FUNDAMENTALS OF BUSINESS

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Fundamentals of Business (NWTC)

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25: Preface

Purpose of the book

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What's new

This version of the book, the Second Edition, improves upon the 2016 edition. Improvements include:

- Correction of errata identified in the 2016 compilation and many minor improvements.
- Renumbering of chapters and added front matter.
- Addition of new content: the PESTEL model in Chapter 2, Qualtrax case study in Chapter 7, and substantive revision of Chapter 16 Hospitality and Tourism.
- Addition of desktop and mobile friendly navigation features and interactive self-quizzing (Pressbooks version only).
- Addition of links to related external videos.
- Addition of accessibility features: Figures now include alternative text (AltText) which enables access by users of screen reader software.
- Broader format availability: PDF, epub, mobi, html, xhtml, Pressbooks XML, and OpenDocument (ODF) which is editable with MSWord.
- Addition of a feedback form for reporting errata: http://bit.ly/business-feedback
- Addition of a faculty listserv and a sharing portal: https://groups.google.com/a/vt.edu/forum/#!forum/fundamentalsofbusiness-g and https://www.oercommons.org/groups/fundamentals-of-business-user-group/1379

Features of the book

Each chapter lists learning objectives at the beginning of the chapter and key takeaways at the end of the chapter.

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Preface

About This Book

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Each chapter lists learning objectives at the beginning of the chapter and key takeaways at the end of the chapter. The Pressbooks https://doi.org/10.21061/fundamentals-of-business version of this book also includes interactive self-quizzing.

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1: The Foundations of Business

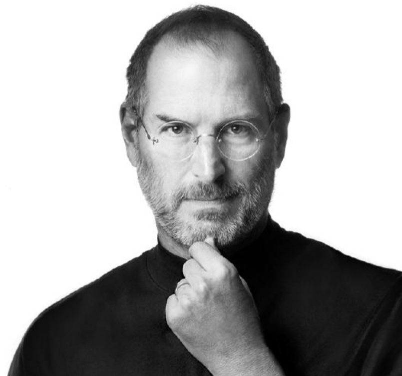
Learning Objectives

1. Describe the concept of stakeholders and identify the stakeholder groups relevant to an organization
2. Discuss and be able to apply the PESTEL macro-business-environment model to an industry or emerging technology
3. Explain other key terms related to this chapter including: entrepreneur; profit; revenue.

Why Is Apple Successful?

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

Figure 1.



1: Steve Jobs

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

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

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

Introduction

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

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

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

Getting Down to Business

A business is any activity that provides goods or services to consumers for the purpose of making a profit. Be careful not to confuse the terms *revenue* and *profit*. **Revenue** represents the funds an enterprise receives in exchange for its goods or services. **Profit** is what's left (hopefully) after all the bills are paid. When Steve Jobs and Steve Wozniak launched the Apple I, they created Apple Computer in Jobs' family garage in the hope of making a profit. Before we go on, let's make a couple of important distinctions concerning the terms in our definitions. First, whereas Apple produces and sells *goods* (Mac, iPhone, iPod, iPad, Apple Watch), many businesses provide *services*. Your bank is a service company, as is your Internet provider. Hotels, airlines, law firms, movie theaters, and hospitals are also service companies. Many companies provide both goods and services. For example, your local car dealership sells goods (cars) and also provides services (automobile repairs). Second, some organizations are not set up to make profits. Many are established to provide social or educational services. Such not-for profit (or nonprofit), organizations include the United Way of America, Habitat for Humanity, the Boys and Girls Clubs, the Sierra Club, the American Red Cross, and many colleges and universities. Most of these organizations, however, function in much the same way as a business. They establish goals and work to meet them in an effective, efficient manner. Thus, most of the business principles introduced in this text also apply to nonprofits.

Business Participants and Activities

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

Participants

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

Stakeholders

Consider your favorite restaurant. It may be an outlet or franchise of a national chain (more on franchises in a later chapter) or a local "mom and pop" without affiliation to a larger entity. Whether national or local, every business has **stakeholders** – those with a legitimate interest in the success or failure of the business and the policies it adopts. Stakeholders include customers, vendors, employees, landlords, bankers, and others (Figure 1.1). All have a keen interest in how the business operates, in most cases for obvious reasons. If the business fails, employees will need new jobs, vendors will need new customers, and banks may have to write off loans they made to the business. Stakeholders do not always see things the same way – their interests sometimes conflict with each other. For example, lenders are more likely to appreciate high profit margins that ensure the loans they made will be repaid, while customers would probably appreciate the lowest possible prices. Pleasing stakeholders can be a real balancing act for any company.

Figure 1.1: Business Stakeholders

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

Management

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

Operations

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

Marketing

Marketing consists of everything that a company does to identify customers' needs (i.e. market research) and design products to meet those needs. Marketers develop the benefits and features of products, including price and quality. They also decide on the best method of delivering products and the best means of promoting them to attract and keep customers. They manage relationships with customers and make them aware of the organization's desire and ability to satisfy their needs.

Accounting

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

Finance

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

External Forces that Influence Business Activities

Apple and other businesses don't operate in a vacuum; they're influenced by a number of external factors. These include the economy, government, consumer trends, technological developments, public pressure to act as good corporate citizens, and other factors. Collectively, these forces constitute what is known as the "**macro environment**" – essentially the big picture world external to a company over which the business exerts very little if any control. Figure 2.3 "Business and Its Environment" sums up the relationship between a business and the outside forces that influence its activities. One industry that's clearly affected by all these factors is the fast-food industry. Companies such as Taco Bell, McDonald's, Cook-Out and others all compete in this industry. A strong **economy** means people have more money to eat out. Food standards are monitored by a **government** agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by **consumer trends** (fast food companies are being pressured to make their menus healthier). Finally, a number of decisions made by the industry result from its desire to be a good corporate citizen. For example, several fast-food chains have responded to **environmental** concerns by eliminating Styrofoam containers.[9]

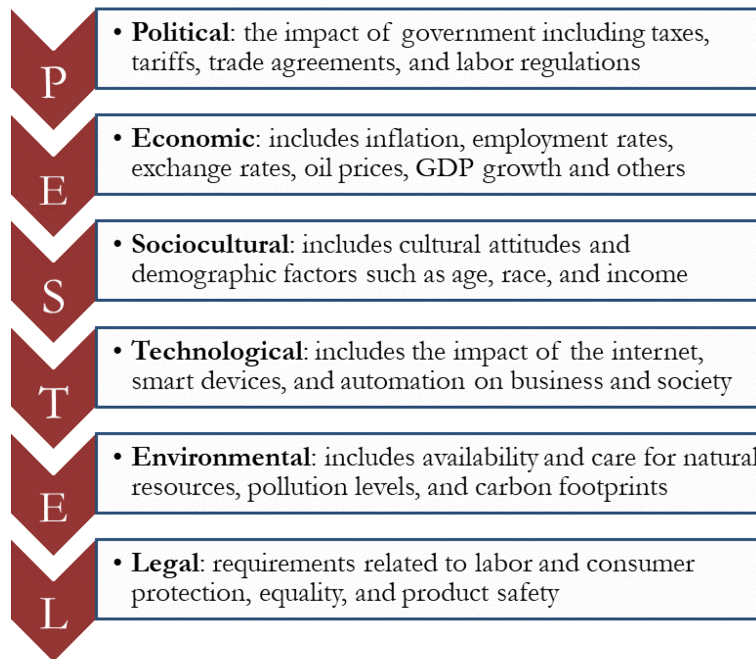


Figure 1.3: Business and its Environment – PESTEL

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

PESTEL Analysis

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

P stands for the political environment. Governments influence the environment in which businesses operate in many ways, including taxation, tariffs, trade agreements, labor regulations, and environmental regulations.

E represents the economic environment. As we will see in detail in a later chapter, whether the economy is growing or not is a major concern to business. Numerous economic indicators have been created for the specific purpose of measuring the health of the economy.

S indicates the sociocultural environment, which is a category that captures societal attitudes, trends in national demographics, and even fashion trends. The term *demographics* applies to any attribute that can be used to describe people, such as age, income level, gender, race, and so on. As a society's attitudes or its demographics change, the market for goods and services can shift right along with it.

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

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

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

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

Video 1.1: This video covers the six macro environmental forces that make up the PESTEL model. Alyssa Duong. "The PESTEL Model" (VTech Works). February 16th, 2019. Retrieved from: https://vtechworks.lib.vt.edu/handle/10919/88014

Key Takeaways

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

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2: Ethics and Social Responsibility

Learning Objectives

1. Define business ethics and explain what it means to act ethically in business.
2. Explain why we study business ethics.
3. Identify ethical issues that you might face in business, such as insider trading, conflicts of interest, and bribery, and explain rationalizations for unethical behavior.
4. Identify steps you can take to maintain your honesty and integrity in a business environment.
5. Define corporate social responsibility and explain how organizations are responsible to their stakeholders, including owners, employees, customers, and the community.
6. Discuss how you can identify an ethical organization, and how organizations can prevent behavior like sexual harassment.
7. Learn how to avoid an ethical lapse, and why you should not rationalize when making decisions.

Introduction

"Mommy, Why Do You Have to Go to Jail?"

The one question Betty Vinson would have preferred to avoid is "Mommy, why do you have to go to jail?"[1] Vinson graduated with an accounting degree from Mississippi State and married her college sweetheart. After a series of jobs at small banks, she landed a mid-level accounting job at WorldCom, at the time still a small long-distance provider. Sparked by the telecom boom, however, WorldCom soon became a darling of Wall Street, and its stock price soared. Now working for a wildly successful company, Vinson rounded out her life by reading legal thrillers and watching her daughter play soccer.

Her moment of truth came in mid-2000, when company executives learned that profits had plummeted. They asked Vinson to make some accounting adjustments to boost income by $828 million. Vinson knew that the scheme was unethical (at the very least) but she gave in and made the adjustments. Almost immediately, she felt guilty and told her boss that she was quitting. When news of her decision came to the attention of CEO Bernard Ebbers and CFO Scott Sullivan, they hastened to assure Vinson that she'd never be asked to cook any more books. Sullivan explained it this way: "We have planes in the air. Let's get the planes landed. Once they've landed, if you still want to leave, then leave. But not while the planes are in the air."[2] Besides, she'd done nothing illegal, and if anyone asked, he'd take full responsibility. So Vinson decided to stay. After all, Sullivan was one of the top CFOs in the country; at age thirty-seven, he was already making $19 million a year.[3] Who was she to question his judgment?[4]

Six months later, Ebbers and Sullivan needed another adjustment—this time for $771 million. This scheme was even more unethical than the first: it entailed forging dates to hide the adjustment. Pretty soon, Vinson was making adjustments on a quarterly basis—first for $560 million, then for $743 million, and yet again for $941 million. Eventually, Vinson had juggled almost $4 billion, and before long, the stress started to get to her: she had trouble sleeping, lost weight, and withdrew from people at work. She decided to hang on when she got a promotion and a $30,000 raise.

