5,000,000	
12/31/18		10,000		5,010,000	
10/31/19			2,000	5,008,000	
10/31/19			5,008,000	0	

Ledger account balance (on income statement):

Unrealized Holding Gain/Loss — Net Income

Date	Item	Debit	Credit	Debit	Credit
3/31/19		2,000		2,000	
12/31/18		10,000		10,000	
12/31/18			10,000	0	
3/31/19		2,000		2,000	

Ledger account balance (on balance sheet):

Unrealized Holding Gain/Loss — Available-For-Sale

Date	Item	Debit	Credit	Debit	Credit
12/31/18		10,000		10,000	
12/1/19		2,000		8,000	
10/31/19			8,000	0	

Ledger account balance (on income statement):

Gain on Sale of Investment

Date	Item	Debit	Credit	Debit	Credit

							10/31/19		8,000		8,000	

The *Unrealized Holding Gain/Loss – Net Income* account appears on the income statement as part of other comprehensive income. It represents that amount of gain or loss on investments that have not yet been sold, but whose fair value is different than their initial cost. A fair value greater than cost represents an unrealized gain; a fair value less than cost represents an unrealized loss. The *Unrealized Holding Gain/Loss – Net Income* account is adjusted before financial statements are prepared to update the unrealized gain or loss amount based on the most current fair value.

The *Gain on Sale of Investment* and *Loss on Sale of Investment* accounts that represent actual gains and losses from the sale of investments is not used for trading securities. This is because the *Unrealized Holding Gain/Loss – Net Income* account is updated just prior to the sale, which at the same time brings the investment account to fair value. Since the cash received equals the fair value amount, there is no gain or loss recognized at that time.

14.5: Buying and Selling at Securities Exchanges

7. Where can investors buy and sell securities, and how are securities markets regulated?

When we think of stock markets, we are typically referring to secondary markets, which handle most of the securities trading activity. The two segments of the secondary markets are broker markets and dealer markets, as **Exhibit 16.6** shows. The primary difference between broker and dealer markets is the way each executes securities trades. Securities trades can also take place in alternative market systems and on non-U.S. securities exchanges.

The securities markets both in the United States and around the world are in flux and undergoing tremendous changes. We present the basics of securities exchanges in this section and discuss the latest trends in the global securities markets later in the chapter.

Broker Markets

The **broker market** consists of national and regional securities exchanges that bring buyers and sellers together through brokers on a centralized trading floor. In the broker market, the buyer purchases the securities directly from the seller through the broker. Broker markets account for about 60 percent of the total dollar volume of all shares traded in the U.S. securities markets.

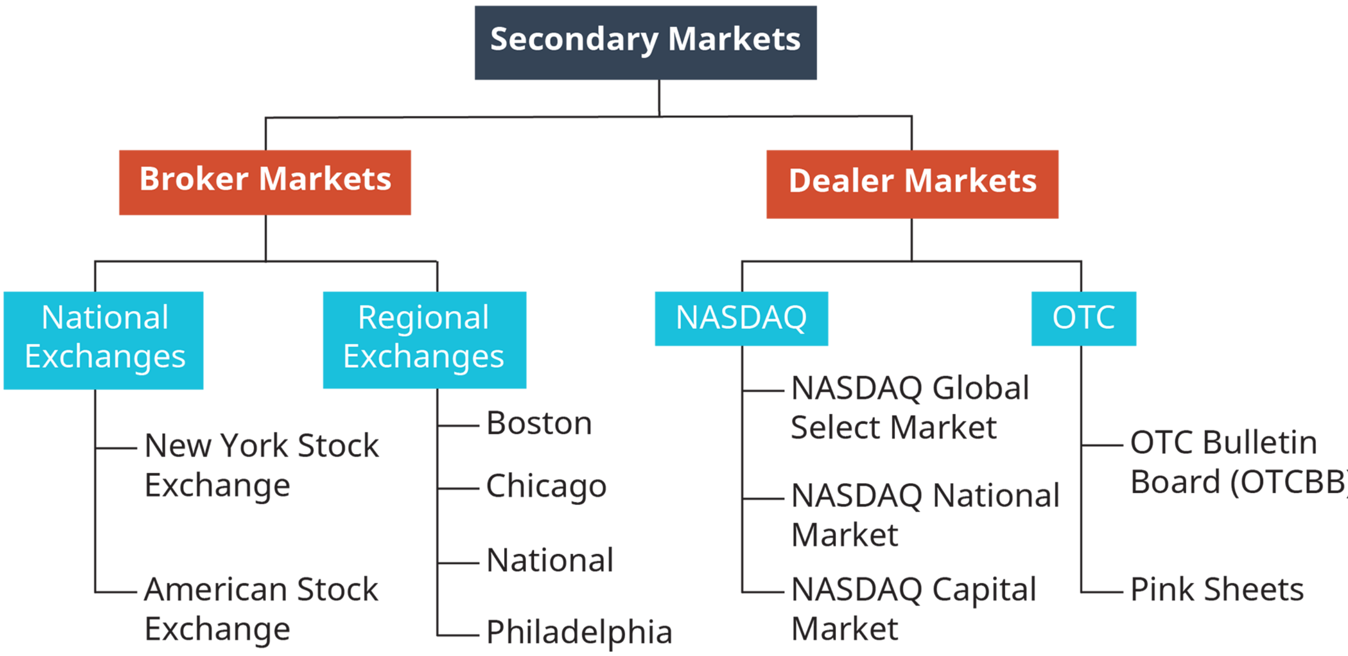


Exhibit **16.6 The Secondary Markets: Broker and Dealer Markets** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

New York Stock Exchange

The oldest and most prestigious broker market is the *New York Stock Exchange (NYSE)*, which has existed since 1792. Often called the Big Board, it is located on Wall Street in downtown New York City. The NYSE, which lists the shares of some 2,400 corporations, had a total market capitalization (domestic and foreign companies) of $25.8 trillion at year-end 2016. On a typical day, more than 3 billion shares of stock are traded on the NYSE.[18] It represents 90 percent of the trading volume in the U.S. broker marketplace. Major companies such as IBM, Coca-Cola, AT&T, Procter & Gamble, Ford Motor Co., and Chevron list their shares on the NYSE. Companies that list on the NYSE must meet stringent listing requirements and annual maintenance requirements, which give them creditability.

The NYSE is also popular with non-U.S. companies. More than 490 foreign companies with a global market capitalization of almost $63 trillion now list their securities on the NYSE. [19]

Until recently, all NYSE transactions occurred on the vast NYSE trading floor. Each of the companies traded at the NYSE is assigned to a trading post on the floor. When an exchange member receives an order to buy or sell a particular stock, the order is transmitted to a floor broker at the company's trading post. The floor brokers then compete with other brokers on the trading floor to get the best price for their customers.

In response to competitive pressures from electronic exchanges, the NYSE created a hybrid market that combines features of the floor auction market and automated trading. Its customers now have a choice of how they execute trades. In the trends section, we'll discuss other changes the NYSE is making to maintain a leadership position among securities exchanges.

Another national stock exchange, the American Stock Exchange (AMEX), lists the securities of more than 700 corporations but handles only 4 percent of the annual share volume of shares traded on U.S. securities exchanges. Because the AMEX's rules are less strict than those of the NYSE, most AMEX firms are smaller and less well known than NYSE-listed corporations. Some firms move up to the NYSE once they qualify for listing there. Other companies choose to remain on the AMEX. Companies cannot be listed on both exchanges at the same time. The AMEX has become a major market, however, for exchange-traded funds and in options trading.

Exhibit **16.7** The New York Stock Exchange (NYSE) is the largest securities market in the world. Its market capitalization dwarfs both foreign and domestic markets. Unlike other financial markets, the NYSE trades mostly through specialists, financial professionals who match up buyers and sellers of securities, while pocketing the spread between the bid and ask price on market orders. *How does the NYSE's hybrid trading system differ from fully automated, electronic trading?* (Credit: Kevin Hutchison/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Regional Exchanges

The remaining 6 percent of annual share volume takes place on several regional exchanges in the United States. These exchanges list about 100 to 500 securities of firms located in their area. Regional exchange membership rules are much less strict than for the NYSE. The top regional exchanges are the Boston, Chicago, Philadelphia, and National (formerly the Cincinnati) exchanges. An electronic network linking the NYSE and many of the regional exchanges allows brokers to make securities transactions at the best prices.

The regional exchanges, which have struggled to compete, benefited from the passage of the Securities and Exchange Commission's (SEC's) Regulation NMS (National Market System), which became fully effective in 2007. Regulation NMS makes price the most important factor in making securities trades, and all orders must go to the trading venue with the best price.[20]

Dealer Markets

Unlike broker markets, **dealer markets** do not operate on centralized trading floors but instead use sophisticated telecommunications networks that link dealers throughout the United States. Buyers and sellers do not trade securities directly, as they do in broker markets. They work through securities dealers called *market makers*, who make markets in one or more securities and offer to buy or sell securities at stated prices. A security transaction in the dealer market has two parts: the selling investor sells his or her securities to one dealer, and the buyer purchases the securities from another dealer (or in some cases, the same dealer).

Exhibit **16.8** The New York Stock Exchange (NYSE) named Stacy Cunningham the first female head of the exchange in its 226-year history. Outside the exchange, the statue "Fearless Girl" by Kristen Virbal stared down the "bull" statue and represented the need for more female representation on the world's most important exchange. *How does the naming of Stacy Cunningham as head of the NYSE demonstrate that the glass ceiling has been shattered?* (Anthony Quintano/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

NASDAQ

The largest dealer market is the **National Association of Securities Dealers Automated Quotation system**, commonly referred to as NASDAQ. The first electronic-based stock market, the NASDAQ is a sophisticated telecommunications network that links dealers throughout the United States. Founded in 1971 with origins in the over-the-counter (OTC) market, today NASDAQ is a separate securities exchange that is no longer part of the OTC market. The NASDAQ lists more companies than the NYSE, but the NYSE still leads in total market capitalization. An average of 1.6 billion shares were exchanged daily in 2016 through NASDAQ, which is now the largest electronic stock market.[21] It provides up-to-date bid and ask prices on about 3,700 of the most active OTC securities. Its sophisticated electronic communication system provides faster transaction speeds than traditional floor markets and is the main reason for the popularity and growth of the OTC market.

In January 2006, the SEC approved NASDAQ's application to operate as a national securities exchange. As a result, the NASDAQ Stock Market LLC began operating independently in August 2006.[22] The securities of many well-known companies, some of which could be listed on the organized exchanges, trade on the NASDAQ. Examples include Amazon, Apple, Costco, Comcast, JetBlue, Microsoft, Qualcomm, and Starbucks. The stocks of most commercial banks and insurance companies also trade in this market, as do most government and corporate bonds. More than 400 foreign companies also trade on the NASDAQ.

More than a decade ago, the NASDAQ changed its structure to a three-tier market:

- The NASDAQ Global Select Market, a new tier with "financial and liquidity requirements that are higher than those of any other market," according to NASDAQ. More than 1,000 NASDAQ companies qualify for this group.
- The NASDAQ Global Market (formerly the NASDAQ National Market), which will list about 1,650 companies.
- The NASDAQ Capital Market will replace the NASDAQ Small Cap Market and list about 550 companies.

All three market tiers adhere to NASDAQ's rigorous listing and corporate governance standards.[23]

The Over-the-Counter Market

The **over-the-counter (OTC) markets** refer to those other than the organized exchanges described above. There are two OTC markets: the *Over-the-Counter Bulletin Board (OTCBB)* and the *Pink Sheets*. These markets generally list small companies and have no listing or maintenance standards, making them attractive to young companies looking for funding. OTC companies do not have to file with the SEC or follow the costly provisions of Sarbanes-Oxley. Investing in OTC companies is therefore highly risky and should be for experienced investors only.

Alternative Trading Systems

In addition to broker and dealer markets, alternative trading systems such as **electronic communications networks (ECNs)** make securities transactions. ECNs are private trading networks that allow institutional traders and some individuals to make direct transactions in what is called the *fourth market*. ECNs bypass brokers and dealers to automatically match electronic buy and sell orders. They are most effective for high-volume, actively traded stocks. Money managers and institutions such as pension funds and mutual funds with large amounts of money to invest like ECNs because they cost far less than other trading venues.

Global Trading and Foreign Exchanges

Improved communications and the elimination of many legal barriers are helping the securities markets go global. The number of securities listed on exchanges in more than one country is growing. Foreign securities are now traded in the United States. Likewise, foreign investors can easily buy U.S. securities.

Stock markets also exist in foreign countries: more than 60 countries operate their own securities exchanges. NASDAQ ranks second to the NYSE, followed by the London Stock Exchange (LSE) and the Tokyo Stock Exchange. Other important foreign stock exchanges include Euronext (which merged with the NYSE but operates separately) and those in Toronto, Frankfurt, Hong Kong, Zurich, Australia, Paris, and Taiwan.[24] The number of big U.S. corporations with listings on foreign exchanges is growing steadily, especially in Europe. For example, significant activity in NYSE-listed stocks also occurs on the LSE. The LSE also is getting a growing share of the world's IPOs. Emerging markets such as India, whose economy has been growing 6 percent or more a year, continue to attract investor attention. The Sensex, the benchmark index of the Bombay Stock Exchange, increased close to 40 percent between 2013 and 2017 as foreign investors continue to pump billions into Indian stocks.[25]

Why should U.S. investors pay attention to international stock markets? Because the world's economies are increasingly interdependent, businesses must look beyond their own national borders to find materials to make their goods and markets for foreign goods and services. The same is true for investors, who may find that they can earn higher returns in international markets.