By spring 2002, however, it was obvious that adjusting the books was business as usual at WorldCom. Vinson finally decided that it was time to move on, but, unfortunately, an internal auditor had already put two and two together and blown the whistle. The Securities and Exchange Commission charged WorldCom with fraud amounting to $11 billion—the largest in U.S. history. Seeing herself as a valuable witness, Vinson was eager to tell what she knew. The government, however, regarded her as more than a mere witness. When she was named a co-conspirator, she agreed to cooperate fully and pleaded guilty to criminal conspiracy and securities fraud. But she won't be the only one doing time: Scott Sullivan will be in jail for five years, and Bernie Ebbers will be locked up for twenty-five years. Both maintain that they are innocent.[5]

So where did Betty Vinson, mild-mannered midlevel executive and mother, go wrong? How did she manage to get involved in a scheme that not only bilked investors out of billions but also cost seventeen thousand people their jobs?[6] Ultimately, of course, we can only guess. Maybe she couldn't say no to her bosses; perhaps she believed that they'd take full responsibility for her accounting "adjustments." Possibly she was afraid of losing her job or didn't fully understand the ramifications of what she was doing. What we do know is that she disgraced herself and went to jail.[7]

The WorldCom situation is not an isolated incident. Perhaps you have heard of Bernie Madoff, founder of Bernard L. Madoff Investment Securities and former chairman of the NASDAQ stock exchange.[8] Madoff is alleged to have run a giant Ponzi scheme[9] that cheated investors of up to $65 billion. His wrongdoings won him a spot at the top of Time Magazine's Top 10 Crooked CEOs. According to the SEC charges, Madoff convinced investors to give him large sums of money. In return, he gave them an impressive

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

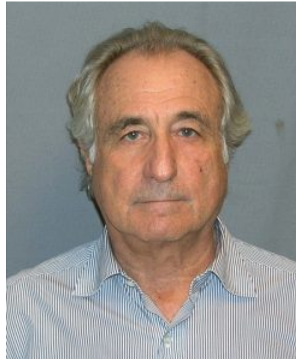

Figure 2.1: Bernie Madoff's mug shot

What is Business Ethics?

The Idea of Business Ethics

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

Let's begin this section by addressing this question: What can individuals, organizations, and government agencies do to foster an environment of ethical behavior in business? First, of course, we need to define the term.

What Is Ethics?

You probably already know what it means to be **ethical**: to know right from wrong and to know when you're practicing one instead of the other. We can say that **business ethics** is the application of ethical behavior in a business context. Acting ethically in business means more than simply obeying applicable laws and regulations: It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your company, its owners, and its workers. If you're in business you obviously need a strong sense of what's right and wrong. You need the personal conviction to do what's right, even if it means doing something that's difficult or personally disadvantageous.

Why Study Ethics?

Ideally, prison terms, heavy fines, and civil suits would discourage corporate misconduct, but, unfortunately, many experts suspect that this assumption is a bit optimistic. Whatever the condition of the ethical environment in the near future, one thing seems clear: the next generation entering business—which includes most of you—will find a world much different than the one that waited for the previous generation. Recent history tells us in no uncertain terms that today's business students, many of whom are tomorrow's business leaders, need a much sharper understanding of the difference between what is and isn't ethically acceptable. As a business student, one of your key tasks is learning how to recognize and deal with the ethical challenges that will confront you. Asked what he looked for in a new hire, Warren Buffet, the world's most successful investor, replied: "I look for three things. The first is personal integrity, the second is intelligence, and the third is a high energy level." He paused and then added: "But if you don't have the first, the second two don't matter."[10]

Identifying Ethical Issues and Dilemmas

Ethical issues are the difficult social questions that involve some level of controversy over what is the right thing to do. Environmental protection is an example of a commonly discussed ethical issue, because there can be tradeoffs between environmental and economic factors.

Ethical dilemmas are situations in which it is difficult for an individual to make decisions either because the right course of action is unclear or carries some potential negative consequences for the person or people involved.

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

1. Is it OK to accept a pair of sports tickets from a supplier?
2. Can I buy office supplies from my brother-in-law?
3. Is it appropriate to donate company funds to a local charity?
4. If I find out that a friend is about to be fired, can I warn her?

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

Issues of Honesty and Integrity

Master investor Warren Buffet once told a group of business students the following: "I cannot tell you that honesty is the best policy. I can't tell you that if you behave with perfect **honesty** and **integrity** somebody somewhere won't behave the other way and make more money. But honesty is a good policy. You'll do fine, you'll sleep well at night and you'll feel good about the example you are setting for your coworkers and the other people who care about you."[11]

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

Think about this story:

> "A chef put two frogs in a pot of warm soup water. The first frog smelled the onions, recognized the danger, and immediately jumped out. The second frog hesitated: The water felt good, and he decided to stay and relax for a minute. After all, he could always jump out when things got too hot (so to speak). As the water got hotter, however, the frog adapted to it, hardly noticing the change. Before long, of course, he was the main ingredient in frog-leg soup."[12]

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

We've summed them up in Figure 2.2.

Figure 2.2: How to maintain honesty and integrity

Conflicts of Interest

Conflicts of interest occur when individuals must choose between taking actions that promote their personal interests over the interests of others or taking actions that don't. A conflict can exist, for example, when an employee's own interests interfere with, or have the potential to interfere with, the best interests of the company's stakeholders (management, customers, and owners). Let's say that you work for a company with a contract to cater events at your college and that your uncle owns a local bakery. Obviously, this situation could create a conflict of interest (or at least give the appearance of one—which is a problem in itself). When you're called on to furnish desserts for a luncheon, you might be tempted to send some business your uncle's way even if it's not in the best interest of your employer. What should you do? You should disclose the connection to your boss, who can then arrange things so that your personal interests don't conflict with the company's.

The same principle holds that an employee shouldn't use private information about an employer for personal financial benefit. Say that you learn from a coworker at your pharmaceutical company that one of its most profitable drugs will be pulled off the market because of dangerous side effects. The recall will severely hurt the company's financial performance and cause its stock price to plummet. Before the news becomes public, you sell all the stock you own in the company. What you've done is called **insider**

trading – acting on information that is not available to the general public, either by trading on it or providing it to others who trade on it. Insider trading is illegal, and you could go to jail for it.

Conflicts of Loyalty

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

Bribes versus Gifts

It's not uncommon in business to give and receive small gifts of appreciation, but when is a gift unacceptable? When is it really a **bribe**?

There's often a fine line between a gift and a bribe. The following information may help in drawing it, because it raises key issues in determining how a gesture should be interpreted: the cost of the item, the timing of the gift, the type of gift, and the connection between the giver and the receiver. If you're on the receiving end, it's a good idea to refuse any item that's overly generous or given for the purpose of influencing a decision. Because accepting even small gifts may violate company rules, always check on company policy.

JCPenney's "Statement of Business Ethics," for instance, states that employees can't accept any cash gifts or any noncash gifts except those that have a value below $50 and that are generally used by the giver for promotional purposes. Employees can attend paid-for business functions, but other forms of entertainment, such as sports events and golf outings, can be accepted only if it's practical for the Penney's employee to reciprocate. Trips of several days can't be accepted under any circumstances.[13]

Whistle-Blowing

As we've seen, the misdeeds of Betty Vinson and her accomplices at WorldCom didn't go undetected. They caught the eye of Cynthia Cooper, the company's director of internal auditing. Cooper, of course, could have looked the other way, but instead she summoned up the courage to be a **whistle-blower**—an individual who exposes illegal or unethical behavior in an organization. Like Vinson, Cooper had majored in accounting at Mississippi State and was a hard-working, dedicated employee. Unlike Vinson, however, she refused to be bullied by her boss, CFO Scott Sullivan. In fact, she had tried to tell not only Sullivan but also auditors from the Arthur Andersen accounting firm that there was a problem with WorldCom's books. The auditors dismissed her warnings, and when Sullivan angrily told her to drop the matter, she started cleaning out her office. But she didn't relent. She and her team worked late each night, conducting an extensive, secret investigation. Two months later, Cooper had evidence to take to Sullivan, who told her once again to back off. Again, however, she stood up to him, and though she regretted the consequences for her WorldCom coworkers, she reported the scheme to the company's board of directors. Within days, Sullivan was fired and the largest accounting fraud in history became public.[14]

As a result of Cooper's actions, executives came clean about the company's financial situation. The conspiracy of fraud was brought to an end, and though public disclosure of WorldCom's problems resulted in massive stock-price declines and employee layoffs, investor and employee losses would have been greater without Cooper's intervention. Even though Cooper did the right thing, and landed on the cover of *Time* magazine for it, the experience wasn't exactly gratifying.

A lot of people applauded her action, but many coworkers shunned her; some even blamed her for the company's troubles.[15]

Whistle-blowing is sometimes career suicide. A survey of two hundred whistle-blowers conducted by the National Whistleblower Center found that half were fired for blowing the whistle.[16] Even those who keep their jobs can experience repercussions. As long as they stay, some will treat them (as one whistle-blower put it) "like skunks at a picnic"; if they leave, they may be blackballed in the industry.[17] On a positive note, new Federal laws have been passed which are intended to protect whistle-blowers.

For her own part, Cynthia Cooper doesn't regret what she did. As she told a group of students at Mississippi State: "Strive to be persons of honor and integrity. Do not allow yourself to be pressured. Do what you know is right even if there may be a price to be paid."[18] If your company tells employees to do whatever it takes, push the envelope, look the other way, and "be sure that we make

our numbers,” you have three choices: go along with the policy, try to change things, or leave. If your personal integrity is part of the equation, you’re probably down to the last two choices.[19]

Corporate social responsibility refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions. Remember that we previously defined **stakeholders** as those with a legitimate interest in the success or failure of the business and the policies it adopts. The term social responsibility refers to the approach that an organization takes in balancing its responsibilities toward their various stakeholders.

What motivates companies to be “socially responsible”? We hope it’s because they want to do the right thing, and for many companies, “doing the right thing” is a key motivator. The fact is, it’s often hard to figure out what the “right thing” is: what’s “right” for one group of stakeholders isn’t necessarily just as “right” for another. One thing, however, is certain: companies today are held to higher standards than ever before. Consumers and other groups consider not only the quality and price of a company’s products but also its character. If too many groups see a company as a poor corporate citizen, it will have a harder time attracting qualified employees, finding investors, and selling its products. Good corporate citizens, by contrast, are more successful in all these areas.

Figure 4.3 presents a model of corporate responsibility based on a company’s relationships with its stakeholders. In this model, the focus is on **managers**—not owners—as the principals involved in these relationships. **Owners** are the stakeholders who invest risk capital in the firm in expectation of a financial return. Other stakeholders include **employees**, **suppliers**, and the **communities** in which the firm does business. Proponents of this model hold that customers, who provide the firm with revenue, have a special claim on managers’ attention. The arrows indicate the two-way nature of corporation-stakeholder relationships: All stakeholders have some claim on the firm’s resources and returns, and management’s job is to make decisions that balance these claims.[20]

Figure 2.3: Management’s relationships with stakeholders

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

Owners

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

Managers

Managers have what is known as a fiduciary responsibility to owners: they're responsible for safeguarding the company's assets and handling its funds in a trustworthy manner. Yet managers experience what is called the agency problem; a situation in which their best interests do not align with those of the owners who employ them. To enforce managers' fiduciary responsibilities for a firm's financial statements and accounting records, the Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to attest to their accuracy. The law also imposes penalties on corporate officers, auditors, board members, and any others who commit fraud. You'll learn more about this law in your accounting and business law courses.

Employees

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

Wages and Benefits

At the very least, employers must obey laws governing minimum wage and overtime pay. A **minimum wage** is set by the federal government, though states can set their own rates as long as they are higher. The current federal rate, for example, is $7.25, while the rate in many states is far higher.[21] By law, employers must also provide certain **benefits**—social security (retirement funds), unemployment insurance (protects against loss of income in case of job loss), and workers' compensation (covers lost wages and medical costs in case of on-the-job injury). Most large companies pay most of their workers more than minimum wage and offer broader benefits, including medical, dental, and vision care, as well as savings programs, in order to compete for talent.

Safety and Health

Though it seems obvious that companies should guard workers' **safety and health**, some simply don't. For over four decades, for example, executives at Johns Manville suppressed evidence that one of its products, asbestos, was responsible for the deadly lung disease developed by many of its workers.[22] The company concealed chest X- rays from stricken workers, and executives decided that it was simply cheaper to pay workers' compensation claims than to create a safer work environment. A New Jersey court was quite blunt in its judgment: Johns Manville, it held, had made a deliberate, cold-blooded decision to do nothing to protect at-risk workers, in blatant disregard of their rights.[23]

About four in one hundred thousand U.S. workers die in workplace "incidents" each year. The Department of Labor categorizes deaths caused by conditions like those at Johns Manville as "exposure to harmful substances or environments." How prevalent is this condition as a cause of workplace deaths? See Figure 4.4, "Workplace Deaths by Event or Exposure, 2014", which breaks down workplace fatalities by cause. Some jobs are more dangerous than others. For a comparative overview based on workplace deaths by occupation, see Figure 2.5.

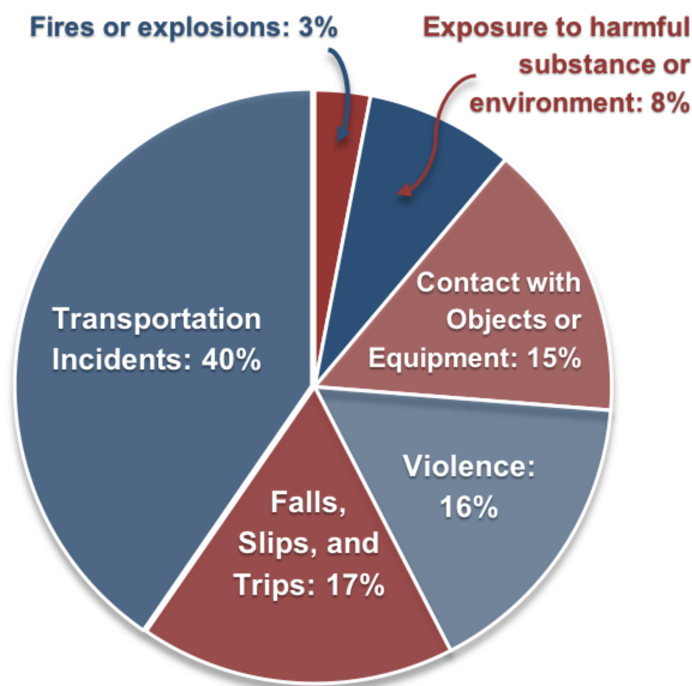

Figure 2.4: Workplace deaths by event or exposure, 2014

Figure 2.5: Workplace deaths by Occupation, 2014

Industry	% of Total Workplace Deaths
Construction	19%
Transportation and Warehousing	16%
Agriculture, Forestry, and Fishing	12%
Government	9%
Professional and Business Services	9%
Manufacturing	7%
Retail Trade	6%
Leisure and Hospitality	4%
Mining, Quarrying, and Natural Gas Extraction	4%

Fortunately for most people, things are far better than they were at Johns Manville. Procter & Gamble (P&G), for example, considers the safety and health of its employees paramount and promotes the attitude that "Nothing we do is worth getting hurt for." With nearly one hundred thousand employees worldwide, P&G uses a measure of worker safety called "total incident rate per employee," which records injuries resulting in loss of consciousness, time lost from work, medical transfer to another job, motion restriction, or medical treatment beyond first aid. The company attributes the low rate of such incidents—less than one incident per hundred employees—to a variety of programs to promote workplace safety.[24]

Customers

The purpose of any business is to satisfy **customers**, who reward businesses by buying their products. Sellers are also responsible —both ethically and legally—for treating customers fairly. The rights of consumers were first articulated by President John F. Kennedy in 1962 when he submitted to Congress a presidential message devoted to consumer issues.[25] Kennedy identified four consumer rights:

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

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

Communities

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

Philanthropy

Many large corporations support various charities, an activity called **philanthropy**. Some donate a percentage of sales or profits to worthwhile causes. Retailer Target, for example, donates 5 percent of its profits—about $2 million per week—to schools, neighborhoods, and local projects across the country; its store-based grants underwrite programs in early childhood education, the arts, and family-violence prevention.[26] The late actor Paul Newman donated 100 percent of the profits from "Newman's Own" foods (salad dressing, pasta sauce, popcorn, and other products sold in eight countries). His company continues his legacy of donating all profits and distributing them to thousands of organizations, including the Hole in the Wall Gang camps for seriously ill children.[27]

Ethical Organizations

How Can You Recognize an Ethical Organization?

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

- Treating employees, customers, investors, and the public fairly
- Holding every member personally accountable for his or her action
- Communicating core values and principles to all members
- Demanding and rewarding integrity from all members in all situations[28]

Employees at companies that consistently make Business Ethics magazine's list of the "100 Best Corporate Citizens" regard the items on the previous list as business as usual in the workplace. Companies at the top of the 2016 list include Microsoft, Hasbro, Ecolab, Bristol-Myers-Squibb, and Lockheed Martin.[29]

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

- They consistently feel uneasy about the work they do.
- They object to the way they're treated.
- They're uncomfortable about the way coworkers are treated.
- They question the appropriateness of management directives and policies.[30]

Sexual Harassment

Sexual harassment occurs when an employee makes "unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature" to another employee. It's also considered sexual harassment when "submission to or rejection of this conduct explicitly or implicitly affects an individual's employment, unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment."[31]

To prevent sexual harassment—or at least minimize its likelihood—a company should adopt a formal anti-harassment **policy** describing prohibited conduct, asserting its objections to the behavior, and detailing penalties for violating the policy.[32] Employers also have an obligation to investigate harassment complaints. Failure to enforce anti-harassment policies can be very costly. In 1998, for example, Mitsubishi paid $34 million to more than three hundred fifty female employees of its Normal, Illinois, plant to settle a sexual harassment case supported by the **Equal Employment Opportunity Commission**. The EEOC reprimanded the company for permitting an atmosphere of verbal and physical abuse against women, charging that female workers had been subjected to various forms of harassment, ranging from exposure to obscene graffiti and vulgar jokes to fondling and groping.[33]

Workforce Diversity

In addition to complying with equal employment opportunity laws, many companies make special efforts to recruit employees who are underrepresented in the workforce according to sex, race, or some other characteristic. In helping to build more **diverse** workforces, such initiatives contribute to competitive advantage for two reasons:

1. People from diverse backgrounds bring new talents and fresh perspectives to an organization, typically enhancing creativity in the development of new products.
2. By more accurately reflecting the demographics of the marketplace, a diverse workforce improves a company's ability to serve an ethnically diverse population.

The Individual Approach to Ethics

Betty Vinson didn't start out at WorldCom with the intention of going to jail. She undoubtedly knew what the right behavior was, but the bottom line is that she didn't do it. How can you make sure that you do the right thing in the business world? How should you respond to the kinds of challenges that you'll be facing? Because your actions in the business world will be strongly influenced by your moral character, let's begin by assessing your current moral condition. Which of the following best applies to you (select one)?

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

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

Apparently, most people realize that being ethical all the time takes a great deal of moral energy. If you placed yourself in category number two, ask yourself this question: How can I change my behavior so that I can move up a notch? The answer to this question may be simple. Just ask yourself an easier question: How would I like to be treated in a given situation?[34]

Unfortunately, practicing this philosophy might be easier in your personal life than in the business world. Ethical challenges arise in business because companies, especially large ones, have multiple stakeholders who sometimes make competing demands. Making decisions that affect multiple stakeholders isn't easy even for seasoned managers; and for new entrants to the business world, the task can be extremely daunting. You can, however, get a head start in learning how to make ethical decisions by looking at two types of challenges that you'll encounter in the business world: ethical dilemmas and ethical decisions.

Addressing Ethical Dilemmas

An **ethical dilemma** is a morally problematic situation: you must choose between two or more acceptable but often opposing alternatives that are important to different groups. Experts often frame this type of situation as a "right-versus-right" decision. It's the sort of decision that Johnson & Johnson (known as J&J) CEO James Burke had to make in 1982.[35] On September 30, twelve-year-old Mary Kellerman of Chicago died after her parents gave her Extra-Strength Tylenol. That same morning, twenty-seven-

year-old Adam Janus, also of Chicago, died after taking Tylenol for minor chest pain. That night, when family members came to console his parents, Adam's brother and his wife took Tylenol from the same bottle and died within forty-eight hours. Over the next two weeks, four more people in Chicago died after taking Tylenol. The actual connection between Tylenol and the series of deaths wasn't made until an off-duty fireman realized from news reports that every victim had taken Tylenol. As consumers panicked, J&J pulled Tylenol off Chicago-area retail shelves. Researchers discovered Tylenol capsules containing large amounts of deadly cyanide. Because the poisoned bottles came from batches originating at different J&J plants, investigators determined that the tampering had occurred after the product had been shipped.[36]

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

Burke had two options:

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

Burke opted to recall all 31 million bottles of Extra-Strength Tylenol on the market. The cost to J&J was $100 million, but public reaction was quite positive. Less than six weeks after the crisis began, Tylenol capsules were reintroduced in new tamper-resistant bottles, and by responding quickly and appropriately, J&J was eventually able to restore the Tylenol brand to its previous market position. When Burke was applauded for moral courage, he replied that he'd simply adhered to the long-standing J&J credo that put the interests of customers above those of other stakeholders. His only regret was that the perpetrator was never caught.[37]

If you're wondering what your thought process should be if you're confronted with an ethical dilemma, you might wish to remember the mental steps listed here—which happen to be the steps that James Burke took in addressing the Tylenol crisis:

1. **Define the problem**: How to respond to the tampering case without destroying the reputation of the Tylenol brand.
2. **Identify feasible options**: (1) Recall only the lots of Tylenol that were found to be tainted or (2) order a nationwide recall of all bottles of Extra-Strength Tylenol.
3. **Assess the effect of each option on stakeholders**: Option 1 (recalling only the tainted lots of Tylenol) is cheaper but puts more people at risk. Option 2 (recalling all bottles of Extra-Strength Tylenol) puts the safety of the public above stakeholders' financial interests.
4. **Establish criteria for determining the most appropriate action**: Adhere to the J&J credo, which puts the interests of customers above those of other stakeholders.
5. **Select the best option based on the established criteria**: In 1982, Option 2 was selected, and a nationwide recall of all bottles of Extra-Strength Tylenol was conducted.

Making Ethical Decisions

In contrast to the "right-versus-right" problem posed by an ethical dilemma, an **ethical decision** entails a "right-versus-wrong" decision—one in which there is clearly a right (ethical) choice and a wrong (unethical or illegal) choice. When you make a decision that's unmistakably unethical or illegal, you've committed an ethical lapse. If you're presented with this type of choice, asking yourself the questions in Figure 4.6 "How to Avoid an Ethical Lapse" will increase your odds of making an ethical decision.