Regulation of Securities Markets

Both state and federal governments regulate the securities markets. The states were the first to pass laws aimed at preventing securities fraud. But most securities transactions occur across state lines, so federal securities laws are more effective. In addition to legislation, the industry has self-regulatory groups and measures.

Securities Legislation

Congress passed the Securities Act of 1933 in response to the 1929 stock market crash and subsequent problems during the Great Depression. It protects investors by requiring full disclosure of information about new securities issues. The issuer must file a *registration statement* with the SEC, which must be approved by the SEC before the security can be sold.

The *Securities Exchange Act of 1934* formally gave the SEC power to regulate securities exchanges. The act was amended in 1964 to give the SEC authority over the dealer markets as well. The amendment included rules for operating the stock exchanges and granted the SEC control over all participants (exchange members, brokers, dealers) and the securities traded in these markets.

The 1934 act also banned **insider trading**, the use of information that is not available to the general public to make profits on securities transactions. Because of lax enforcement, however, several big insider trading scandals occurred during the late 1980s. The *Insider Trading and Fraud Act of 1988* greatly increased the penalties for illegal insider trading and gave the SEC more power to investigate and prosecute claims of illegal actions. The meaning of *insider* was expanded beyond a company's directors, employees, and their relatives to include anyone who gets private information about a company.

Other important legislation includes the *Investment Company Act of 1940,* which gives the SEC the right to regulate the practices of investment companies (such as mutual funds managed by financial institutions), and the *Investment Advisers Act of 1940,* which requires investment advisers to disclose information about their background. The *Securities Investor Protection Corporation (SIPC)*was established in 1970 to protect customers if a brokerage firm fails, by insuring each customer's account for up to $500,000.

In response to corporate scandals that hurt thousands of investors, the SEC passed new regulations designed to restore public trust in the securities industry. It issued *Regulation FD* (for "fair disclosure") in October 2000. Regulation FD requires public companies to share information with all investors at the same time, leveling the information playing field. The *Sarbanes-Oxley Act of 2002* has given the SEC more power when it comes to regulating how securities are offered, sold, and marketed.

Self-Regulation

The investment community also regulates itself, developing and enforcing ethical standards to reduce the potential for abuses in the financial marketplace. The Financial Industry Regulatory Authority (FINRA) oversees the nation's more than 3,700 brokerage firms and more 600,000 registered brokers. It develops rules and regulations, provides a dispute resolution forum, and conducts regulatory reviews of member activities for the protection and benefit of investors.

In response to "Black Monday"—October 19, 1987, when the Dow Jones Industrial Average plunged 508 points and the trading activity severely overloaded the exchange's computers—the securities markets instituted corrective measures to prevent a repeat of the crisis. Now, under certain conditions, **circuit breakers** stop trading for a 15-minute cooling-off period to limit the amount the market can drop in one day. Under revised rules approved in 2012 by the SEC, market-wide circuit breakers kick in when the S&P 500 Index drops 7 percent (level 1), 13 percent (level 2), and 20 percent (level 3) from the prior day's closing numbers.[26]

ETHICS IN PRACTICE

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.

Critical Thinking Questions

1. Despite assurances that companies involved in financial fraud are not allowed to retaliate against their accusers, would you blow the whistle on your employer? Why or why not?
2. What can companies do to make sure their employees are aware of the consequences of financial securities fraud? Provide several examples.

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.

CONCEPT CHECK

1. How do the broker markets differ from dealer markets, and what organizations compose each of these two markets?
2. Why is the globalization of the securities markets important to U.S. investors? What are some of the other exchanges where U.S companies can list their securities?
3. Briefly describe the key provisions of the main federal laws designed to protect securities investors. What is insider trading, and how can it be harmful? How does the securities industry regulate itself?

CHAPTER OVERVIEW

15: Bonus Section 1 - Business Ethics. 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

https://assessments.lumenlearning.co...essments/14358

https://assessments.lumenlearning.co...essments/14359

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

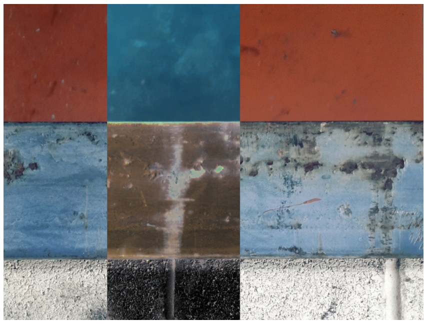
- Explain the concept of business ethics
- Explain how ethics relates to the business and the individual
- Define "corporate code of ethics"
- Explain the role of managers in setting standards for ethical behavior

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

https://assessments.lumenlearning.co...essments/14361

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

https://assessments.lumenlearning.co...essments/14362

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

https://assessments.lumenlearning.co...essments/14364

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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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

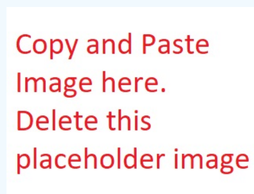
Bribery

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

https://assessments.lumenlearning.co...essments/14365

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

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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.

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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.

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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

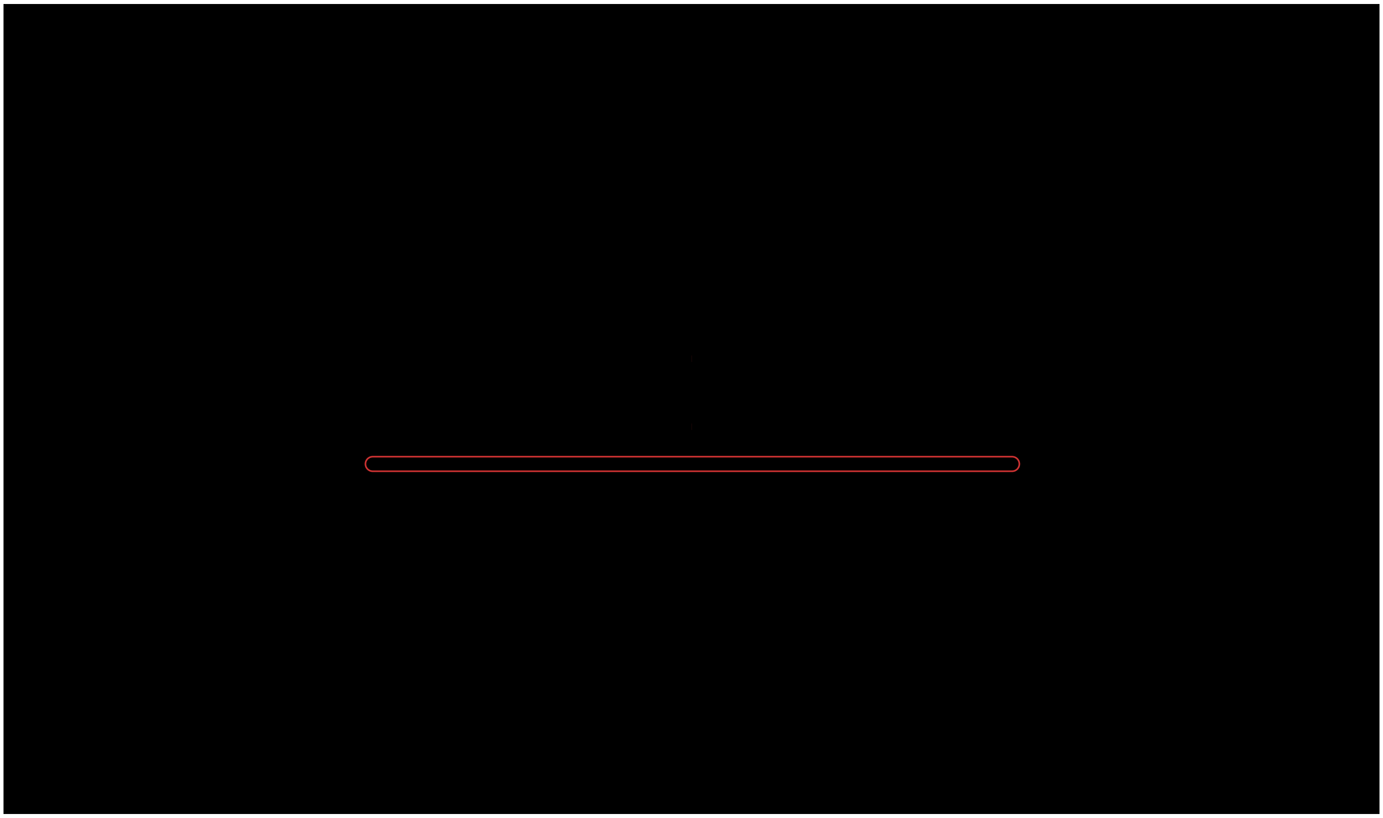
https://assessments.lumenlearning.co...essments/14370

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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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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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.

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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

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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

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1. Hayzlett, Jeffrey. "Why Should Your Business Care About Social Responsibility?" Entrepreneur. October 10, 2016. Accessed February 27, 2019. https://www.entrepreneur.com/article/269665. ↵
2. Barko, Tamas, Martijn Cremers, and Luc Renneboog. "Shareholder Engagement on Environmental, Social, and Governance Performance." Finance Working Paper N° 509/2017, 2017. Accessed June 10, 2019. https://ecgi.global/sites/default/files/working_papers/documents/5092017_1.pdf. ↵

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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: Putting It Together- Business Ethics and Corporate Social Responsibility

Synthesis

Throughout this module you learned about the legal and ethical challenges businesses face in today's complex environment. Decisions about doing the "right thing" are not necessarily represented by a single big decision; rather, they are often a series of many apparently small decisions that can culminate in an organization finding itself on the wrong side of its stakeholders, society, and the law. Even corporate executives who have been imprisoned for unethical conduct later admit that they *knew* that what they were doing was wrong, but somewhere along the line they lost sight of their own standards or honesty and integrity. Unfortunately, such behavior can have devastating consequences for the public, the environment, and the company—and it can cast a cloud on businesses that make good ethical, legal, and socially responsible choices every day. As the public demands a higher level of corporate social responsibility, companies are adjusting their strategies to respond to the external environment and conduct business in a way that promotes trust and loyalty from their customers. In addition, the government has stepped in and enacted legislation intended to set forth stronger guidelines, processes, and even punishments for unethical business practices. When you leave school and begin to look for your first job, a new job, or even take a closer look at your current employer, one of the questions you should now be prepared to ask is whether or not the ethics of the organization are aligned with your own sense of right and wrong.

Summary

Ethical and Legal Behavior

Standards of ethical and legal behavior are intertwined but are separate "codes" arising from different sources. Legality comes from legislation or case law that establishes standards of behaviors—illegal behavior may be punished by fines, imprisonment, or both. As a branch of philosophy, ethics investigates the questions "What is the best way for people to live?" and "What actions are right or wrong in particular circumstances?" In practice, ethics seeks to resolve questions of human morality, by defining concepts such as good and evil, right and wrong, virtue and vice, justice and crime.

Business Ethics

Businesses and organizations possess a set of ethical standards just like people. When we refer to "business ethics" we are referring to the culture, attitudes, or actions governing "right vs. wrong." Most organizations have a formal code of ethics that guide the decisions and actions of the company.

Ethical Challenges

Businesses and their employees, managers, and owners face a variety of ethical issues as they go about their working lives. Ethical issues include conflicts of interest, bribes, conflicts of loyalty, and issues of honesty and integrity.

Corporate Social Responsibility

Corporate social responsibility (CSR) refers to actions that businesses take or refrain from taking based on the impact of those actions on the external environment and community. Areas of CSR include environmental concerns (green business), poverty, human rights, and animal rights. Today, businesses are realizing the importance of CSR (Corporate Social Responsibility) in attracting and maintaining employees and customers. Stakeholders are demanding that businesses give back to the larger community in which they operate. Examples of stakeholder and social responsibility can be seen at companies such as Toms Shoes and Starbucks.

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CHAPTER OVERVIEW

16: Bonus Section 2 - Financial Markets and System

16.1: 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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16.2: 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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16.3: 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 16.3.1: 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 16.3.1: 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).

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16.4: 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:

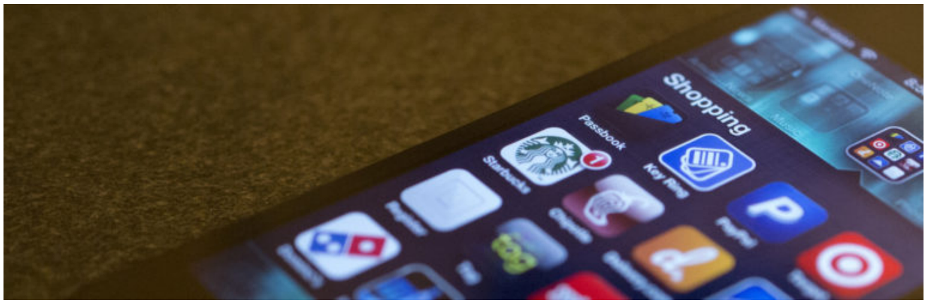
- Cryptocurrency is not backed by the faith and credit of a trusted individual or institution
- Cryptocurrency is not legal tender (has limited acceptance)
- There is no central authority with responsibility for the maintenance, security or reliability of the technology or ecosystem
- There is currently 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

16.5: 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.

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16.6: 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.

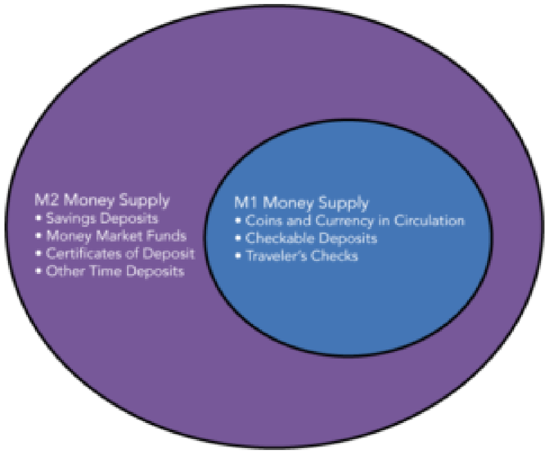

Figure 16.6.1: The Relationship between M1 and M2 Money.

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 16.6.1.[1]

Table 16.6.1. 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 16.6.2. 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

https://assessments.lumenlearning.co...essments/14321

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/↵

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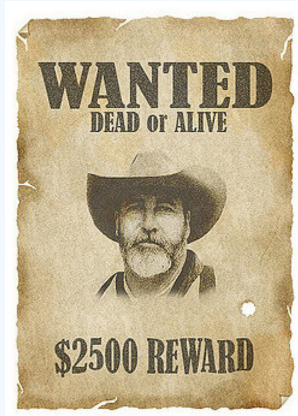
16.7: Banks As Financial Intermediaries

16.7: 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.

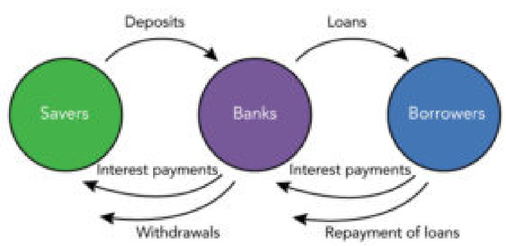


Figure 16.7.1: Banks As Financial Intermediaries.

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).

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16.8: The Federal Reserve System

Learning Objectives

- Explain the structure and key functions of the Federal Reserve

Figure 16.8.1: **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 16.8.2: **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.

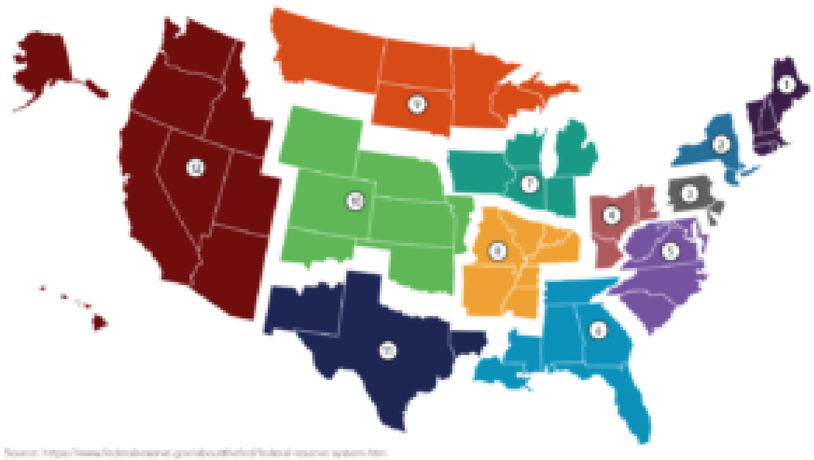

Figure 16.8.1: **The Twelve Federal Reserve Districts**. There are twelve regional Federal Reserve banks, each with its own district.

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

16.9: 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

https://assessments.lumenlearning.co...essments/14324

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16.10: 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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16.11: 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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16.12: 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 16.12.1: **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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16.13: 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

https://assessments.lumenlearning.co...essments/14325

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

https://assessments.lumenlearning.co...essments/14326

https://assessments.lumenlearning.co...essments/14327

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**
>
> https://assessments.lumenlearning.co...essments/14328

1. Lioudis, Nick. "Why to Companies Issue Debt and Bond?" Investopedia. June 25, 2019. https://www.investopedia.com/ask/answers/05/reasonforcorporatebonds.asp↵

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16.14: 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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Glossary

absolute advantage | Condition whereby a country is the only source of a product or is able to make more of a product using the same or fewer resources than other countries.

account payable | Record of cash owed to sellers from whom a business has purchased products on credit.

account payable | Record of cash owed to sellers from whom a business has purchased products on credit.

account receivable | Record of cash that will be received from a customer to whom a business has sold products on credit.

account receivable | Record of cash that will be received from a customer to whom a business has sold products on credit.

Accountants | Financial advisor responsible for measuring, summarizing, and communicating financial and managerial information.

Accountants | Financial advisor responsible for measuring, summarizing, and communicating financial and managerial information.

accounting | System for measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other decision makers.

accounting | System for measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other decision makers.

accounting equation | Accounting tool showing the resources of a business (assets) and the claims on those resources (liabilities and owner's equity).

accounting equation | Accounting tool showing the resources of a business (assets) and the claims on those resources (liabilities and owner's equity).

accrual accounting | Accounting system that records transactions when they occur, regardless of when cash is paid or received.

accrual accounting | Accounting system that records transactions when they occur, regardless of when cash is paid or received.

acquisition | The purchase of one company by another with no new company being formed.

acquisition | The purchase of one company by another with no new company being formed.

adjustable-rate mortgage (ARM) | Mortgage that's pegged to the increase or decrease of certain interest rates that your lender has to pay.

adjustable-rate mortgage (ARM) | Mortgage that's pegged to the increase or decrease of certain interest rates that your lender has to pay.

administrative law | Body of law dealing with statutes and regulations related to the activities of administrative agencies.

Advertising | Paid, nonpersonal communication designed to create an awareness of a product or company.

Advertising | Paid, nonpersonal communication designed to create an awareness of a product or company.

advertising agency | Marketing consulting firm that develops and executes promotional campaigns for clients.

advertising agency | Marketing consulting firm that develops and executes promotional campaigns for clients.

agency | Legal relationship in which one party acts on behalf of, and under the control of, another.

agency | Legal relationship in which one party acts on behalf of, and under the control of, another.

American Stock Exchange (AMEX) | Stock market where shares of smaller companies are traded.

American Stock Exchange (AMEX) | Stock market where shares of smaller companies are traded.

amortization | Schedule by which you'll reduce the balance of your debt.

amortization | Schedule by which you'll reduce the balance of your debt.

application | Document completed by a job applicant that provides factual information on the person's education and work background.

application | Document completed by a job applicant that provides factual information on the person's education and work background.

applications software | Software that performs a specific task, such as word processing or spreadsheet creation.

applications software | Software that performs a specific task, such as word processing or spreadsheet creation.

arbitration | Process of resolving a labor-contract dispute by having a third party study the situation and arrive at a *binding* agreement.

arbitration | Process of resolving a labor-contract dispute by having a third party study the situation and arrive at a *binding* agreement.

Artificial intelligence | Science of developing computer systems that can mimic human behavior.

Artificial intelligence | Science of developing computer systems that can mimic human behavior.

assets | Resource from which a business expects to gain some future benefit.

assets | Resource from which a business expects to gain some future benefit.

audits | Accountant's examination of and report on a company's financial statements.

audits | Accountant's examination of and report on a company's financial statements.

balance of payments | Difference between the total flow of money coming into a country and the total flow of money going out.

balance of payments | Difference between the total flow of money coming into a country and the total flow of money going out.

balance sheet | Report on a company's assets, liabilities, and owner's equity at a specific point in time.

balance sheet | Report on a company's assets, liabilities, and owner's equity at a specific point in time.

bear market | Period of declining or sluggish stock prices.

bear market | Period of declining or sluggish stock prices.

behavioral segmentation | Process of dividing consumers by behavioral variables, such as attitude toward the product, user status, or usage rate.

behavioral segmentation | Process of dividing consumers by behavioral variables, such as attitude toward the product, user status, or usage rate.

benchmarking | Practice of comparing a company's own performance with that of a company that excels in the same activity.

benchmarking | Practice of comparing a company's own performance with that of a company that excels in the same activity.

benefits | Compensation other than salaries, hourly wages, or financial incentives.

benefits | Compensation other than salaries, hourly wages, or financial incentives.

blocking roles | Behavior that inhibits either team performance or that of individual members.

blocking roles | Behavior that inhibits either team performance or that of individual members.

bonds | Debt securities that require annual interest payments to bondholders.

bonds | Debt securities that require annual interest payments to bondholders.

bonuses | Annual income given to employees (in addition to salary) based on company-wide performance.

bonuses | Annual income given to employees (in addition to salary) based on company-wide performance.

boycotting | Method used by union members to voice displeasure with certain organizations by refusing to buy the company's products and encouraging others to follow suit.

boycotting | Method used by union members to voice displeasure with certain organizations by refusing to buy the company's products and encouraging others to follow suit.

brand loyalty | Consumer preference for a particular brand that develops over time based on satisfaction with a company's products.

brand loyalty | Consumer preference for a particular brand that develops over time based on satisfaction with a company's products.

breakeven analysis | Method of determining the level of sales at which the company will break even (have no profit or loss).

breakeven analysis | Method of determining the level of sales at which the company will break even (have no profit or loss).

breakeven analysis | Method of determining the level of sales at which the company will break even (have no profit or loss).

breakeven analysis | Method of determining the level of sales at which the company will break even (have no profit or loss).

breakeven point in units | Number of sales units at which net income is zero.

breakeven point in units | Number of sales units at which net income is zero.

breakeven point in units | Number of sales units at which net income is zero.

breakeven point in units | Number of sales units at which net income is zero.

browsers | Software (such as Internet Explorer) that locates and displays Web pages.

browsers | Software (such as Internet Explorer) that locates and displays Web pages.

budget | A document that itemizes the sources of income and expenditures for a future period (often a year).

budget | A document that itemizes the sources of income and expenditures for a future period (often a year).

business cycle | Pattern of expansion and contraction in an economy.

business cycle | Pattern of expansion and contraction in an economy.

business ethics | Application of ethical behavior in a business context.

business ethics | Application of ethical behavior in a business context.

business plan | Formal document describing a proposed business concept, description of the proposed business, industry analysis, mission statement and core values, a management plan, a description of goods or services, a description of production processes, and marketing and financial plans.

business plan | Formal document describing a proposed business concept, description of the proposed business, industry analysis, mission statement and core values, a management plan, a description of goods or services, a description of production processes, and marketing and financial plans.

capacity | Maximum number of products that a facility can produce over a given period under normal working conditions.

capacity | Maximum number of products that a facility can produce over a given period under normal working conditions.

capital budget | Budget that shows anticipated expenditures for major equipment.

capital budget | Budget that shows anticipated expenditures for major equipment.

capital structure | Relationship between a company's debt (funds acquired from creditors) and its equity (funds invested by owners).

capital structure | Relationship between a company's debt (funds acquired from creditors) and its equity (funds invested by owners).

capitalism | Economic system featuring the lowest level of government control over allocation and distribution.

capitalism | Economic system featuring the lowest level of government control over allocation and distribution.

Cash-flow management | Process of monitoring cash inflows and outflows to ensure that the company has the right amount of funds on hand.

Cash-flow management | Process of monitoring cash inflows and outflows to ensure that the company has the right amount of funds on hand.

cash-flow or income statement | Shows where your money has come from and where it's slated to go.

cash-flow or income statement | Shows where your money has come from and where it's slated to go.

cellular layout | Layout in which teams of workers perform all the tasks involved in building a component, group of related components, or finished product.

cellular layout | Layout in which teams of workers perform all the tasks involved in building a component, group of related components, or finished product.

certificate authority | Third-party (such as VeriSign) that verifies the identify of a computer site.

certificate authority | Third-party (such as VeriSign) that verifies the identify of a computer site.

chain of command | Authority and reporting relationships among people working at different levels of an organization.

chain of command | Authority and reporting relationships among people working at different levels of an organization.

civil law | Body of law governing disputes between private parties.

civil law | Body of law governing disputes between private parties.

classified balance sheet | Balance sheet that totals assets and liabilities in separate categories.

classified balance sheet | Balance sheet that totals assets and liabilities in separate categories.

client-server systems | System connecting client machines (which are used by employees for data input and retrieval) and a server (that stores shared databases and programs).

client-server systems | System connecting client machines (which are used by employees for data input and retrieval) and a server (that stores shared databases and programs).

cloud computing | Cloud computing means performing computer tasks using services provided over the Internet.

cloud computing | Cloud computing means performing computer tasks using services provided over the Internet.

code of conduct | Statement that defines the principles and guidelines that employees must follow in the course of all job-related activities.

code of conduct | Statement that defines the principles and guidelines that employees must follow in the course of all job-related activities.

collective bargaining | Process by which management and union-represented workers settle differences.

collective bargaining | Process by which management and union-represented workers settle differences.

Commercial banks | Financial institution that generates profits by lending funds and providing customers with services, such as check processing.