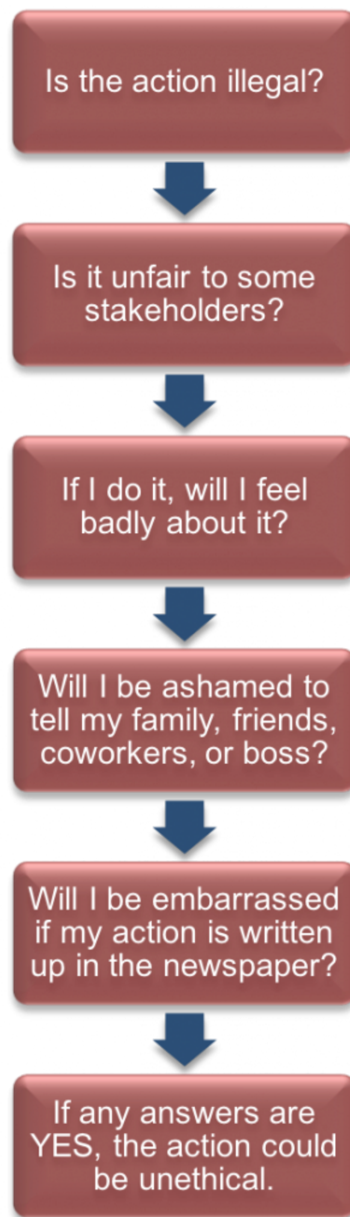

Figure 2.6: How to avoid an ethical lapse: questions to ask

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

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

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

Revisiting Johnson & Johnson

As discussed earlier, Johnson & Johnson received tremendous praise for the actions taken by its CEO, James Burke, in response to the 1982 Tylenol catastrophe. However, things change. To learn how a company can destroy its good **reputation**, let's fast forward to 2008 and revisit J&J and its credo, which states, "We believe our first responsibility is to the doctors, nurses and patients, to

mothers and fathers and all others who use our products and services. In meeting their needs everything we do must be of high quality."[38] How could a company whose employees believed so strongly in its credo find itself under criminal and congressional investigation for a series of recalls due to defective products?[39] In a three-year period, the company recalled twenty-four products, including Children's, Infants' and Adults' Tylenol, Motrin, and Benadryl;[40] 1-Day Acuvue TruEye contact lenses sold outside the U.S.;[41] and hip replacements.[42]

Unlike the Tylenol recall, no one had died from the defective products, but customers were certainly upset to find they had purchased over-the-counter medicines for themselves and their children that were potentially contaminated with dark particles or tiny specks of metal;[43] contact lenses that contained a type of acid that caused stinging or pain when inserted in the eye;[44] and defective hip implants that required patients to undergo a second hip replacement.[45]

Who bears the responsibility for these image-damaging blunders? Two individuals who were at least partially responsible were William Weldon, CEO, and Colleen Goggins, Worldwide Chairman of J&J's Consumer Group. Weldon has been criticized for being largely invisible and publicly absent during the recalls.[46] Additionally, he admitted that he did not understand the consumer division where many of the quality control problems originated.[47] Goggins was in charge of the factories that produced many of the recalled products. She was heavily criticized by fellow employees for her excessive cost-cutting measures and her propensity to replace experienced scientists with new hires.[48] In addition, she was implicated in scheme to avoid publicly disclosing another J&J recall of a defective product.

After learning that J&J had released packets of Motrin that did not dissolve correctly, the company hired contractors to go into convenience stores and secretly buy up every pack of Motrin on the shelves. The instructions given to the contractors were the following: "You should simply 'act' like a regular customer while making these purchases. THERE MUST BE NO MENTION OF THIS BEING A RECALL OF THE PRODUCT!"[49] In May 2010, when Goggins appeared before a congressional committee investigating the "phantom recall," she testified that she was not aware of the behavior of the contractors[50] and that she had "no knowledge of instructions to contractors involved in the phantom recall to not tell store employees what they were doing." In her September 2010 testimony to the House Committee on Oversight and Government Reform, she acknowledged that the company in fact wrote those very instructions.

Refusing to Rationalize

Despite all the good arguments in favor of doing the right thing, why do many reasonable people act unethically (at least at times)? Why do good people make bad choices? According to one study, there are four common **rationalizations** (excuses) for justifying misconduct:[51]

1. **My behavior isn't really illegal or immoral**. Rationalizers try to convince themselves that an action is OK if it isn't downright illegal or blatantly immoral. They tend to operate in a gray area where there's no clear evidence that the action is wrong.
2. **My action is in everyone's best interests**. Some rationalizers tell themselves: "I know I lied to make the deal, but it'll bring in a lot of business and pay a lot of bills." They convince themselves that they're expected to act in a certain way.[52]
3. **No one will find out what I've done**. Here, the self-questioning comes down to "If I didn't get caught, did I really do it?" The answer is yes. There's a simple way to avoid succumbing to this rationalization: Always act as if you're being watched.
4. **The company will condone my action and protect me**. This justification rests on a fallacy. Betty Vinson may honestly have believed that her actions were for the good of the company and that her boss would, therefore, accept full responsibility (as he promised). When she goes to jail, however, she'll go on her own.

Here's another rule of thumb: If you find yourself having to rationalize a decision, it's probably a bad one.

What to Do When the Light Turns Yellow

Like our five questions, some ethical problems are fairly straightforward. Others, unfortunately, are more complicated, but it will help to think of our five-question test as a set of signals that will warn you that you're facing a particularly tough decision— that you should think carefully about it and perhaps consult someone else. The situation is like approaching a traffic light. Red and green lights are easy; you know what they mean and exactly what to do. Yellow lights are trickier. Before you decide which pedal to hit, try posing our five questions. If you get a single yes, you'll almost surely be better off hitting the brake.[53]

Figure 2.7

Chapter Video

Foxconn is a major supplier to Apple. All of its factories are in China and Taiwan, although it recently announced building a new one in the United States. Working conditions are much different than in a typical US factory. As you watch the video, think about what responsibilities Apple has in this situation. They don't own Foxconn or its factories, yet their reputation can be nevertheless impacted.

To view this video, visit: https://www.youtube.com/watch?v=Jk-xqPKOxl4&=&t=39s

(Copyrighted material)

Key Takeaways

1. Business ethics is the application of ethical behavior in a business context. Ethical (trustworthy) companies are better able to attract and keep customers, talented employees, and capital.
2. Acting ethically in business means more than just obeying laws and regulations. It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your employer and coworkers.
3. In the business world, you'll encounter conflicts of interest: situations in which you'll have to choose between taking action that promotes your personal interest and action that favors the interest of others.
4. Corporate social responsibility refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders (owners, employees, customers, and the communities in which they conduct business) when making legal, economic, ethical, and social decisions.
5. Managers have several responsibilities: to increase the value of owners' investments through profitable operations, to provide owners and other stakeholders with accurate, reliable financial information, and to safeguard the company's assets and handle its funds in a trustworthy manner.
6. Companies have a responsibility to pay appropriate wages and benefits, treat all workers fairly, and provide equal opportunities for all employees. In addition, the must guard workers' safety and health and to provide them with a work environment that's free from sexual harassment.
7. Consumers have certain legal rights: to use safe products, to be informed about products, to choose what to buy, and to be heard. Sellers must comply with these requirements.
8. Businesspeople face two types of ethical challenges: ethical dilemmas and ethical decisions.
9. An ethical dilemma is a morally problematic situation in which you must choose competing and often conflicting options which do not satisfy all stakeholders.
10. An ethical decision is one in which there's a right (ethical) choice and a wrong (unethical or downright illegal) choice.

Chapter 2 Text References and Image Credits

Image Credits: Chapter 2

Figure 2.1: "Bernie Madoff's Mug Shot." U.S. Department of Justice, public domain. Retrieved from: en.Wikipedia.org/wiki/Bernard_Madoff#/media/File:BernardMadoff.jpg

Figure 2.4: "Workplace deaths by event or exposure, 2014." Data retrieved from: Bureau of Labor Statistics: http://www.bls.gov/iif/oshwc/cfoi/cfch0013.pdf (p. 3).

Figure 2.5: “Workplace deaths by occupation, 2014.” Data retrieved from: Bureau of Labor Statistics: http://www.bls.gov/iif/oshwc/cfoi/cfch0013.pdf (p. 13).

Figure 2.7: Yellow traffic light. Sir James (2009). “Traffic light modern version Ireland Dublin.” Creative Commons Attribution-Share Alike 3.0 Unported. Retrieved from: https://commons.wikimedia.org/wiki/File:Traffic_light_modern_version_Ireland_Dublin_2_yellow_2009-09-27.jpg

Video Credits: Chapter 2

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3: Economics and Business

Learning Objectives

1. Describe the foundational philosophies of capitalism and socialism.
2. Discuss private property rights and why they are key to economic development.
3. Discuss the concept of GDP (gross domestic product).
4. Explain the difference between fiscal and monetary policy.
5. Discuss the concept of the unemployment rate measurement.
6. Discuss the concepts of inflation and deflation.
7. Explain other key terms related to this chapter including: supply; demand; equilibrium price; monopoly; recession; depression.

What is Economics?

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

Resources: Inputs and Outputs

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

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

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

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

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

Input and Output Markets

Many of the factors of production are provided to businesses by households. For example, households provide businesses with labor (as workers), land and buildings (as landlords), and capital (as investors). In turn, businesses pay households for these resources by providing them with income, such as wages, rent, and interest. The resources obtained from households are then used by businesses to produce **goods** and **services**, which are sold to provide businesses with revenue. The revenue obtained by businesses is then used to buy additional resources, and the cycle continues. This is described in Figure 3.1 “The Circular Flow of Inputs and Outputs”, which illustrates the dual roles of households and businesses:

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

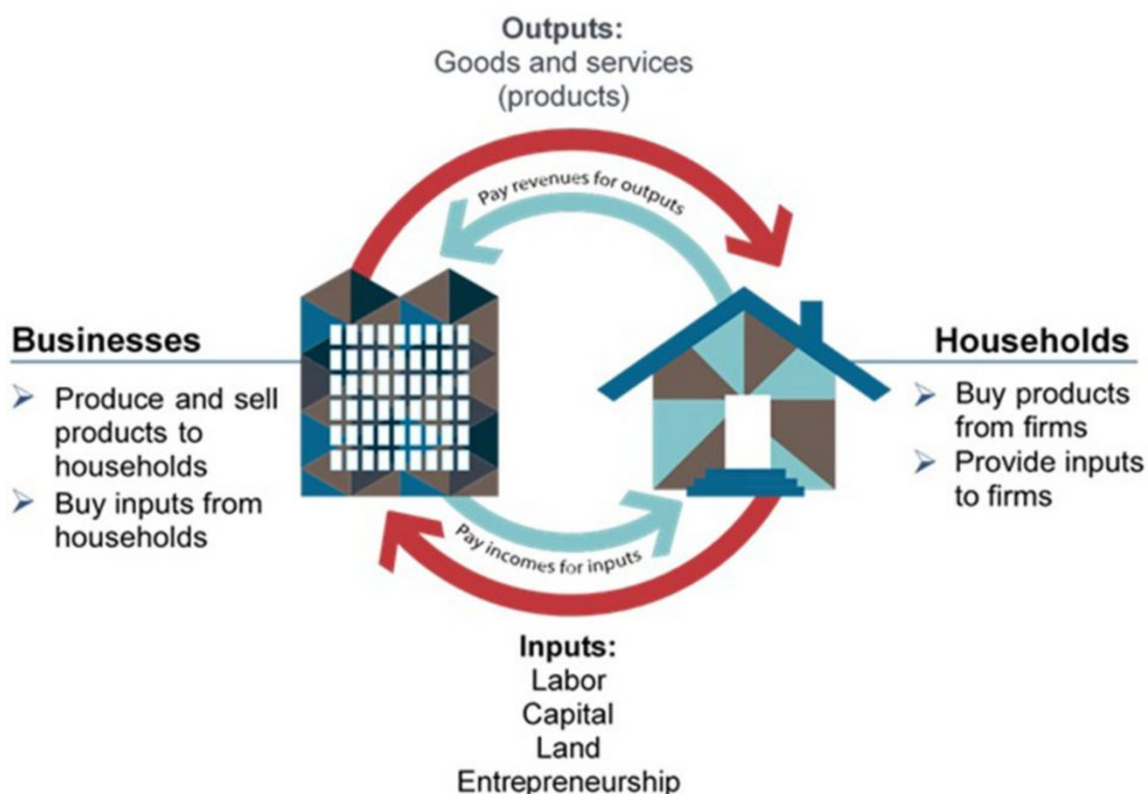


Figure 3.1: The Circular Flow of Inputs and Outputs

Economic Systems

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

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

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

Generally speaking, economic systems can be divided into two systems: planned systems and free market systems.