Commercial banks | Financial institution that generates profits by lending funds and providing customers with services, such as check processing.

commission | Compensation paid to employees based on the dollar amount of sales that they make.

commission | Compensation paid to employees based on the dollar amount of sales that they make.

common stock | Stock whose owners bear the ultimate rewards and risks of ownership.

common stock | Stock whose owners bear the ultimate rewards and risks of ownership.

communication | Process of transferring information from a sender to a receiver.

communication | Process of transferring information from a sender to a receiver.

communism | Economic system featuring the highest level of government control over allocation and distribution.

communism | Economic system featuring the highest level of government control over allocation and distribution.

comparative advantage | Condition whereby one nation is able to produce a product at a lower opportunity cost compared to another nation.

comparative advantage | Condition whereby one nation is able to produce a product at a lower opportunity cost compared to another nation.

comparative income statement | Financial statement showing income for more than one year.

comparative income statement | Financial statement showing income for more than one year.

compensatory damages | Monetary awards intended to restore tort victims to the conditions that they would have been in had their injuries never taken place.

compensatory damages | Monetary awards intended to restore tort victims to the conditions that they would have been in had their injuries never taken place.

compound interest | Interest earned on your savings is added to the money in your savings account, and the new total (principle plus interest) earns more interest.

compound interest | Interest earned on your savings is added to the money in your savings account, and the new total (principle plus interest) earns more interest.

computer-aided design (CAD) | System using computer technology to create models representing the design of a product.

computer-aided design (CAD) | System using computer technology to create models representing the design of a product.

computer-aided manufacturing (CAM) | System using computer technology to control production processes and equipment.

computer-aided manufacturing (CAM) | System using computer technology to control production processes and equipment.

conceptual skills | Skills used to reason abstractly and analyze complex situations.

conceptual skills | Skills used to reason abstractly and analyze complex situations.

Conflicts of interest | Situation in which an individual must choose between the promotion of personal interests and the interests of others.

Conflicts of interest | Situation in which an individual must choose between the promotion of personal interests and the interests of others.

consumer behavior | Decision process that individuals go through when purchasing or using products.

consumer behavior | Decision process that individuals go through when purchasing or using products.

consumer confidence index | Measure of optimism that consumers express about the economy as they go about their everyday lives.

consumer confidence index | Measure of optimism that consumers express about the economy as they go about their everyday lives.

consumer market | Buyers who want a product for personal use.

consumer market | Buyers who want a product for personal use.

consumer price index (CPI) | Index that measures inflation by measuring the prices of goods purchased by a typical consumer.

consumer price index (CPI) | Index that measures inflation by measuring the prices of goods purchased by a typical consumer.

contingency planning | Process of identifying courses of action to be taken in the event that a business is adversely affected by a change.

contingency planning | Process of identifying courses of action to be taken in the event that a business is adversely affected by a change.

contingent workers | Temporary or part-time worker hired to supplement a company's permanent workforce.

contingent workers | Temporary or part-time worker hired to supplement a company's permanent workforce.

continuous improvement | Company's commitment to making constant improvements in the design, production, and delivery of its products.

continuous improvement | Company's commitment to making constant improvements in the design, production, and delivery of its products.

contract | Exchange of promises or exchange of a promise for an act.

contract | Exchange of promises or exchange of a promise for an act.

contribution margin per unit | Excess of revenue per unit over variable cost per unit.

contribution margin per unit | Excess of revenue per unit over variable cost per unit.

contribution margin per unit | Excess of revenue per unit over variable cost per unit.

contribution margin per unit | Excess of revenue per unit over variable cost per unit.

controlling | Management process of comparing actual to planned performance and taking corrective actions when necessary.

controlling | Management process of comparing actual to planned performance and taking corrective actions when necessary.

convertible preferred stock | Preferred stock that gives its owner the option of exchanging it for common stock.

convertible preferred stock | Preferred stock that gives its owner the option of exchanging it for common stock.

cooperative | A business owned and controlled by those who use its services.

cooperative | A business owned and controlled by those who use its services.

Core values | Statement of fundamental beliefs describing what's appropriate and important in conducting organizational activities and providing a guide for the behavior of organization members.

Core values | Statement of fundamental beliefs describing what's appropriate and important in conducting organizational activities and providing a guide for the behavior of organization members.

Corporate social responsibility | Approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions.

Corporate social responsibility | Approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions.

corporation | Legal entity that is entirely separate from the parties who own it and that is responsible for its own debts.

corporation | Legal entity that is entirely separate from the parties who own it and that is responsible for its own debts.

cost-based pricing | Pricing strategy that bases the selling price of a product on its cost plus a reasonable profit.

cost-based pricing | Pricing strategy that bases the selling price of a product on its cost plus a reasonable profit.

cover letter | A document accompanying your résumé that explains why you're sending your résumé and highlights your qualifications.

cover letter | A document accompanying your résumé that explains why you're sending your résumé and highlights your qualifications.

credit union | Financial institution that provides services to only its members (who are associated with a particular organization).

credit union | Financial institution that provides services to only its members (who are associated with a particular organization).

crimes | Violation of statute for which the law imposes punishment.

crimes | Violation of statute for which the law imposes punishment.

crisis management | Action plans that outline steps to be taken by a company in case of a crisis.

crisis management | Action plans that outline steps to be taken by a company in case of a crisis.

cross-functional teams | Team designed to take advantage of the special expertise of members drawn from different functional areas of the organization.

cross-functional teams | Team designed to take advantage of the special expertise of members drawn from different functional areas of the organization.

Cultural barriers | Barriers that result from differences among people of different cultures.

Cultural barriers | Barriers that result from differences among people of different cultures.

culture | System of shared beliefs, values, customs, and behaviors that govern the interactions of members of a society.

culture | System of shared beliefs, values, customs, and behaviors that govern the interactions of members of a society.

current ratio | Financial ratio showing the relationship between a company's current assets and current liabilities.

current ratio | Financial ratio showing the relationship between a company's current assets and current liabilities.

customer division | Organizational structure that groups employees into customer-based business segments.

customer division | Organizational structure that groups employees into customer-based business segments.

customer value triad | Three factors that customers consider in determining the value of a product: quality, service, and price.

customer value triad | Three factors that customers consider in determining the value of a product: quality, service, and price.

customer-relationship management | Strategy for retaining customers by gathering information about them, understanding them, and treating them well.

customer-relationship management | Strategy for retaining customers by gathering information about them, understanding them, and treating them well.

data communication networks | Large network used to transmit digital data from one computer to another using a variety of wired and wireless communication channels.

data communication networks | Large network used to transmit digital data from one computer to another using a variety of wired and wireless communication channels.

data mining | Technique used to search and analyze data to reveal patterns and trends that can be used to predict future behavior.

data mining | Technique used to search and analyze data to reveal patterns and trends that can be used to predict future behavior.

data warehouse | Centralized database that stores data from several databases so they can be easily analyzed.

data warehouse | Centralized database that stores data from several databases so they can be easily analyzed.

databases | Electronic collection of related data accessible to various users.

databases | Electronic collection of related data accessible to various users.

debit card | Pulls money out of your checking account whenever you use the card to buy something or get cash from an ATM.

debit card | Pulls money out of your checking account whenever you use the card to buy something or get cash from an ATM.

Debt financing | Process of raising capital for a company through the sale of bonds.

Debt financing | Process of raising capital for a company through the sale of bonds.

decentralization | Decision-making process in which most decision making is spread throughout the organization.

decentralization | Decision-making process in which most decision making is spread throughout the organization.

decision support system | Interactive system that extracts, integrates, and displays data from multiple sources to help managers make nonroutine decisions.

decision support system | Interactive system that extracts, integrates, and displays data from multiple sources to help managers make nonroutine decisions.

decision-making skills | Skills used in defining a problem, analyzing possible solutions, and selecting the best outcome.

decision-making skills | Skills used in defining a problem, analyzing possible solutions, and selecting the best outcome.

defendant | Party charged in a legal complaint; in criminal law, party against whom a criminal charge is brought; in civil law, party being sued for compensation for wrong allegedly done to plaintiff.

defendant | Party charged in a legal complaint; in criminal law, party against whom a criminal charge is brought; in civil law, party being sued for compensation for wrong allegedly done to plaintiff.

defined contribution retirement plan | A form of retirement savings plan in which both the employee and the employer may contribute.

defined contribution retirement plan | A form of retirement savings plan in which both the employee and the employer may contribute.

deflation | Decrease in overall price level.

deflation | Decrease in overall price level.

delegation | Process of entrusting work to subordinates.

delegation | Process of entrusting work to subordinates.

Demand | Quantity of a product that buyers are willing to purchase at various prices.

Demand | Quantity of a product that buyers are willing to purchase at various prices.

demand curve | Graph showing the quantity of a product that will be bought at certain prices.

demand curve | Graph showing the quantity of a product that will be bought at certain prices.

demand deposits | Checking accounts that pay given sums to "payees" when they demand them.

demand deposits | Checking accounts that pay given sums to "payees" when they demand them.

demand-based pricing | Pricing strategy that bases the price of a product on how much people are willing to pay for it.

demand-based pricing | Pricing strategy that bases the price of a product on how much people are willing to pay for it.

Demographic segmentation | Process of dividing the market into groups based on such variables as age and income.

Demographic segmentation | Process of dividing the market into groups based on such variables as age and income.

departmentalization | Process of grouping specialized jobs into meaningful units.

departmentalization | Process of grouping specialized jobs into meaningful units.

depreciation expense | Costs of a long-term or fixed asset spread over its useful life.

depreciation expense | Costs of a long-term or fixed asset spread over its useful life.

depression | Severe, long-lasting recession.

depression | Severe, long-lasting recession.

directing | Management process that provides focus and direction to others and motivates them to achieve organizational goals.

directing | Management process that provides focus and direction to others and motivates them to achieve organizational goals.

Disability insurance | Pays an income to an insured person when he or she is unable to work for an extended period.

Disability insurance | Pays an income to an insured person when he or she is unable to work for an extended period.

discount rate | Rate of interest the Fed charges member banks when they borrow reserve funds.

discount rate | Rate of interest the Fed charges member banks when they borrow reserve funds.

Distribution | All activities involved in getting the right quantity of a product to the right customer at the right time and at a reasonable cost.

Distribution | All activities involved in getting the right quantity of a product to the right customer at the right time and at a reasonable cost.

distribution center | Location where products are received from multiple suppliers, stored temporarily, and then shipped to their final destinations.

distribution center | Location where products are received from multiple suppliers, stored temporarily, and then shipped to their final destinations.

dividends | Earnings distributed to stockholders.

dividends | Earnings distributed to stockholders.

dividends | Earnings distributed to stockholders.

dividends | Earnings distributed to stockholders.

divisional organizations | Form of organization that groups people into several smaller, self-contained units, or divisions, which are accountable for their own performance.

divisional organizations | Form of organization that groups people into several smaller, self-contained units, or divisions, which are accountable for their own performance.

Dow Jones Industrial Average (DJIA) | Market index that reflects the total value of a "market basket" of thirty large U.S. companies.

Dow Jones Industrial Average (DJIA) | Market index that reflects the total value of a "market basket" of thirty large U.S. companies.

downsizing | Practice of eliminating jobs to cut costs.

downsizing | Practice of eliminating jobs to cut costs.

downward communication | Communication flow from higher to lower organizational levels.

downward communication | Communication flow from higher to lower organizational levels.

dumping | Practice of selling exported goods below the price that producers would normally charge home markets.

dumping | Practice of selling exported goods below the price that producers would normally charge home markets.

Duty of care | Basic obligation that one person owes another; duty not to cause harm or unreasonable risk of harm.

Duty of care | Basic obligation that one person owes another; duty not to cause harm or unreasonable risk of harm.

e-commerce | Business conducted over the Internet.

e-commerce | Business conducted over the Internet.

economic indicator | Statistic that provides information about trends in the economy.

economic indicator | Statistic that provides information about trends in the economy.

economic system | Means by which a society makes decisions about allocating resources to produce and distribute products.

economic system | Means by which a society makes decisions about allocating resources to produce and distribute products.

electronic data interchange | Computerized exchange of business transaction documents.

electronic data interchange | Computerized exchange of business transaction documents.

electronic data interchange (EDI) | Computerized exchange of business transaction documents.

electronic data interchange (EDI) | Computerized exchange of business transaction documents.

embargo | Extreme form of quota that bans the import or export of certain goods to a country for economic or political reasons.

embargo | Extreme form of quota that bans the import or export of certain goods to a country for economic or political reasons.

employment-at-will | Legal doctrine that allows an employer to fire an employee at will.

employment-at-will | Legal doctrine that allows an employer to fire an employee at will.

encryption | Process of encoding data so that only individuals or computers armed with a secret code (or key) can decode it.

encryption | Process of encoding data so that only individuals or computers armed with a secret code (or key) can decode it.

enterprise resource planning (ERP) system | Integrated computer system used to channel information to multiple users.

enterprise resource planning (ERP) system | Integrated computer system used to channel information to multiple users.

entrepreneur | Individual who identifies a business opportunity and assumes the risk of creating and running a business to take advantage of it.

entrepreneur | Individual who identifies a business opportunity and assumes the risk of creating and running a business to take advantage of it.

Equal Employment Opportunity Commission (EEOC) | Federal agency in charge of enforcing federal laws on employment discrimination.

Equal Employment Opportunity Commission (EEOC) | Federal agency in charge of enforcing federal laws on employment discrimination.

equilibrium price | Price at which buyers are willing to buy exactly the amount that sellers are willing to sell.

equilibrium price | Price at which buyers are willing to buy exactly the amount that sellers are willing to sell.

equity theory | Theory of motivation that focuses on our perceptions of how fairly we're treated relative to others.

equity theory | Theory of motivation that focuses on our perceptions of how fairly we're treated relative to others.

ethical dilemma | Morally problematic situation.

ethical dilemma | Morally problematic situation.

ethical lapse | Situation in which an individual makes a decision that's unmistakably unethical or illegal.

ethical lapse | Situation in which an individual makes a decision that's unmistakably unethical or illegal.

European Union (EU) | Association of European countries that joined together to eliminate trade barriers among themselves.

European Union (EU) | Association of European countries that joined together to eliminate trade barriers among themselves.

exchange rate | Value of one currency relative to another.

exchange rate | Value of one currency relative to another.

executive information system | System that provides senior managers with strategic information customized to meet their needs and presented in a convenient format.

executive information system | System that provides senior managers with strategic information customized to meet their needs and presented in a convenient format.

executive summary | Overview emphasizing the key points of a business plan to get the reader excited about the business's prospects.

executive summary | Overview emphasizing the key points of a business plan to get the reader excited about the business's prospects.

expectancy theory | Theory of motivation that proposes that employees will work hard to earn rewards they value and consider obtainable.

expectancy theory | Theory of motivation that proposes that employees will work hard to earn rewards they value and consider obtainable.

expenses | Costs incurred by selling products to customers.

expenses | Costs incurred by selling products to customers.

Expert systems | Program that mimics the judgment of experts.

Expert systems | Program that mimics the judgment of experts.

exporting | Practice of selling domestic products to foreign customers.

exporting | Practice of selling domestic products to foreign customers.

express warranty | Warranty created when a seller affirms that a product meets certain standards of quality, description, performance, or condition.

express warranty | Warranty created when a seller affirms that a product meets certain standards of quality, description, performance, or condition.

External communication | Channel through which communication occurs between parties inside a company and parties outside it.

External communication | Channel through which communication occurs between parties inside a company and parties outside it.

external marketing environment | Factors external to the firm that present threats and opportunities and that require shifts in marketing plans.

external marketing environment | Factors external to the firm that present threats and opportunities and that require shifts in marketing plans.

externalities | Cost that doesn't show up as part of the market price for a product.

externalities | Cost that doesn't show up as part of the market price for a product.

extranet | Intranet that's partially available to certain parties outside the organization.

extranet | Intranet that's partially available to certain parties outside the organization.

factors of production | Resources consisting of land, labor, capital (money, buildings, equipment), and entrepreneurial skills combined to produce goods and services.

factors of production | Resources consisting of land, labor, capital (money, buildings, equipment), and entrepreneurial skills combined to produce goods and services.

fair market value | The price you could get by selling assets at their present price.

fair market value | The price you could get by selling assets at their present price.

Federal Depository Insurance Corporation (FDIC) | Government agency that regulates banks and insures deposits in its member banks up to $250,000.

Federal Depository Insurance Corporation (FDIC) | Government agency that regulates banks and insures deposits in its member banks up to $250,000.

federal funds rate | The interest rate that a Federal Reserve member bank pays when it borrows from other member banks to meet reserve requirements.

federal funds rate | The interest rate that a Federal Reserve member bank pays when it borrows from other member banks to meet reserve requirements.

Federal Reserve System | U.S. central banking system, which has three goals: price stability, sustainable economic growth, and full employment.

Federal Reserve System | U.S. central banking system, which has three goals: price stability, sustainable economic growth, and full employment.

fiduciary responsibility | Duty of management to safeguard a company's assets and handle its funds in a trustworthy manner.

fiduciary responsibility | Duty of management to safeguard a company's assets and handle its funds in a trustworthy manner.

Finance | Activities involved in planning for, obtaining, and managing a company's funds.

Finance | Activities involved in planning for, obtaining, and managing a company's funds.

Finance companies | Nondeposit financial institution that makes loans from funds acquired by selling securities or borrowing from commercial banks.

Finance companies | Nondeposit financial institution that makes loans from funds acquired by selling securities or borrowing from commercial banks.

Financial condition ratios | Financial ratio that helps to assess a firm's financial strength.

Financial condition ratios | Financial ratio that helps to assess a firm's financial strength.

financial plan | Planning document that shows the amount of funds a company needs and details a strategy for getting those funds.

financial plan | Planning document that shows the amount of funds a company needs and details a strategy for getting those funds.

financial planning | The process of managing your personal finances to meet goals that you've set for yourself or your family.

financial planning | The process of managing your personal finances to meet goals that you've set for yourself or your family.

financing activities | Activity that creates cash inflows or outflows through the obtaining or repaying of borrowed or invested funds.

financing activities | Activity that creates cash inflows or outflows through the obtaining or repaying of borrowed or invested funds.

firewall | Software program that controls access to a company's intranet.

firewall | Software program that controls access to a company's intranet.

First-line managers | Those at the bottom of the management hierarchy who supervise employees and coordinate their activities.

First-line managers | Those at the bottom of the management hierarchy who supervise employees and coordinate their activities.

fiscal policy | Governmental use of taxation and spending to influence economic conditions.

fiscal policy | Governmental use of taxation and spending to influence economic conditions.

fiscal year | Company's designated business year.

fiscal year | Company's designated business year.

fixed costs | Costs that don't change when the amount of goods sold changes.

fixed costs | Costs that don't change when the amount of goods sold changes.

fixed costs | Costs that don't change when the amount of goods sold changes.

fixed costs | Costs that don't change when the amount of goods sold changes.

fixed-position layout | Layout in which workers are moved to the product, which stays in one place.

fixed-position layout | Layout in which workers are moved to the product, which stays in one place.

fixed-rate mortgage | A mortgage on which the interest rate remains the same regardless of changes in market interest rates.

fixed-rate mortgage | A mortgage on which the interest rate remains the same regardless of changes in market interest rates.

flexible manufacturing system | System in which computer-controlled equipment is programmed to handle materials used in manufacturing.

flexible manufacturing system | System in which computer-controlled equipment is programmed to handle materials used in manufacturing.

flexible manufacturing systems (FMS) | System in which computer-controlled equipment is programmed to handle materials used in manufacturing.

flexible manufacturing systems (FMS) | System in which computer-controlled equipment is programmed to handle materials used in manufacturing.

flexible spending account | Allows a specified amount of pretax dollars to be used to pay for qualified expenses, including health care and child care.

flexible spending account | Allows a specified amount of pretax dollars to be used to pay for qualified expenses, including health care and child care.

flextime | Alternative work arrangement that allows employees to designate starting and quitting times.

flextime | Alternative work arrangement that allows employees to designate starting and quitting times.

focus group | Group of individuals brought together for the purpose of asking them questions about a product or marketing strategy.

focus group | Group of individuals brought together for the purpose of asking them questions about a product or marketing strategy.

foreign subsidiary | Independent company owned by a foreign firm (called its parent).

foreign subsidiary | Independent company owned by a foreign firm (called its parent).

formal communication network | Network consisting of all communications that flow along an organization's official lines of authority.

formal communication network | Network consisting of all communications that flow along an organization's official lines of authority.

franchise | Form of business ownership in which a *franchiser* (a seller) grants a *franchisee* (a buyer) the right to use a brand name and to sell its products or services.

franchise | Form of business ownership in which a *franchiser* (a seller) grants a *franchisee* (a buyer) the right to use a brand name and to sell its products or services.

full employment | Condition under which about 95 percent of those who want to work are employed.

full employment | Condition under which about 95 percent of those who want to work are employed.

functional organization | Form of business organization that groups together people who have comparable skills and perform similar tasks.

functional organization | Form of business organization that groups together people who have comparable skills and perform similar tasks.

Gantt chart | Graphical tool for determining the status of projects.

Gantt chart | Graphical tool for determining the status of projects.

General Agreement on Tariffs and Trade (GATT) | International trade agreement that encourages free trade by regulating and reducing tariffs and provides a forum for resolving trade disputes.

General Agreement on Tariffs and Trade (GATT) | International trade agreement that encourages free trade by regulating and reducing tariffs and provides a forum for resolving trade disputes.

generally accepted accounting principles (GAAP) | Uniform set of rules for financial reporting issued by an independent agency called the Financial Accounting Standards Board (FASB).

generally accepted accounting principles (GAAP) | Uniform set of rules for financial reporting issued by an independent agency called the Financial Accounting Standards Board (FASB).

generic branding | Product with no branding information attached to it except a description of its contents.

generic branding | Product with no branding information attached to it except a description of its contents.

Geographic segmentation | Process of dividing a market according to such variables as climate, region, and population density.

Geographic segmentation | Process of dividing a market according to such variables as climate, region, and population density.

Geographical division | Organizational structure that groups people into divisions based on location.

Geographical division | Organizational structure that groups people into divisions based on location.

goods-producing sector | All businesses whose primary purpose is to produce tangible goods.

goods-producing sector | All businesses whose primary purpose is to produce tangible goods.

grievances | Union worker complaints on contract-related matters.

grievances | Union worker complaints on contract-related matters.

gross domestic product (GDP) | Measure of the market value of all goods and services produced by a nation's economy in a given year.

gross domestic product (GDP) | Measure of the market value of all goods and services produced by a nation's economy in a given year.

gross profit or gross margin | Positive difference between revenues and cost of goods sold.

gross profit or gross margin | Positive difference between revenues and cost of goods sold.

group cohesiveness | Principle that groups are most effective when members like being members.

group cohesiveness | Principle that groups are most effective when members like being members.

groupthink | Tendency to conform to group pressure in making decisions while failing to think critically or to consider outside influences.

groupthink | Tendency to conform to group pressure in making decisions while failing to think critically or to consider outside influences.

hierarchy-of-needs theory | Theory of motivation that holds that people are motivated by a hierarchical series of unmet needs.

hierarchy-of-needs theory | Theory of motivation that holds that people are motivated by a hierarchical series of unmet needs.

high-context cultures | Cultures in which personal and family connections have an effect on most interactions, including those in business.

high-context cultures | Cultures in which personal and family connections have an effect on most interactions, including those in business.

human resource management (HRM) | All actions that an organization takes to attract, develop, and retain quality employees.

human resource management (HRM) | All actions that an organization takes to attract, develop, and retain quality employees.

implied warranties | Warranty arising automatically out of a transaction.

implied warranties | Warranty arising automatically out of a transaction.

incentive programs | Program designed to financially reward employees for good performance.

incentive programs | Program designed to financially reward employees for good performance.

individual retirement account (IRA) | Personal retirement account set up by an individual to save money tax free until retirement.

individual retirement account (IRA) | Personal retirement account set up by an individual to save money tax free until retirement.

industrial market | Buyers who want a product for use in making other products.

industrial market | Buyers who want a product for use in making other products.

industrial robots | Computer-controlled machine used to perform repetitive tasks that are also hard or dangerous for human workers.

industrial robots | Computer-controlled machine used to perform repetitive tasks that are also hard or dangerous for human workers.

industry | Group of businesses that compete with one another to market products that are the same or similar.

industry | Group of businesses that compete with one another to market products that are the same or similar.

informal communication network (or grapevine) | Network that carries information whenever two or more employees get together and start talking about the company and their jobs.

informal communication network (or grapevine) | Network that carries information whenever two or more employees get together and start talking about the company and their jobs.

information | Data that have been processed or turned into some useful form.

information | Data that have been processed or turned into some useful form.

information managers | Manager with responsibility for determining the information needs of members of the organization and meeting those needs.

information managers | Manager with responsibility for determining the information needs of members of the organization and meeting those needs.

insider trading | Practice of buying or selling of securities using important information about the company before it's made public.

insider trading | Practice of buying or selling of securities using important information about the company before it's made public.

insider trading | Practice of buying or selling of securities using important information about the company before it's made public.

insider trading | Practice of buying or selling of securities using important information about the company before it's made public.

Insurance companies | Nondeposit institution that collects premiums from policyholders for protection against losses and invests these funds.

Insurance companies | Nondeposit institution that collects premiums from policyholders for protection against losses and invests these funds.

intentional tort | Intentional act that poses harm to another person or another person's property.

intentional tort | Intentional act that poses harm to another person or another person's property.

Interest | Cost charged to use someone else's money.

Interest | Cost charged to use someone else's money.

interest coverage ratio | Financial ratio showing a company's ability to pay interest on its debts from its operating income.

interest coverage ratio | Financial ratio showing a company's ability to pay interest on its debts from its operating income.

intermediary | Wholesaler or retailer who helps move products from their original source to the end user.

intermediary | Wholesaler or retailer who helps move products from their original source to the end user.

International Financial Reporting Standards (IFRS) | A set of worldwide accounting rules and guidelines used by companies to prepare financial statements that can be compared with those of other countries.

International Financial Reporting Standards (IFRS) | A set of worldwide accounting rules and guidelines used by companies to prepare financial statements that can be compared with those of other countries.

international franchise | Agreement in which a domestic company (franchiser) gives a foreign company (franchisee) the right to use its brand and sell its products.

international franchise | Agreement in which a domestic company (franchiser) gives a foreign company (franchisee) the right to use its brand and sell its products.

international licensing agreement | Agreement that allows a foreign company to sell a domestic company's products or use its intellectual property in exchange for royalty fees.

international licensing agreement | Agreement that allows a foreign company to sell a domestic company's products or use its intellectual property in exchange for royalty fees.

International Monetary Fund (IMF) | International organization set up to lend money to countries with troubled economies.

International Monetary Fund (IMF) | International organization set up to lend money to countries with troubled economies.

Internet service providers | Company, such as America Online, that links into the Internet infrastructure to connect paying subscribers.