Planned Systems

In a **planned system**, the government exerts control over the allocation and distribution of all or some goods and services. The system with the highest level of government control is communism. In theory, a communist economy is one in which the government owns all or most enterprises. Central planning by the government dictates which goods or services are produced, how they are produced, and who will receive them. In practice, pure communism is practically nonexistent today, and only a few countries (notably North Korea and Cuba) operate under rigid, centrally planned economic systems.

Under **socialism**, industries that provide essential services, such as utilities, banking, and health care, may be government owned. Some businesses may also be owned privately. Central planning allocates the goods and services produced by government-run industries and tries to ensure that the resulting wealth is distributed equally. In contrast, privately owned companies are operated for the purpose of making a profit for their owners. In general, workers in socialist economies work fewer hours, have longer vacations, and receive more health care, education, and child-care benefits than do workers in capitalist economies. To offset the

high cost of public services, taxes are generally steep. Examples of countries that lean towards a socialistic approach include Venezuela, Sweden, and France.

Free Market System

The economic system in which most businesses are owned and operated by individuals is the **free market system**, also known as **capitalism**. In a free market economy, **competition** dictates how goods and services will be allocated. Business is conducted with more limited government involvement concentrated on regulations that dictate how businesses are permitted to operate. A key aspect of a free market system is the concept of **private property rights**, which means that business owners can expect to own their land, buildings, machines, etc., and keep the majority of their profits, except for taxes. The profit incentive is a key driver of any free market system. The economies of the United States and other countries, such as Japan, are based on capitalism. However, a purely capitalistic economy is as rare as one that is purely communist. Imagine if a service such as police protection, one provided by government in the United States, were instead allocated based on market forces. The ability to pay would then become a key determinant in who received these services, an outcome that few in American society would consider to be acceptable.

How Economic Systems Compare

In comparing economic systems, it can be helpful to think of a continuum with communism at one end and pure capitalism at the other, as in Figure 3.2 on the next page. As you move from left to right, the amount of government control over business diminishes. So, too, does the level of social services, such as health care, child-care services, social security, and unemployment benefits. Moving from left to right, taxes are correspondingly lower as well.

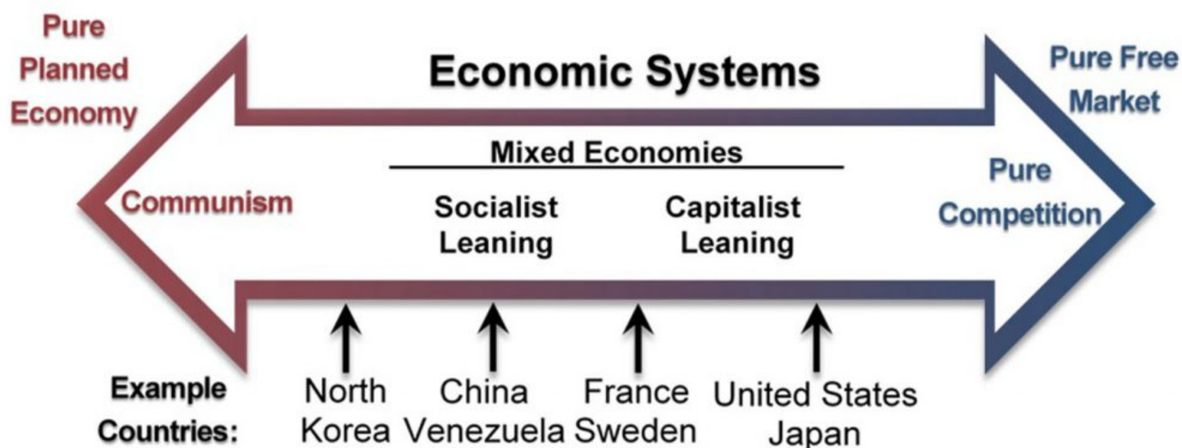


Figure 3.2: The Economic Spectrum

Mixed Market Economies

Though it’s possible to have a pure communist system, or a pure capitalist (free market) system, in reality many economic systems are mixed. A **mixed market economy** relies on both markets and the government to allocate resources. In practice, most economies are mixed, with a leaning towards either free market or socialistic principles, rather than being purely one or the other. Some previously communist economies, such as those of Eastern Europe and China, are becoming more mixed as they adopt more capitalistic characteristics and convert businesses previously owned by the government to private ownership through a process called **privatization**. By contrast, Venezuela is a country that has moved increasingly towards socialism, taking control of industries such as oil and media through a process called **nationalization**.

The U.S. Economic System

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

The free market system was espoused by Adam Smith in his book *The Wealth of Nations*, published in 1776. According to Smith, competition alone would ensure that consumers received the best products at the best prices. In the kind of competition he assumed, a seller who tries to charge more for his product than other sellers would not be able to find any buyers. A job-seeker who asks

more than the going wage won't be hired. Because the "invisible hand" of competition will make the market work effectively, there won't be a need to regulate prices or wages. Almost immediately, however, a tension developed among free market theorists between the principle of ***laissez-faire***—leaving things alone—and government intervention. Today, it's common for the U.S. government to intervene in the operation of the economic system. For example, government exerts influence on the food and pharmaceutical industries through the Food and Drug Administration, which protects consumers by preventing unsafe or mislabeled products from reaching the market.

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

Perfect Competition and Supply and Demand

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

Perfect Competition

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

The Basics of Supply and Demand

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

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

Demand and the Demand Curve

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

Using this logic, we can construct a demand curve that shows the quantity of a product that will be demanded at different prices. Let's assume that the diagram in Figure 3.3 "The Demand Curve" represents the daily price and quantity of apples sold by farmers at a local market. Note that as the price of apples goes down, buyers' demand goes up. Thus, if a pound of apples sells for $0.80, buyers will be willing to purchase only fifteen hundred pounds per day. But if apples cost only $0.60 a pound, buyers will be willing to purchase two thousand pounds. At $0.40 a pound, buyers will be willing to purchase twenty-five hundred pounds.

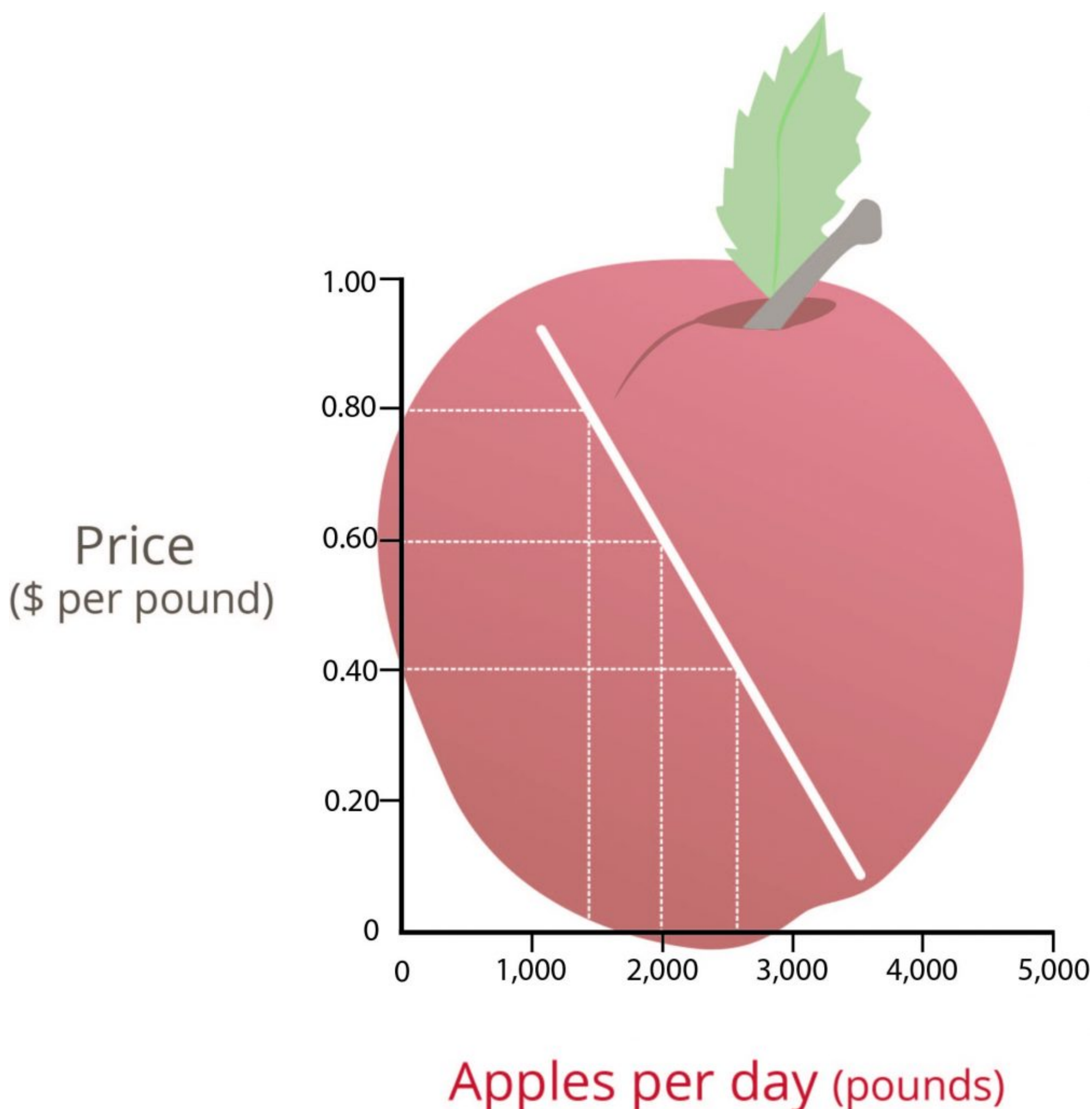


Figure 3.3: The Demand Curve

Supply and the Supply Curve

Supply is the quantity of a product that sellers are willing to sell at various prices. The quantity of a product that a business is willing to sell depends on its price. Businesses are *more* willing to sell a product when the price *rises* and *less* willing to sell it when prices *fall*. Again, this fact makes sense: businesses are set up to make profits, and there are larger profits to be made when prices are high.

Now we can construct a supply curve that shows the quantity of apples that farmers would be willing to sell at different prices, regardless of demand. As you can see in Figure 3.4 "The Supply Curve", the supply curve goes in the opposite direction from the demand curve: as prices rise, the quantity of apples that farmers are willing to sell also goes up. The supply curve shows that farmers are willing to sell only a thousand pounds of apples when the price is $0.40 a pound, two thousand pounds when the price is $0.60, and three thousand pounds when the price is $0.80.