Internet service providers | Company, such as America Online, that links into the Internet infrastructure to connect paying subscribers.

interpersonal skills | Skills used to get along with and motivate other people.

interpersonal skills | Skills used to get along with and motivate other people.

interruption marketing | Marketing that interrups people to get their attention (with the hope they will listen to the ad), such as TV advertising.

interruption marketing | Marketing that interrups people to get their attention (with the hope they will listen to the ad), such as TV advertising.

interview | Formal meeting during which the employer learns more about an applicant and the applicant learns more about the prospective employer.

interview | Formal meeting during which the employer learns more about an applicant and the applicant learns more about the prospective employer.

inventory | Goods that a business has made or bought and expects to sell in the process of normal operations.

inventory | Goods that a business has made or bought and expects to sell in the process of normal operations.

inventory control | Management of inventory to ensure that a company has enough inventory to keep operations flowing smoothly but not so much that money is being wasted in holding it.

inventory control | Management of inventory to ensure that a company has enough inventory to keep operations flowing smoothly but not so much that money is being wasted in holding it.

inventory turnover ratio | Financial ratio that shows how efficiently a company turns over its inventory.

inventory turnover ratio | Financial ratio that shows how efficiently a company turns over its inventory.

investing activities | Activity that creates cash inflows or outflows through the selling or buying of long-term assets.

investing activities | Activity that creates cash inflows or outflows through the selling or buying of long-term assets.

investment banking firm | Financial institution that specializes in issuing securities.

investment banking firm | Financial institution that specializes in issuing securities.

ISO 14000 | Set of international standards for environmental management established by the International Organization for Standardization.

ISO 14000 | Set of international standards for environmental management established by the International Organization for Standardization.

job analysis | Identification of the tasks, responsibilities, and skills of a job, as well as the knowledge and abilities needed to perform it.

job analysis | Identification of the tasks, responsibilities, and skills of a job, as well as the knowledge and abilities needed to perform it.

job description | Outline of the duties and responsibilities of a position.

job description | Outline of the duties and responsibilities of a position.

job enlargement | Job redesign strategy in which management enhances a job by adding tasks at similar skill levels.

job enlargement | Job redesign strategy in which management enhances a job by adding tasks at similar skill levels.

Job enrichment | Job redesign strategy in which management enriches a job by adding tasks that increase both responsibility and opportunity for growth.

Job enrichment | Job redesign strategy in which management enriches a job by adding tasks that increase both responsibility and opportunity for growth.

job redesign | Management strategy used to increase job satisfaction by making jobs more interesting and challenging.

job redesign | Management strategy used to increase job satisfaction by making jobs more interesting and challenging.

job rotation | Job redesign strategy that allows employees to rotate from one job to another on a systematic basis.

job rotation | Job redesign strategy that allows employees to rotate from one job to another on a systematic basis.

job sharing | Work arrangement in which two people share one full-time position.

job sharing | Work arrangement in which two people share one full-time position.

job specification | Detailed list of the qualifications needed to perform a job, including required skills, knowledge, and abilities.

job specification | Detailed list of the qualifications needed to perform a job, including required skills, knowledge, and abilities.

joint ventures | Alliances in which the partners fund a separate entity (partnership or corporation) to manage their joint operations.

joint ventures | Alliances in which the partners fund a separate entity (partnership or corporation) to manage their joint operations.

just-in-time (JIT) production | System for reducing inventories and costs by requiring suppliers to deliver materials *just in time* to go into the production process.

just-in-time (JIT) production | System for reducing inventories and costs by requiring suppliers to deliver materials *just in time* to go into the production process.

just-in-time production | System for reducing inventories and costs by requiring suppliers to deliver materials *just in time* to go into the production process.

just-in-time production | System for reducing inventories and costs by requiring suppliers to deliver materials *just in time* to go into the production process.

Labeling | Information on the package of a product that identifies the product and provides details of the package contents.

Labeling | Information on the package of a product that identifies the product and provides details of the package contents.

labor union | Organized group of workers that bargains with employers to improve its members' pay, job security, and working conditions.

labor union | Organized group of workers that bargains with employers to improve its members' pay, job security, and working conditions.

laissez-faire leadership style | Management style used by those who follow a "hands-off" approach and provide relatively little direction to subordinates.

laissez-faire leadership style | Management style used by those who follow a "hands-off" approach and provide relatively little direction to subordinates.

Lateral (or horizontal) communication | Communication flow across the organization, among personnel on the same level.

Lateral (or horizontal) communication | Communication flow across the organization, among personnel on the same level.

law | Body of enforceable rules and principles of conduct.

law | Body of enforceable rules and principles of conduct.

layout | Arrangement in a facility of equipment, machinery, and people to make a production process as efficient as possible.

layout | Arrangement in a facility of equipment, machinery, and people to make a production process as efficient as possible.

leadership style | Particular approach used by a manager to interact with and influence others.

leadership style | Particular approach used by a manager to interact with and influence others.

leading economic indicators | Statistical data that predict the status of the economy three to twelve months in the future.

leading economic indicators | Statistical data that predict the status of the economy three to twelve months in the future.

legal monopoly | Monopoly in which one seller supplies a product or technology to which it holds a patent.

legal monopoly | Monopoly in which one seller supplies a product or technology to which it holds a patent.

legal system | Institutions and processes that enforce laws.

legal system | Institutions and processes that enforce laws.

liabilities | Debt owed by a business to an outside individual or organization.

liabilities | Debt owed by a business to an outside individual or organization.

limited liability | Legal condition under which an owner or investor can't lose more than the amount invested.

limited liability | Legal condition under which an owner or investor can't lose more than the amount invested.

limited partnership | Partnership made up of a single general partner (who runs the business and is responsible for its liabilities) and any number of limited partners.

limited partnership | Partnership made up of a single general partner (who runs the business and is responsible for its liabilities) and any number of limited partners.

limited-liability company | Corporation whose members are not personally liable for company debts and whose earnings are taxed only once, when they are paid out as dividends. It has fewer rules and restrictions than does an S-corporation.

limited-liability company | Corporation whose members are not personally liable for company debts and whose earnings are taxed only once, when they are paid out as dividends. It has fewer rules and restrictions than does an S-corporation.

lines of credit | Commitment by a bank that allows a company to borrow up to a specified amount of money as the need arises.

lines of credit | Commitment by a bank that allows a company to borrow up to a specified amount of money as the need arises.

liquidity | Speed with which an asset can be converted into cash.

liquidity | Speed with which an asset can be converted into cash.

local area network (LAN) | Network that links computers that are in close proximity.

local area network (LAN) | Network that links computers that are in close proximity.

Long-term liabilities | Liability that a business need not pay off within the following year.

Long-term liabilities | Liability that a business need not pay off within the following year.

low-context cultures | Cultures in which personal and work relationships are compartmentalized.

low-context cultures | Cultures in which personal and work relationships are compartmentalized.

M-1 | Measure of the money supply that includes only the most liquid forms of money, such as cash and checking-account funds.

M-1 | Measure of the money supply that includes only the most liquid forms of money, such as cash and checking-account funds.

M-2 | Measure of the money supply that includes everything in M-1 plus near-cash.

M-2 | Measure of the money supply that includes everything in M-1 plus near-cash.

make-to-order strategy | Production method in which products are made to customer specification.

make-to-order strategy | Production method in which products are made to customer specification.

management | Process of planning for, organizing, directing, and controlling a company's resources so that it can achieve its goals.

management | Process of planning for, organizing, directing, and controlling a company's resources so that it can achieve its goals.

Management | Process of planning for, organizing, directing, and controlling a company's resources so that it can achieve its goals.

Management | Process of planning for, organizing, directing, and controlling a company's resources so that it can achieve its goals.

Management accounting | Branch of accounting that provides information and analysis to decision makers inside the organization to help them operate the business.

Management accounting | Branch of accounting that provides information and analysis to decision makers inside the organization to help them operate the business.

management information system | System used to extract data from a database and compile reports that help managers make routine decisions.

management information system | System used to extract data from a database and compile reports that help managers make routine decisions.

manager | Individual in an organization who is responsible for making a group of people more effective and efficient.

manager | Individual in an organization who is responsible for making a group of people more effective and efficient.

manager-led team | Team on which a manager defines goals and methods and is solely responsible for interactions with higher-level management.

manager-led team | Team on which a manager defines goals and methods and is solely responsible for interactions with higher-level management.

manufacturer branding | Branding strategy in which a manufacturer sells one or more products under its own brand names.

manufacturer branding | Branding strategy in which a manufacturer sells one or more products under its own brand names.

manufacturing resource planning (MRP II) | System for coordinating a firm's material requirements planning activities with the activities of its other functional areas.

manufacturing resource planning (MRP II) | System for coordinating a firm's material requirements planning activities with the activities of its other functional areas.

market indexes | Measure for tracking stock prices.

market indexes | Measure for tracking stock prices.

market segments | Group of potential customers with common characteristics that influence their buying decisions.

market segments | Group of potential customers with common characteristics that influence their buying decisions.

market share | Company's portion of the market that it has targeted.

market share | Company's portion of the market that it has targeted.

Marketing | Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

Marketing | Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

Marketing | Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

Marketing | Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

marketing concept | Basic philosophy of satisfying customer needs while meeting organizational goals.

marketing concept | Basic philosophy of satisfying customer needs while meeting organizational goals.

marketing mix | Combination of product, price, place, and promotion (often called the four Ps) used to market products.

marketing mix | Combination of product, price, place, and promotion (often called the four Ps) used to market products.

marketing research | Process of collecting and analyzing data that's relevant to a specific marketing situation.

marketing research | Process of collecting and analyzing data that's relevant to a specific marketing situation.

marketing strategy | Plan for selecting a target market and creating, pricing, promoting, and distributing products that satisfy customers.

marketing strategy | Plan for selecting a target market and creating, pricing, promoting, and distributing products that satisfy customers.

mass customization | Production method in which fairly high volumes of customized products are made at fairly low prices.

mass customization | Production method in which fairly high volumes of customized products are made at fairly low prices.

mass production (or make-to-stock strategy) | Production method in which high volumes of products are made at low cost and held in inventory in anticipation of future demand.

mass production (or make-to-stock strategy) | Production method in which high volumes of products are made at low cost and held in inventory in anticipation of future demand.

master production schedule (MPS) | Timetable that specifies which and how many products will be produced and when.

master production schedule (MPS) | Timetable that specifies which and how many products will be produced and when.

material requirements planning (MRP) | Technique of using a computerized program to calculate the quantity of materials needed for production and to reschedule inventory ordering.

material requirements planning (MRP) | Technique of using a computerized program to calculate the quantity of materials needed for production and to reschedule inventory ordering.

materials handling | Process of physically moving or carrying goods during production, warehousing, and distribution.

materials handling | Process of physically moving or carrying goods during production, warehousing, and distribution.

materials management | All decisions pertaining to the purchase of inputs, the inventory of components and finished products, and the scheduling of production processes.

materials management | All decisions pertaining to the purchase of inputs, the inventory of components and finished products, and the scheduling of production processes.

matrix structure | Structure in which employees from various functional areas form teams to combine their skills in working on a specific project.

matrix structure | Structure in which employees from various functional areas form teams to combine their skills in working on a specific project.

middle managers | Those in the middle of the management hierarchy who report to top management and oversee the activities of first-line managers.

middle managers | Those in the middle of the management hierarchy who report to top management and oversee the activities of first-line managers.

misdemeanor | Crime that's not "inherently evil" but that's nevertheless prohibited by society.

misdemeanor | Crime that's not "inherently evil" but that's nevertheless prohibited by society.

mission statement | Statement describing an organization's purpose or *mission*—its reason for existence—and telling stakeholders what the organization is committed to doing.

mission statement | Statement describing an organization's purpose or *mission*—its reason for existence—and telling stakeholders what the organization is committed to doing.

Money | Anything commonly accepted as a medium of exchange, measure of value, and store of value.

Money | Anything commonly accepted as a medium of exchange, measure of value, and store of value.

money market funds | Fund invested in safe, highly liquid securities.

money market funds | Fund invested in safe, highly liquid securities.

money market mutual funds | Accounts that pay interest to investors who pool funds to make short-term loans to businesses and the government.

money market mutual funds | Accounts that pay interest to investors who pool funds to make short-term loans to businesses and the government.

money multiplier | The amount by which an initial bank deposit will expand the money supply.

money multiplier | The amount by which an initial bank deposit will expand the money supply.

monopolistic competition | Market in which many sellers supply differentiated products.

monopolistic competition | Market in which many sellers supply differentiated products.

monopoly | Market in which there is only one seller supplying products at regulated prices.

monopoly | Market in which there is only one seller supplying products at regulated prices.

Motivation | Internally generated drive to achieve a goal or follow a particular course of action.

Motivation | Internally generated drive to achieve a goal or follow a particular course of action.

multinational corporation (MNC) | Large corporation that operates in many countries.

multinational corporation (MNC) | Large corporation that operates in many countries.

NASDAQ | Best-known over-the-counter, electronic exchange system.

NASDAQ | Best-known over-the-counter, electronic exchange system.

national debt | Total amount of money owed by the federal government.

national debt | Total amount of money owed by the federal government.

Natural monopolies | Monopoly in which, because of the industry's importance to society, one seller is permitted to supply products without competition.

Natural monopolies | Monopoly in which, because of the industry's importance to society, one seller is permitted to supply products without competition.

negligence tort | Tort resulting from carelessness.

negligence tort | Tort resulting from carelessness.

net income | Positive difference between gross profit and total expenses.

net income | Positive difference between gross profit and total expenses.

net worth | The difference between an individual's assets and liabilities.

net worth | The difference between an individual's assets and liabilities.

net worth statement | A personal balance sheet that lists the value of the things you own, the amounts owed to others, and the difference, called "net worth."

net worth statement | A personal balance sheet that lists the value of the things you own, the amounts owed to others, and the difference, called "net worth."

niche | Narrowly defined group of potential customers with a fairly specific set of needs.

niche | Narrowly defined group of potential customers with a fairly specific set of needs.

nonverbal communication | "Nonword" messages communicated through facial expressions, posture, gestures, and tone of voice.

nonverbal communication | "Nonword" messages communicated through facial expressions, posture, gestures, and tone of voice.