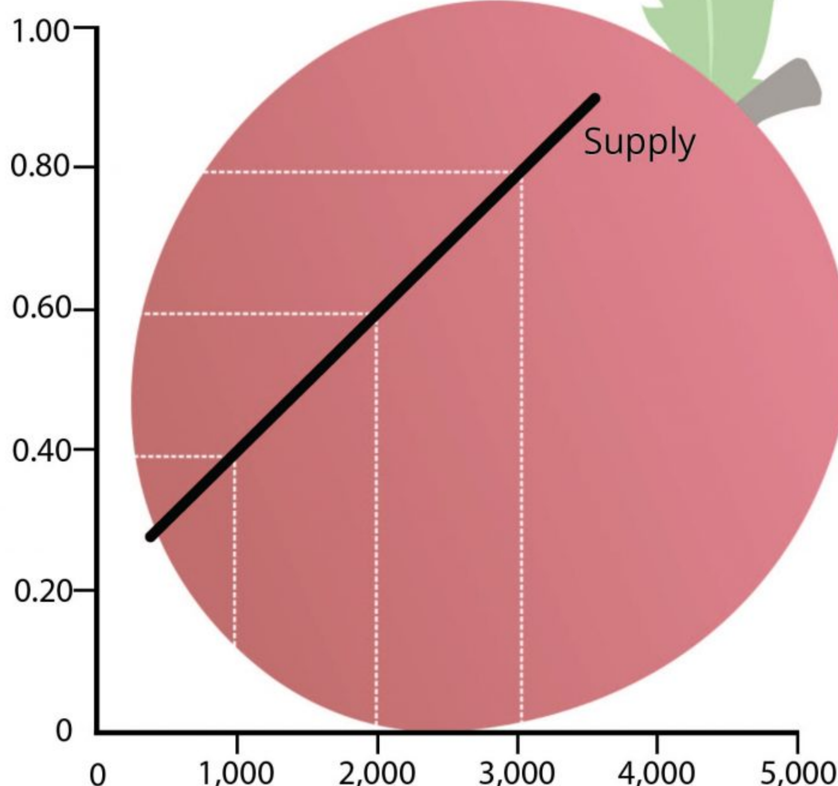


Figure 3.4: The Supply Curve

Equilibrium Price

We can now see how the market mechanism works under perfect competition. We do this by plotting both the supply curve and the demand curve on one graph, as we've done in Figure 3.5 "The Equilibrium Price". The point at which the two curves intersect is the **equilibrium price**.

You can see in Figure 3.5 "The Equilibrium Price" that the supply and demand curves intersect at the price of $0.60 and quantity of two thousand pounds. Thus, $0.60 is the equilibrium price: at this price, the quantity of apples demanded by buyers equals the quantity of apples that farmers are willing to supply. If a single farmer tries to charge more than $0.60 for a pound of apples, he won't sell very many because other suppliers are making them available for less. As a result, his profits will go down. If, on the other hand, a farmer tries to charge less than the equilibrium price of $0.60 a pound, he will sell more apples but his profit per pound will be less than at the equilibrium price. With profit being the motive, there is no incentive to drop the price.

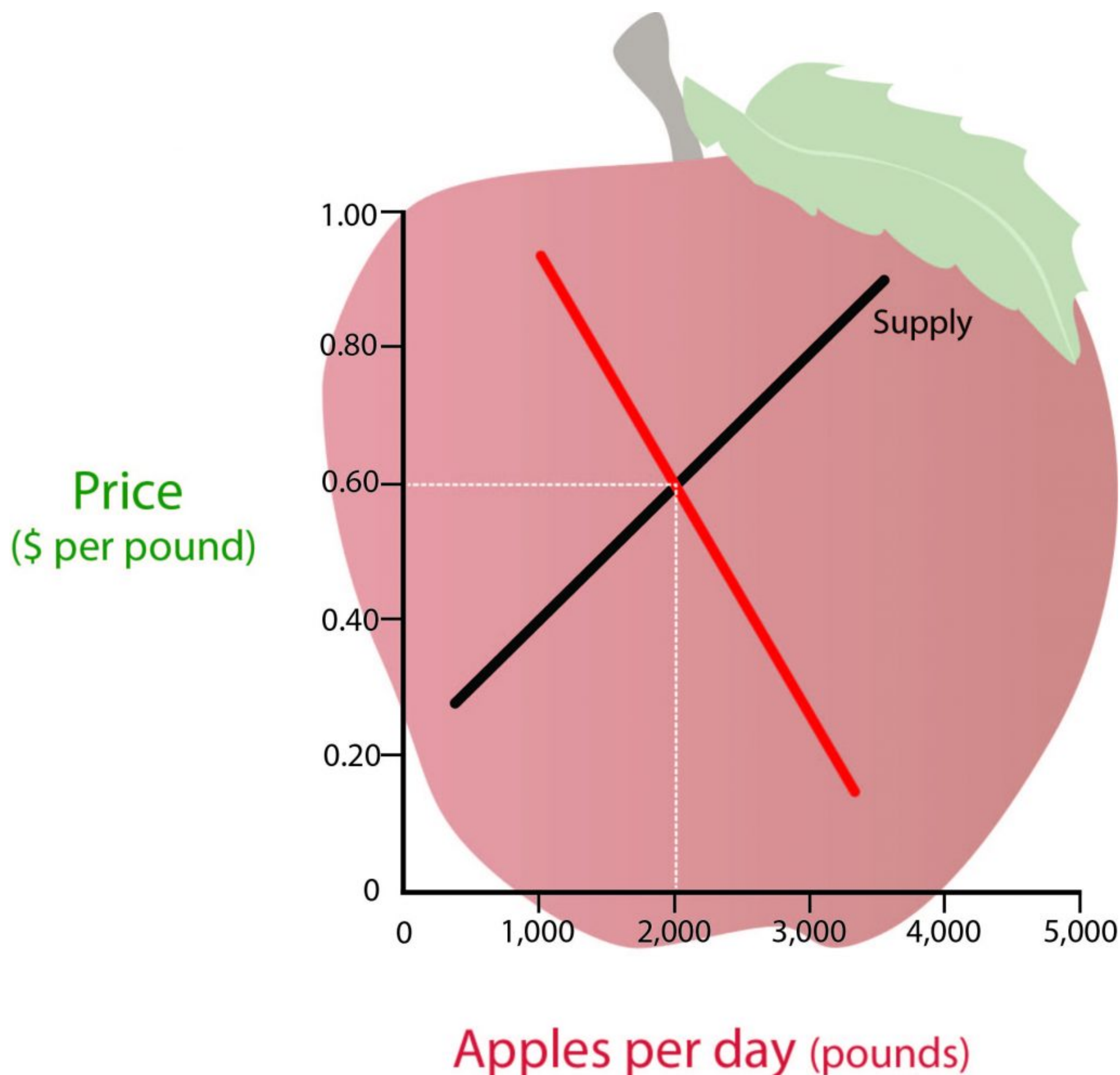


Figure 3.5: The Equilibrium Price

What have we learned in this discussion? Without outside influences, markets in an environment of perfect competition will arrive at an equilibrium point at which both buyers and sellers are satisfied. But we must be aware that this is a very simplistic example. Things are more complex in the real world. For one thing, markets don't always operate without outside influences. For example, if a government set an artificially low price ceiling on a product to keep consumers happy, we would not expect producers to produce enough to satisfy demand, resulting in a **shortage**. If government set prices high to assist an industry, sellers would likely supply more of a product than buyers need; in that case, there would be a **surplus**.

Circumstances also have a habit of changing. What would happen, for example, if incomes rose and buyers were willing to pay more for apples? The demand curve would change, resulting in an increase in equilibrium price. This outcome makes intuitive sense: as demand increases, prices will go up. What would happen if apple crops were larger than expected because of favorable weather conditions? Farmers might be willing to sell apples at lower prices rather than letting part of the crop spoil. If so, the supply curve would shift, resulting in another change in equilibrium price: the increase in supply would bring down prices.

Monopolistic Competition, Oligopoly, and Monopoly

As mentioned previously, economists have identified four types of competition—perfect competition, monopolistic competition, oligopoly, and monopoly. Perfect competition was discussed in the last section; we'll cover the remaining three types of competition here.

Monopolistic Competition

In **monopolistic competition**, we still have many sellers (as we had under perfect competition). Now, however, they don't sell identical products. Instead, they sell **differentiated** products—products that differ somewhat, or are perceived to differ, even though they serve a similar purpose. Products can be differentiated in a number of ways, including quality, style, convenience, location, and brand name. An example in this case might be toothpaste. Although many people are fiercely loyal to their favorites, most products in this category are quite similar and address the same consumer need. But what if there was a substantial price difference among products? In that case, many buyers would likely be persuaded to switch brands, at least on a trial basis.

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

Oligopoly

Oligopoly means few sellers. In an oligopolistic market, each seller supplies a large portion of all the products sold in the marketplace. In addition, because the cost of starting a business in an oligopolistic industry is usually high, the number of firms entering it is low. Companies in oligopolistic industries include such large-scale enterprises as automobile companies and airlines. As large firms supplying a sizable portion of a market, these companies have some control over the prices they charge. But there's a catch: because products are fairly similar, when one company lowers prices, others are often forced to follow suit to remain competitive. You see this practice all the time in the airline industry: When American Airlines announces a fare decrease, Continental, United Airlines, and others do likewise. When one automaker offers a special deal, its competitors usually come up with similar promotions.

Monopoly

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

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

A **legal monopoly** arises when a company receives a patent giving it exclusive use of an invented product or process. Patents are issued for a limited time, generally twenty years.[1] During this period, other companies can't use the invented product or process without permission from the patent holder. Patents allow companies a certain period to recover the heavy costs of researching and developing products and technologies. A classic example of a company that enjoyed a patent-based legal monopoly is Polaroid, which for years held exclusive ownership of instant-film technology.[2] Polaroid priced the product high enough to recoup, over time, the high cost of bringing it to market. Without competition, in other words, it enjoyed a monopolistic position in regard to pricing.

Measuring the Health of the Economy

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

Economic Goals

The world's economies share three main goals:

- Growth
- High employment
- Price stability

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

Economic Growth

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

The Business Cycle

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

- During **prosperity**, the economy expands, unemployment is low, in- comes rise, and consumers buy more products. Businesses respond by increasing production and offering new and better products.
- Eventually, however, things slow down. GDP decreases, unemployment rises, and because people have less money to spend, business revenues decline. This slowdown in economic activity is called a **recession**.
- Economists often say that we're entering a recession when GDP goes down for two consecutive quarters.
- Generally, a recession is followed by a **recovery** in which the economy starts growing again.
- If, however, a recession lasts a long time (perhaps a decade or so), while unemployment remains very high and production is severely curtailed, the economy could sink into a **depression**. Unlike for the term recession, economists have not agreed on a uniform standard for what constitutes a depression, though they are generally characterized by their duration. Though not impossible, it's unlikely that the United States will experience another severe depression like that of the 1930s. The federal government has a number of economic tools (some of which we'll discuss shortly) with which to fight any threat of a depression.

Full Employment

To keep the economy going strong, people must spend money on goods and services. A reduction in personal expenditures for things like food, clothing, appliances, automobiles, housing, and medical care could severely reduce GDP and weaken the economy. Because most people earn their spending money by working, an important goal of all economies is making jobs available to everyone who wants one. In principle, **full employment** occurs when everyone who wants to work has a job. In practice, we say that we have full employment when about 95 percent of those wanting to work are employed.

The Unemployment Rate

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

Figure 3.6 "The U.S. Unemployment Rate, 1970–2010" traces the U.S. unemployment rate between 1970 and 2010. Please be aware that there are multiple measures of unemployment and that this graph is based on what is known as U3, the most commonly used measurement. Another measurement, U6, is considered to provide a broader picture of unemployment in the United States. It

includes two groups of people that U3 doesn't: those who are not actively looking for work but would like a job and have looked for one in the last 12 months; and those who would like to work full-time jobs but have settled for part-time positions because full-time work was not available to them. Since by definition, U6 is always higher than U3, it is likely that U3 is discussed more often because it paints a more favorable, if not completely accurate, picture.

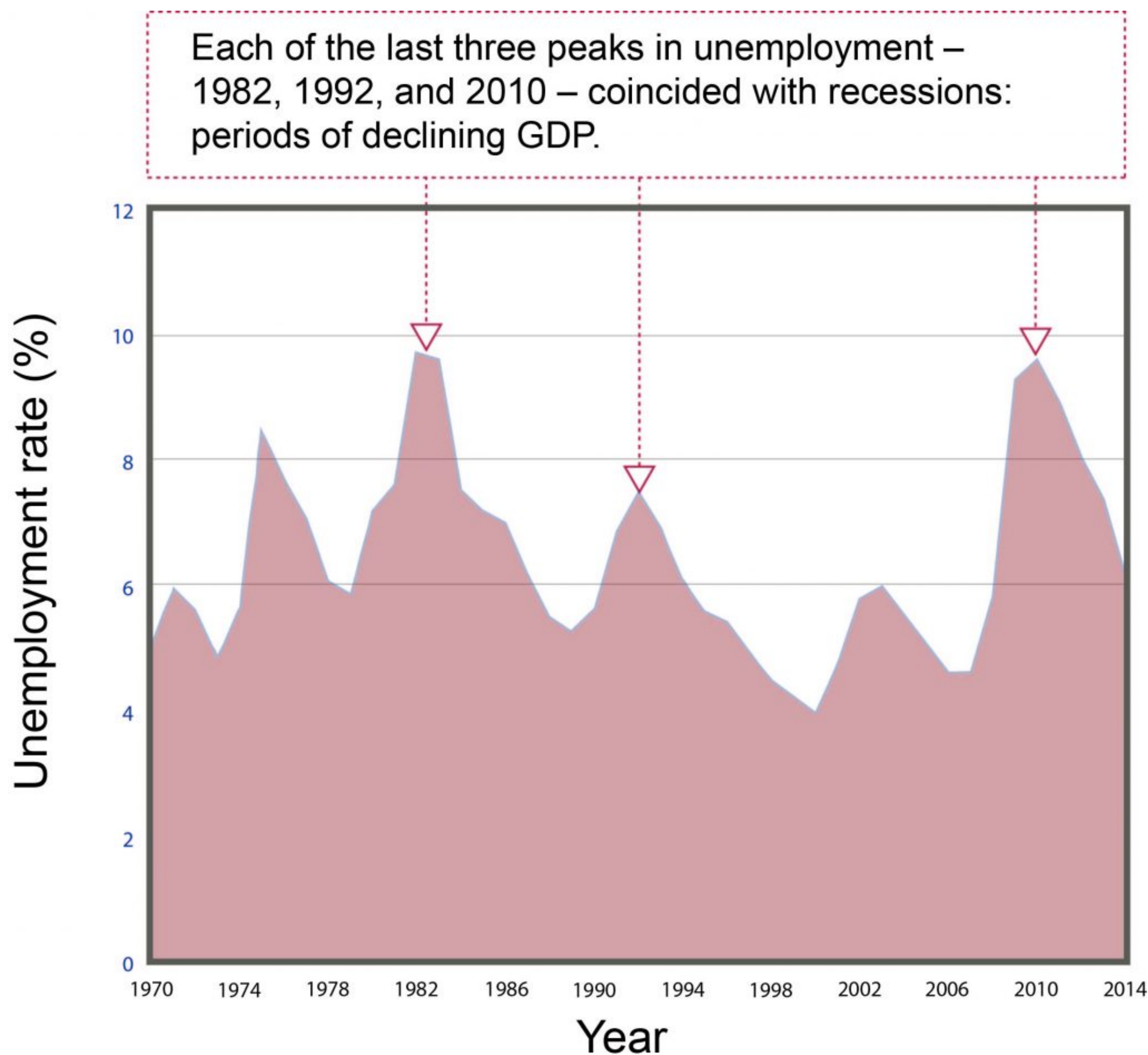


Figure 3.6: The U.S. Unemployment Rate, 1970-2014

Price Stability

A third major goal of all economies is maintaining price stability. Price stability occurs when the average of the prices for goods and services either doesn't change or changes very little. Rapidly rising prices are troublesome for both individuals and businesses. For individuals, rising prices mean people have to pay more for the things they need. For businesses, rising prices mean higher costs, and, at least in the short run, businesses might have trouble passing on higher costs to consumers. When the overall price level goes up, we have **inflation**. Figure 3.7 "The U.S. Inflation Rate, 1960–2010" shows inflationary trends in the U.S. economy since 1960. When the price level goes down (which rarely happens), we have **deflation**. A deflationary situation can also be damaging to an economy. When purchasers believe they can expect lower prices in the future, they may defer making purchases, which has the effect of slowing economic growth (GDP) accompanied by a rise in unemployment. Japan experienced a long period of deflation which contributed to economic stagnation in that country from which it is only now beginning to recover.

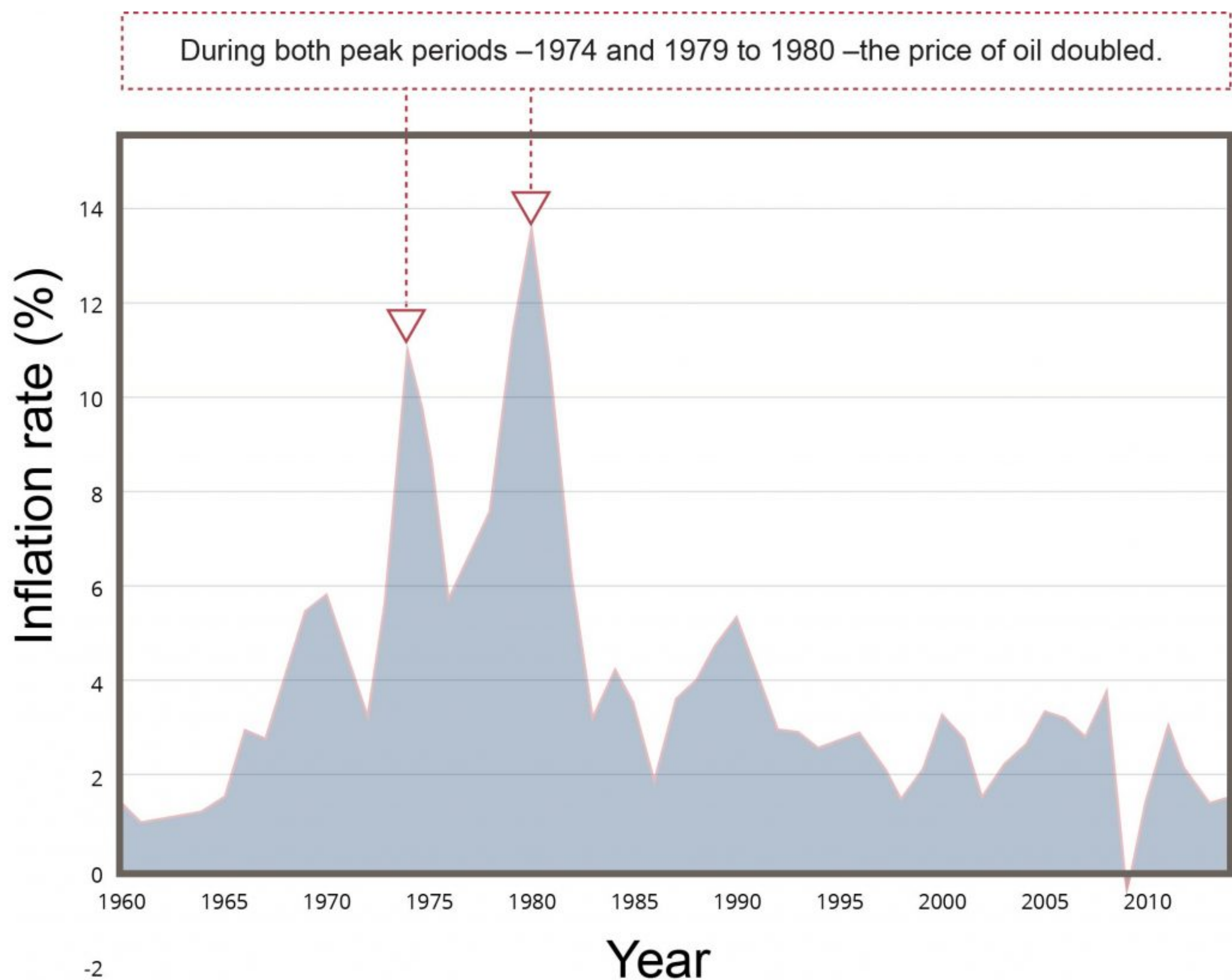


Figure 3.7: The U.S. Inflation Rate, 1960-2014

The Consumer Price Index

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

The CPI base period is 1982 to 1984, which has been given an average value of 100. Figure 3.8 "Selected CPI Values, 1950–2010" gives CPI values computed for selected years. The CPI value for 1950, for instance, is 24. This means that $1 of typical purchases in 1982 through 1984 would have cost $0.24 in 1950. Conversely, you would have needed $2.18 to purchase the same $1 worth of typical goods in 2010. The difference registers the effect of inflation. In fact, that's what an inflation rate is—the percentage change in a price index.

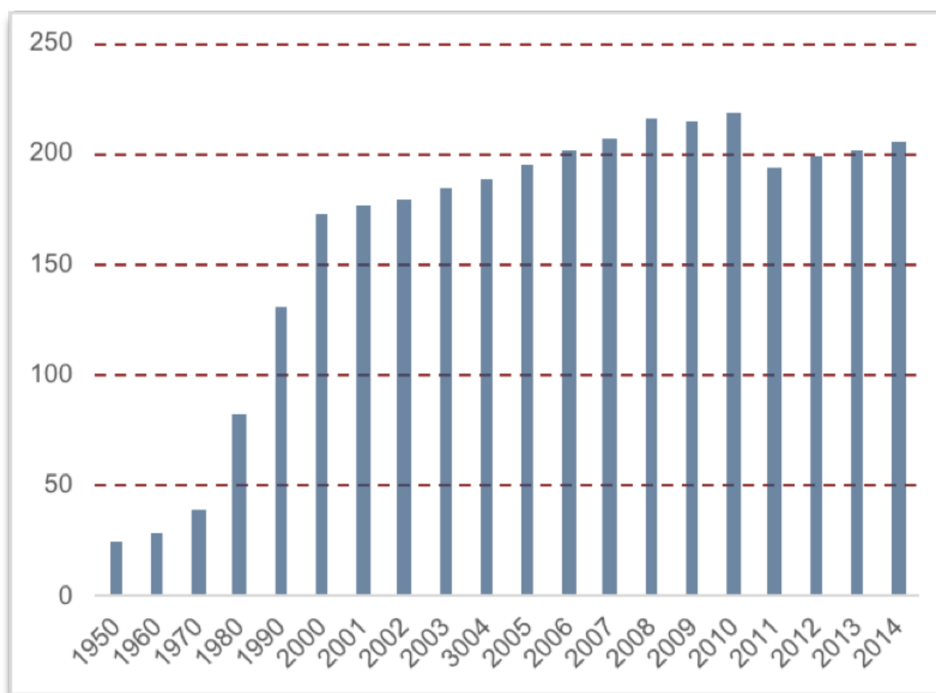


Figure 3.8: Selected CPI Values, 1950-2014

Economic Forecasting

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

Economic Indicators

An **economic indicator** is a statistic that provides valuable information about the economy. There's no shortage of economic indicators, and trying to follow them all would be an overwhelming task. So in this chapter, we'll only discuss the general concept and a few of the key indicators.