North American Free Trade Association (NAFTA) | Agreement among the governments of the United States, Canada, and Mexico to open their borders to unrestricted trade.

North American Free Trade Association (NAFTA) | Agreement among the governments of the United States, Canada, and Mexico to open their borders to unrestricted trade.

not-for-profit (or nonprofit) organizations | Organization that has a purpose other than returning profits to owners.

not-for-profit (or nonprofit) organizations | Organization that has a purpose other than returning profits to owners.

not-for-profit corporation | An organization formed to serve some public purpose rather than for financial gain.

not-for-profit corporation | An organization formed to serve some public purpose rather than for financial gain.

Objectives | Intermediate-term performance targets that direct the activities of an organization toward the attainment of a goal.

Objectives | Intermediate-term performance targets that direct the activities of an organization toward the attainment of a goal.

Occupational Health and Safety Administration (OSHA) | Federal administrative agency empowered to set workplace safety and health standards and to ensure that employers take appropriate steps to meet them.

Occupational Health and Safety Administration (OSHA) | Federal administrative agency empowered to set workplace safety and health standards and to ensure that employers take appropriate steps to meet them.

odd-even pricing | Practice of pricing products a few cents (or dollars) under an even number.

odd-even pricing | Practice of pricing products a few cents (or dollars) under an even number.

offshoring | Setting up facilities in a foreign country that replace U.S. manufacturing facilities to produce goods that will be sent back to the United States for sale.

offshoring | Setting up facilities in a foreign country that replace U.S. manufacturing facilities to produce goods that will be sent back to the United States for sale.

Oligopoly | Market in which a few sellers supply a large portion of all the products sold in the marketplace.

Oligopoly | Market in which a few sellers supply a large portion of all the products sold in the marketplace.

on-the-job training | Employee training (often informal) that occurs while the employee is on the job.

on-the-job training | Employee training (often informal) that occurs while the employee is on the job.

open market operations | The sale and purchase of U.S. government bonds by the Fed in the open market.

open market operations | The sale and purchase of U.S. government bonds by the Fed in the open market.

operating activities | Activity that creates cash inflows or outflows through day-to-day operations.

operating activities | Activity that creates cash inflows or outflows through day-to-day operations.

Operating expenses | Costs of selling products to customers, not including cost of goods sold.

Operating expenses | Costs of selling products to customers, not including cost of goods sold.

operational plans | Detailed action steps to be taken by individuals or groups to implement tactical plans.

operational plans | Detailed action steps to be taken by individuals or groups to implement tactical plans.

operations management (OM) | Management of the process that transforms resources into products.

operations management (OM) | Management of the process that transforms resources into products.

operations manager | Person who designs and oversees the process that converts resources into goods or services.

operations manager | Person who designs and oversees the process that converts resources into goods or services.

Operations support systems | Information system used by lower-level managers to assist them in running day-to-day operations and making routine decisions.

Operations support systems | Information system used by lower-level managers to assist them in running day-to-day operations and making routine decisions.

organization chart | Diagram representing the interrelationships of positions within an organization.

organization chart | Diagram representing the interrelationships of positions within an organization.

organizing | Management process of allocating resources to achieve a company's plans.

organizing | Management process of allocating resources to achieve a company's plans.

orientation | Activities involved in introducing new employees to the organization and their jobs.

orientation | Activities involved in introducing new employees to the organization and their jobs.

outsourcing | Practice of using outside vendors to manufacture all or part of a company's actual products.

outsourcing | Practice of using outside vendors to manufacture all or part of a company's actual products.

outsourcing | Practice of using outside vendors to manufacture all or part of a company's actual products.

outsourcing | Practice of using outside vendors to manufacture all or part of a company's actual products.

owner's equity | Amount which is invested in a business by its owners and which owners can claim from its assets.

owner's equity | Amount which is invested in a business by its owners and which owners can claim from its assets.

partnership (or general partnership) | Business owned jointly by two or more people.

partnership (or general partnership) | Business owned jointly by two or more people.

patent | Grant of the exclusive right to produce or sell a product, process, or invention.

patent | Grant of the exclusive right to produce or sell a product, process, or invention.

penetration pricing | Pricing strategy in which the seller charges a low price on a new product to discourage competition and gain market share.

penetration pricing | Pricing strategy in which the seller charges a low price on a new product to discourage competition and gain market share.

pension funds | Fund set up to collect contributions from participating companies for the purpose of providing its members with retirement income.

pension funds | Fund set up to collect contributions from participating companies for the purpose of providing its members with retirement income.

Perfect competition | Market in which many consumers buy standardized products from numerous small businesses.

Perfect competition | Market in which many consumers buy standardized products from numerous small businesses.

performance appraisals | Formal process in which a manager evaluates an employee's work performance.

performance appraisals | Formal process in which a manager evaluates an employee's work performance.

personal finance | The application of financial principles to the monetary decisions of an individual or a family.

personal finance | The application of financial principles to the monetary decisions of an individual or a family.

Personal selling | One-on-one communication with customers or potential customers.

Personal selling | One-on-one communication with customers or potential customers.

PERT charts | Tool for diagramming the activities required to produce a product, specifying the time required to perform each activity in the process, and organizing activities in the most efficient sequence.

PERT charts | Tool for diagramming the activities required to produce a product, specifying the time required to perform each activity in the process, and organizing activities in the most efficient sequence.

physical distribution | Activities needed to get a product from where it was manufactured to the customer.

physical distribution | Activities needed to get a product from where it was manufactured to the customer.

picketing | Union tactic of parading with signs outside a factory or other facility to publicize a strike.

picketing | Union tactic of parading with signs outside a factory or other facility to publicize a strike.

planning | Process of setting goals and determining the best way to achieve them.

planning | Process of setting goals and determining the best way to achieve them.

platform as a service (PaaS) | Those offering the platform as a service category of cloud computing provide services that enable users to develop customized web applications.

platform as a service (PaaS) | Those offering the platform as a service category of cloud computing provide services that enable users to develop customized web applications.

precedent | Rule of case law that must be used by lower courts in deciding future cases.

precedent | Rule of case law that must be used by lower courts in deciding future cases.

Preferred stock | Stock that pays owners a fixed dividend annually.

Preferred stock | Stock that pays owners a fixed dividend annually.

premises liability | The duty of innkeepers to take reasonable care in preventing customers and third parties from being injured on their property.

prestige-pricing | Practice of setting a price artificially high to foster the impression that it is a product of high quality.

prestige-pricing | Practice of setting a price artificially high to foster the impression that it is a product of high quality.

primary data | Newly collected marketing information that addresses specific questions about the target market.

primary data | Newly collected marketing information that addresses specific questions about the target market.

primary market | Market that deals in the sale of newly issued securities.

primary market | Market that deals in the sale of newly issued securities.

prime rate | Rate that banks charge their best customers.

prime rate | Rate that banks charge their best customers.

private accountants | Accountant who works for a private organization or government agency.

private accountants | Accountant who works for a private organization or government agency.

private branding | Product made by a manufacturer and sold to a retailer who in turn resells it under its own name.

private branding | Product made by a manufacturer and sold to a retailer who in turn resells it under its own name.

privatization | Process of converting government-owned businesses to private ownership.

privatization | Process of converting government-owned businesses to private ownership.

Process control | Application of technology to monitor and control physical processes.

Process control | Application of technology to monitor and control physical processes.

process division | Organizational structure that groups people into operating units based on various stages in the production process.

process division | Organizational structure that groups people into operating units based on various stages in the production process.

process layout | Layout that groups together workers or departments that perform similar tasks.

process layout | Layout that groups together workers or departments that perform similar tasks.

product | Something that can be marketed to customers because it provides a benefit and satisfies a need.

product | Something that can be marketed to customers because it provides a benefit and satisfies a need.

product concept | Description of what a new product will look like and how it will work.

product concept | Description of what a new product will look like and how it will work.

product development process | Series of activities by which a product idea is transformed into a final product.

product development process | Series of activities by which a product idea is transformed into a final product.

Product division | Organizational structure made up of divisions based on product lines.

Product division | Organizational structure made up of divisions based on product lines.

product layout | Layout in which products are produced by people, equipment, or departments arranged in an assembly line.

product layout | Layout in which products are produced by people, equipment, or departments arranged in an assembly line.

product liability | Claim of injury suffered because of a defective product.

product liability | Claim of injury suffered because of a defective product.

product life cycle | Four stages that a product goes through over its life: introduction, growth, maturity, and decline.

product life cycle | Four stages that a product goes through over its life: introduction, growth, maturity, and decline.

profit | Difference between the revenue that a company brings in from selling goods and services and the costs of generating this revenue.

profit | Difference between the revenue that a company brings in from selling goods and services and the costs of generating this revenue.

profit margin | Amount that a company earns on each unit sold.

profit margin | Amount that a company earns on each unit sold.

profit-sharing plan | Incentive program that uses a predetermined formula to distribute a share of company profits to eligible employees.

profit-sharing plan | Incentive program that uses a predetermined formula to distribute a share of company profits to eligible employees.

project team | Individuals from different functional areas assigned to work together throughout the product development process.

project team | Individuals from different functional areas assigned to work together throughout the product development process.

promotion mix | Various ways to communicate with customers, including advertising, personal selling, sales promotion, and publicity.

promotion mix | Various ways to communicate with customers, including advertising, personal selling, sales promotion, and publicity.

prospectus | Written offer to sell securities that provides useful information to prospective buyers.

prospectus | Written offer to sell securities that provides useful information to prospective buyers.

protectionism | Use of trade controls to reduce foreign competition in order to protect domestic industries.

protectionism | Use of trade controls to reduce foreign competition in order to protect domestic industries.

prototype | Physical model of a new product.

prototype | Physical model of a new product.

Psychographic segmentation | Process of classifying consumers on the basis of individual lifestyles as reflected in people's interests, activities, attitudes, and values.

Psychographic segmentation | Process of classifying consumers on the basis of individual lifestyles as reflected in people's interests, activities, attitudes, and values.

public corporations | Corporation whose stock is available to the general public.

public corporations | Corporation whose stock is available to the general public.

public law | Body of law dealing with the relationship of government to private individuals and other private entities.

public law | Body of law dealing with the relationship of government to private individuals and other private entities.

public relations | Communication activities undertaken by companies to garner favorable publicity for themselves and their products.

public relations | Communication activities undertaken by companies to garner favorable publicity for themselves and their products.

publicity | Form of promotion that focuses on getting a company or product mentioned in a newspaper, on TV, or in some other news media.

publicity | Form of promotion that focuses on getting a company or product mentioned in a newspaper, on TV, or in some other news media.

punitive damages | Monetary awards to tort victims intended to deter similar injurious conduct in the future.

punitive damages | Monetary awards to tort victims intended to deter similar injurious conduct in the future.

purchasing | Process of acquiring materials and services to be used in production.

purchasing | Process of acquiring materials and services to be used in production.

quality | Ability of a product to satisfy customer needs.

quality | Ability of a product to satisfy customer needs.

quality circles | Employees who perform similar jobs and work as teams to identify quality, efficiency, and other work-related problems; to propose solutions; and to work with management in implementing their recommendations.

quality circles | Employees who perform similar jobs and work as teams to identify quality, efficiency, and other work-related problems; to propose solutions; and to work with management in implementing their recommendations.

quota | Government-imposed restrictions on the quantity of a good that can be imported over a period of time.

quota | Government-imposed restrictions on the quantity of a good that can be imported over a period of time.

ramp-up stage | Stage in the product development process during which employees are trained in necessary production processes and new products are tested.

ramp-up stage | Stage in the product development process during which employees are trained in necessary production processes and new products are tested.

ratio analysis | Technique for financial analysis that shows the relationship between two numbers.

ratio analysis | Technique for financial analysis that shows the relationship between two numbers.

recession | Economic slowdown measured by a decline in gross domestic productivity.

recession | Economic slowdown measured by a decline in gross domestic productivity.

Recruiting | Process of identifying suitable candidates and encouraging them to apply for openings in the organization.

Recruiting | Process of identifying suitable candidates and encouraging them to apply for openings in the organization.

relationship-building role | Member role that helps a team maintain or improve group cohesiveness.

relationship-building role | Member role that helps a team maintain or improve group cohesiveness.

reporting relationships | Patterns of formal communication among members of an organization.

reporting relationships | Patterns of formal communication among members of an organization.

Resources | Inputs used to produce outputs.

Resources | Inputs used to produce outputs.

restructuring | Process of altering an existing organizational structure to become more competitive under changing conditions.

restructuring | Process of altering an existing organizational structure to become more competitive under changing conditions.

Retailers | Intermediaries who buy goods from producers and sell them to consumers.

Retailers | Intermediaries who buy goods from producers and sell them to consumers.

rule of law | Principle by which government legitimately exercises its authority only in accordance with publicly declared laws that are adopted and enforced according to established procedure.

rule of law | Principle by which government legitimately exercises its authority only in accordance with publicly declared laws that are adopted and enforced according to established procedure.

salary | Compensation paid for fulfilling the responsibilities of a position regardless of the number of hours required to do it.

salary | Compensation paid for fulfilling the responsibilities of a position regardless of the number of hours required to do it.

sales promotion | Sales approach in which a company provides an incentive for potential customers to buy something.

sales promotion | Sales approach in which a company provides an incentive for potential customers to buy something.

Sarbanes-Oxley Act (SOX) | A federal law enacted to encourage ethical corporate behavior and discourage fraud and other wrongdoing.

Sarbanes-Oxley Act (SOX) | A federal law enacted to encourage ethical corporate behavior and discourage fraud and other wrongdoing.

Savings banks | Financial institution originally set up to provide mortgages and encourage saving, which now offers services similar to those of commercial banks.

Savings banks | Financial institution originally set up to provide mortgages and encourage saving, which now offers services similar to those of commercial banks.

search engine | Software program that scans Web pages for specified kewords and provides a list of documents containing them.

search engine | Software program that scans Web pages for specified kewords and provides a list of documents containing them.

secondary data | Information used in marketing decisions that has already been collected for other purposes.

secondary data | Information used in marketing decisions that has already been collected for other purposes.

Securities and Exchange Commission (SEC) | Government agency that enforces securities laws.

Securities and Exchange Commission (SEC) | Government agency that enforces securities laws.

selection | Process of gathering information on candidates, evaluating their qualifications, and choosing the right one.

selection | Process of gathering information on candidates, evaluating their qualifications, and choosing the right one.

Self-managing teams | Team on which employees control the activities needed to meet overall goals.

Self-managing teams | Team on which employees control the activities needed to meet overall goals.

Service Corps of Retired Executives (SCORE) | SBA program in which a businessperson needing advice is matched with a member of a team of retired executives working as volunteers.

Service Corps of Retired Executives (SCORE) | SBA program in which a businessperson needing advice is matched with a member of a team of retired executives working as volunteers.

service-producing sector | All businesses whose primary purpose is to provide a service rather than make tangible goods.

service-producing sector | All businesses whose primary purpose is to provide a service rather than make tangible goods.

skimming pricing | Pricing strategy in which a seller generates early profits by starting off charging the highest price that customers will pay.

skimming pricing | Pricing strategy in which a seller generates early profits by starting off charging the highest price that customers will pay.

small business | According to the SBA, a business that is independently operated, exerts little influence in its industry, and employs fewer than five hundred people.

small business | According to the SBA, a business that is independently operated, exerts little influence in its industry, and employs fewer than five hundred people.

Small Business Administration (SBA) | Government agency that helps prospective owners set up small businesses, obtain financing, and manage ongoing operations.

Small Business Administration (SBA) | Government agency that helps prospective owners set up small businesses, obtain financing, and manage ongoing operations.

Small Business Development Center (SBDC) | SBA program in which centers housed at colleges and other locations provide free training and technical information to current and prospective small business owners.

Small Business Development Center (SBDC) | SBA program in which centers housed at colleges and other locations provide free training and technical information to current and prospective small business owners.

social media marketing | The practice of including social media as part of a company's marketing program.

social media marketing | The practice of including social media as part of a company's marketing program.

socialism | Economic system falling between communism and capitalism in terms of government control over allocation and distribution.

socialism | Economic system falling between communism and capitalism in terms of government control over allocation and distribution.

sole proprietorship | Business owned by only one person.

sole proprietorship | Business owned by only one person.

span of control | Number of people reporting to a particular manager.

span of control | Number of people reporting to a particular manager.

specialization | Process of organizing activities into clusters of related tasks that can be handled by specific individuals or groups.

specialization | Process of organizing activities into clusters of related tasks that can be handled by specific individuals or groups.

stakeholders | Parties who are interested in the activities of a business because they're affected by them.

stakeholders | Parties who are interested in the activities of a business because they're affected by them.

Standard & Poor's Composite Index (S&P 500) | Market index of the stocks of five hundred large U.S. companies.

Standard & Poor's Composite Index (S&P 500) | Market index of the stocks of five hundred large U.S. companies.

statement of cash flows | Financial statement reporting on cash inflows and outflows resulting from operating, investing, and financing activities.

statement of cash flows | Financial statement reporting on cash inflows and outflows resulting from operating, investing, and financing activities.

statement of owner's equity | A financial statement that details changes in owner's equity for a specified period of time.

statement of owner's equity | A financial statement that details changes in owner's equity for a specified period of time.

statistical process control | Technique for monitoring production quality by testing sample outputs to ensure that they meet specifications.

statistical process control | Technique for monitoring production quality by testing sample outputs to ensure that they meet specifications.

stock-option plans | Incentive program that allows eligible employees to buy a specific number of shares of company stock at a set price on a specified date.

stock-option plans | Incentive program that allows eligible employees to buy a specific number of shares of company stock at a set price on a specified date.

stockholders' equity | Amount invested in a corporation by its shareholders.

stockholders' equity | Amount invested in a corporation by its shareholders.

strategic alliance | Agreement between two companies (or a company and a nation) to pool resources in order to achieve business goals that benefit both partners.

strategic alliance | Agreement between two companies (or a company and a nation) to pool resources in order to achieve business goals that benefit both partners.

strategic human resource planning | Process of developing a plan for satisfying an organization's human resource needs.

strategic human resource planning | Process of developing a plan for satisfying an organization's human resource needs.

strategic planning | Process of establishing an overall plan or course of action for an organization.

strategic planning | Process of establishing an overall plan or course of action for an organization.

strict liability torts | Tort resulting from actions that are inherently dangerous and for which a party may be liable no matter how carefully he or she performs them.

strict liability torts | Tort resulting from actions that are inherently dangerous and for which a party may be liable no matter how carefully he or she performs them.

strike | Union tactic by which workers walk away from their jobs and refuse to return until a labor-management dispute has been resolved.

strike | Union tactic by which workers walk away from their jobs and refuse to return until a labor-management dispute has been resolved.

strikebreakers | Nonunion workers who are willing to cross picket lines to replace strikers.

strikebreakers | Nonunion workers who are willing to cross picket lines to replace strikers.

subprime mortgage loan | Mortgage loans made to borrowers who don't qualify for market-set interest rates because of one or more risk factors.

subprime mortgage loan | Mortgage loans made to borrowers who don't qualify for market-set interest rates because of one or more risk factors.

subsidies | Government payments given to certain industries to help offset some of their costs of production.

subsidies | Government payments given to certain industries to help offset some of their costs of production.

Supply | Quantity of a product that sellers are willing to sell at various prices.

Supply | Quantity of a product that sellers are willing to sell at various prices.

supply chain management (SCM) | Process of integrating all the activities in the supply chain.

supply chain management (SCM) | Process of integrating all the activities in the supply chain.

supply curve | Graph showing the quantity of a product that will be offered for sale at certain prices.

supply curve | Graph showing the quantity of a product that will be offered for sale at certain prices.

sustainability | The principle of providing products today that don't compromise the ability of future generations to meet their needs.

sustainability | The principle of providing products today that don't compromise the ability of future generations to meet their needs.

SWOT analysis | Approach used to assess a company's fit with its environment by analyzing its strengths, weaknesses, opportunities, and threats.

SWOT analysis | Approach used to assess a company's fit with its environment by analyzing its strengths, weaknesses, opportunities, and threats.

tactical plans | Short-term plans that specify the activities and resources needed to implement a company's strategic plan.

tactical plans | Short-term plans that specify the activities and resources needed to implement a company's strategic plan.

target costing | Pricing strategy that determines how much to invest in a product by figuring out how much customers will pay and subtracting an amount for profit.

target costing | Pricing strategy that determines how much to invest in a product by figuring out how much customers will pay and subtracting an amount for profit.

target market | Specific group of customers who should be interested in your product, have access to it, and have the means to buy it.

target market | Specific group of customers who should be interested in your product, have access to it, and have the means to buy it.

Tariffs | Government taxes on imports that raise the price of foreign goods and make them less competitive with domestic goods.

Tariffs | Government taxes on imports that raise the price of foreign goods and make them less competitive with domestic goods.

Task-facilitating roles | Member role that helps a team accomplish its goals.

Task-facilitating roles | Member role that helps a team accomplish its goals.

team | Group of people with complementary skills who work together to achieve a specific goal.

team | Group of people with complementary skills who work together to achieve a specific goal.

technical skills | Skills needed to perform specific tasks.

technical skills | Skills needed to perform specific tasks.

Telecommuting | Work arrangement in which the employee regularly works from home.

Telecommuting | Work arrangement in which the employee regularly works from home.

time value of money | The principle whereby a dollar received in the present is worth more than a dollar received in the future.

time value of money | The principle whereby a dollar received in the present is worth more than a dollar received in the future.

time-management skills | Skills used to manage time effectively.

time-management skills | Skills used to manage time effectively.

Top managers | Those at the top of the management hierarchy who are responsible for the health and performance of the organization.

Top managers | Those at the top of the management hierarchy who are responsible for the health and performance of the organization.

tort | Civil wrong; injury done to someone's person or property.

tort | Civil wrong; injury done to someone's person or property.

tort reform | A movement to stem the swelling tide of personal-injury litigation in the United States.

Total quality management (TQM) | All the steps taken by a company to ensure that its products satisfy customer needs.

Total quality management (TQM) | All the steps taken by a company to ensure that its products satisfy customer needs.

trade credit | Credit given to a company by its suppliers.

trade credit | Credit given to a company by its suppliers.

trade deficit | Condition whereby a country buys more products than it sells, resulting in an unfavorable trade balance.

trade deficit | Condition whereby a country buys more products than it sells, resulting in an unfavorable trade balance.

trademark | Word, symbol, or other mark used to identify and legally protect a product from being copied.

trademark | Word, symbol, or other mark used to identify and legally protect a product from being copied.

trading blocs | Groups of countries that have joined together to allow goods and services to flow without restrictions across their mutual borders.

trading blocs | Groups of countries that have joined together to allow goods and services to flow without restrictions across their mutual borders.

transactions | Financial and nonfinancial events that affect a business.

transactions | Financial and nonfinancial events that affect a business.

transformational leaders | Managers who mentor and develop subordinates and stimulate them to look beyond personal interests to those of the group.

transformational leaders | Managers who mentor and develop subordinates and stimulate them to look beyond personal interests to those of the group.

turnover | Permanent separation of an employee from a company.

turnover | Permanent separation of an employee from a company.

two-factor theory | Theory that holds that motivation involves both motivation factors (which contribute to job satisfaction) and hygiene factors (which help to prevent job dissatisfaction).

two-factor theory | Theory that holds that motivation involves both motivation factors (which contribute to job satisfaction) and hygiene factors (which help to prevent job dissatisfaction).

unemployment rate | Percentage of the total labor force that's currently unemployed and actively seeking work.

unemployment rate | Percentage of the total labor force that's currently unemployed and actively seeking work.

Uniform Commercial Code (UCC) | U.S. system of statutes designed to make commercial transactions consistent in all fifty states.

Uniform Commercial Code (UCC) | U.S. system of statutes designed to make commercial transactions consistent in all fifty states.

unlimited liability | Legal condition under which an owner or investor is personally liable for all debts of a business.

unlimited liability | Legal condition under which an owner or investor is personally liable for all debts of a business.

unsecured loan | Loan given by a bank that doesn't require the borrower to put up collateral.

unsecured loan | Loan given by a bank that doesn't require the borrower to put up collateral.

value chain | Entire range of activities involved in delivering value to customers.

value chain | Entire range of activities involved in delivering value to customers.

variable costs | Costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis.

variable costs | Costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis.

variable costs | Costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis.

variable costs | Costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis.

variance | Difference between the actual amount and the budgeted amount.

variance | Difference between the actual amount and the budgeted amount.

Venture capitalists | Individual who pools funds from private and institutional sources and invests them in businesses with strong growth potential.

Venture capitalists | Individual who pools funds from private and institutional sources and invests them in businesses with strong growth potential.

vertical percentage analysis | Analysis of an income statement treating the relationship of each item as a percentage of a base (usually sales).

vertical percentage analysis | Analysis of an income statement treating the relationship of each item as a percentage of a base (usually sales).

virtual company | Company without a significant physical presence that relies on third parties to produce, warehouse, price, and deliver the products it sells over the Internet.

virtual company | Company without a significant physical presence that relies on third parties to produce, warehouse, price, and deliver the products it sells over the Internet.

virtual teams | Teams whose geographically dispersed members interact electronically in the process of pursuing a common goal.

virtual teams | Teams whose geographically dispersed members interact electronically in the process of pursuing a common goal.

whistle-blower | Individual who exposes illegal or unethical behavior in an organization.

whistle-blower | Individual who exposes illegal or unethical behavior in an organization.

wholesalers | Intermediaries who buy goods from suppliers and sell them to businesses that will either resell or use them.

wholesalers | Intermediaries who buy goods from suppliers and sell them to businesses that will either resell or use them.

wide area network (WAN) | Network that links computers that are spread over a relatively large geographical area.

wide area network (WAN) | Network that links computers that are spread over a relatively large geographical area.

Work-study | Federally sponsored program that provides students with paid, part-time jobs on campus.

Work-study | Federally sponsored program that provides students with paid, part-time jobs on campus.

World Bank | International financial institution that provides economic assistance to poor and developing countries.

World Bank | International financial institution that provides economic assistance to poor and developing countries.

World Trade Organization (WTO) | International organization that monitors trade policies and whose members work together to enforce rules of trade and resolve trade disputes.

World Trade Organization (WTO) | International organization that monitors trade policies and whose members work together to enforce rules of trade and resolve trade disputes.

World Wide Web | Subsystem of computers on the Internet that communicate with each other using a special language called HTTP.

World Wide Web | Subsystem of computers on the Internet that communicate with each other using a special language called HTTP.

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