Lagging and Leading Indicators

Economists use a variety of statistics to discuss the health of an economy. Statistics that report the status of the economy looking at past data are called **lagging economic indicators**. This type of indicator looks at trends to determine how strong an economy is and its direction. One such indicator is average length of unemployment. If unemployed workers have remained out of work for a long time, we may infer that the economy has been slow. Another lagging indicator is GDP growth. Even if the last several quarters have followed the same trend, though, there is no way to say with confidence that such a trend will necessarily continue.

Indicators that predict the status of the economy three to twelve months into the future are called **leading economic indicators**. If such an indicator rises, the economy is more likely to expand in the coming year. If it falls, the economy is more likely to contract. An example of a leading indicator is the number of permits obtained to build homes in a particular time period. If people intend to build more homes, they will be buying materials like lumber and appliances, and also employ construction workers. This type of indicator has a direct predictive value since it tells us something about what level of activity is likely in a future period.

In addition to housing, it is also helpful to look at indicators from sectors like labor and manufacturing. One useful indicator of the outlook for future jobs is the number of new claims for unemployment insurance. This measure tells us how many people recently lost their jobs. If it's rising, it signals trouble ahead because unemployed consumers can't buy as many goods and services as they could if they had paychecks. To gauge the level of goods to be produced in the future (which will translate into future sales), economists look at a statistic called average weekly manufacturing hours. This measure tells us the average number of hours worked per week by production workers in manufacturing industries. If it's on the rise, the economy will probably improve.

Since employment is such a key goal in any economy, the Bureau of Labor Statistics tracks total non-farm payroll employment from which the number of net new jobs created can be determined.

The Conference Board also publishes a consumer confidence index based on results of a monthly survey of five thousand U.S. households. The survey gathers consumers' opinions on the health of the economy and their plans for future purchases. It's often a good indicator of consumers' future buying intent.

Government's Role in Managing the Economy

Monetary Policy

Monetary policy is exercised by the Federal Reserve System ("the Fed"), which is empowered to take various actions that decrease or increase the money supply and raise or lower short-term interest rates, making it harder or easier to borrow money. When the Fed believes that inflation is a problem, it will use contractionary policy to decrease the money supply and raise interest rates. When rates are higher, borrowers have to pay more for the money they borrow, and banks are more selective in making loans. Because money is "tighter"—more expensive to borrow—demand for goods and services will go down, and so will prices. In any case, that's the theory.

The Fed will typically tighten or decrease the money supply during inflationary periods, making it harder to borrow money.

To counter a recession, the Fed uses expansionary policy to increase the money supply and reduce interest rates. With lower interest rates, it's cheaper to borrow money, and banks are more willing to lend it. We then say that money is "easy." Attractive interest rates encourage businesses to borrow money to expand production and encourage consumers to buy more goods and services. In theory, both sets of actions will help the economy escape or come out of a recession.

Fiscal Policy

Fiscal policy relies on the government's powers of spending and taxation. Both taxation and government spending can be used to reduce or increase the total supply of money in the economy—the total amount, in other words, that businesses and consumers have to spend. When the country is in a recession, government policy is typically to increase spending, reduce taxes, or both. Such expansionary actions will put more money in the hands of businesses and consumers, encouraging businesses to expand and consumers to buy more goods and services. When the economy is experiencing inflation, the opposite policy is adopted: the government will decrease spending or increase taxes, or both. Because such contractionary measures reduce spending by businesses and consumers, prices come down and inflation eases.

The National Debt

If, in any given year, the government takes in more money (through taxes) than it spends on goods and services (for things such as defense, transportation, and social services), the result is a **budget surplus**. If, on the other hand, the government spends more than it takes in, we have a **budget deficit** (which the government pays off by borrowing through the issuance of Treasury bonds). Historically, deficits have occurred much more often than surpluses; typically, the government spends more than it takes in. Consequently, the U.S. government now has a total **national debt** of more than $19 trillion (Note: This number is moving too quickly for the authors to keep the graph current – you can see the current debt at www.usdebtclock.org/).

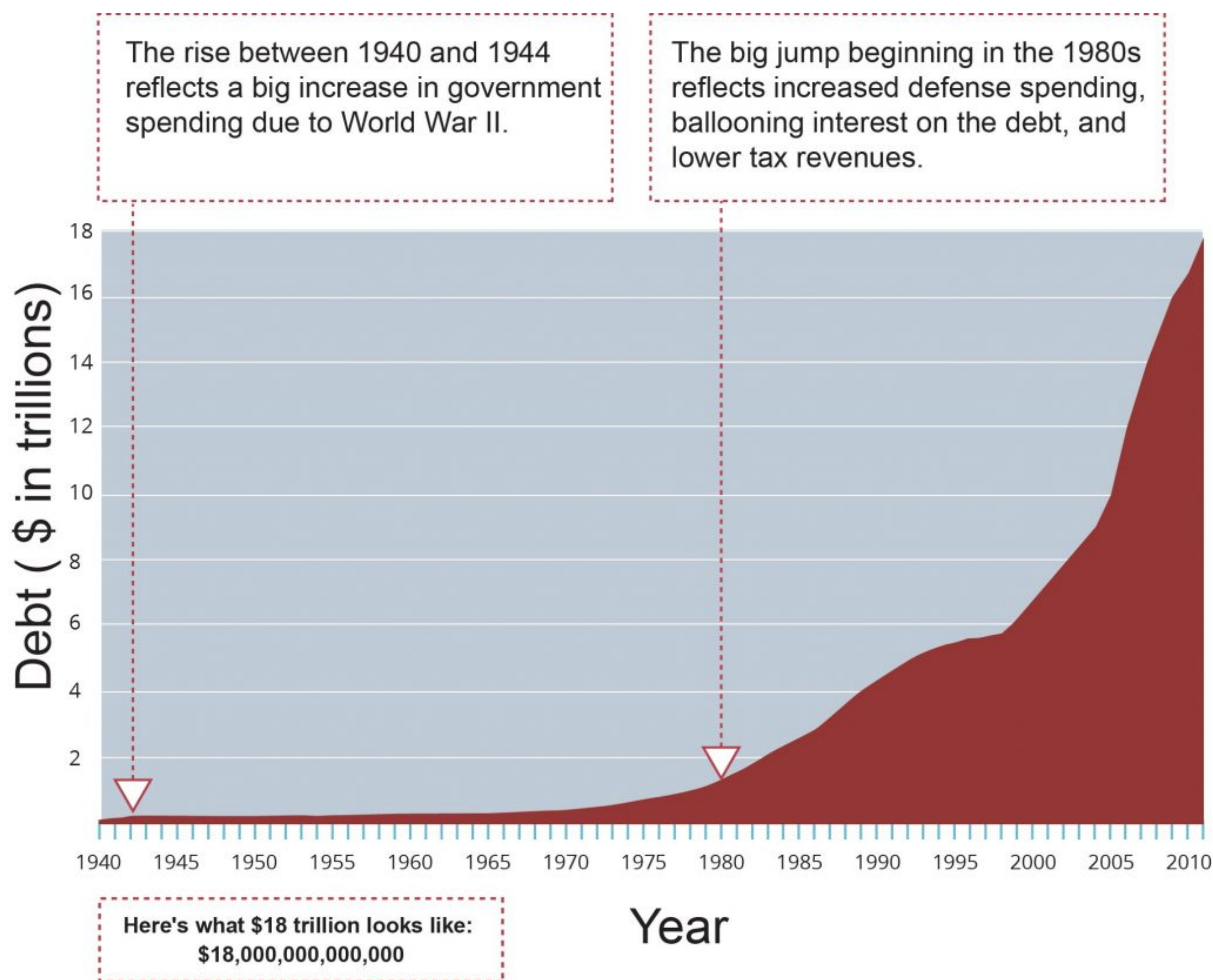
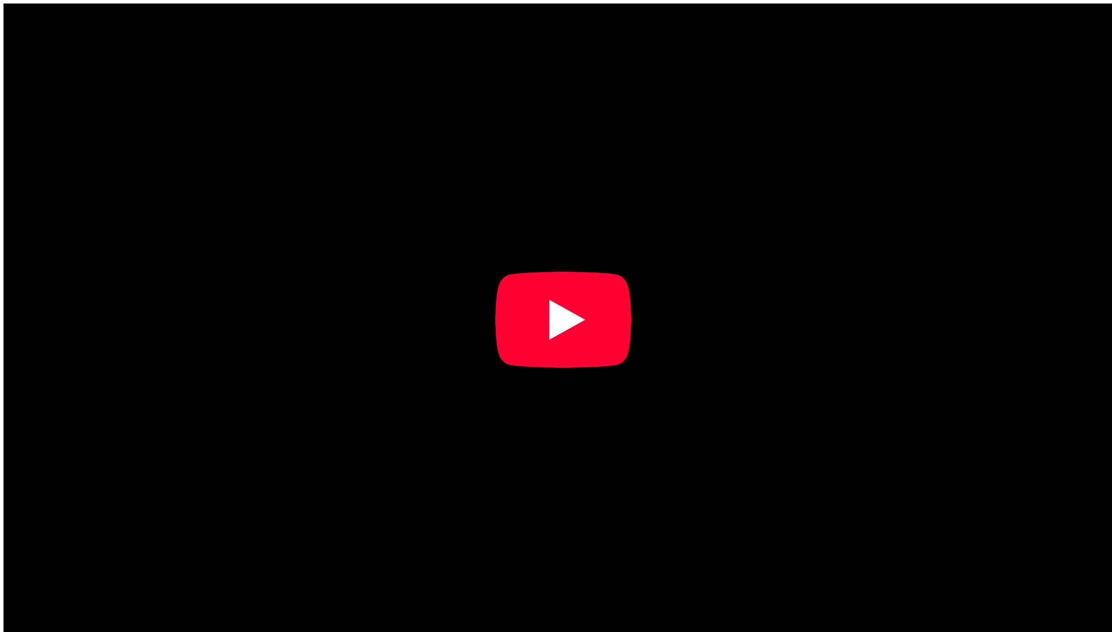


Figure 3.9: The National Debt, 1940-2014

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

Chapter Video

This video presents a balanced view of capitalism and socialism and reinforces key points within the chapter. Since it is rather dry, it would be fine to watch only the first seven minutes or so.



Key Takeaways

1. **Economics** is the study of the production, distribution, and consumption of goods and services.
2. Economists address these three questions: (1) What goods and services should be produced to meet consumer needs? (2) How should they be produced, and who should produce them? (3) Who should receive goods and services?
3. The answers to these questions depend on a country's **economic system**. The primary economic systems that exist today are planned and free-market systems.
4. In a **planned system**, such as communism and socialism, the government exerts control over the production and distribution of all or some goods and services.
5. In a **free-market system**, also known as capitalism, business is conducted with limited government involvement. **Competition** determines what goods and services are produced, how they are produced, and for whom.
6. When the market is characterized by **perfect competition**, many small companies sell identical products. The price is determined by supply and demand. Commodities like corn are an excellent example.
7. **Supply** is the quantity of a product that sellers are willing to sell at various prices. Producers will supply more of a product when prices are high and less when they're low.
8. **Demand** is the quantity of a product that buyers are willing to purchase at various prices; they'll buy more when the price is low and less when it's high.
9. In a competitive market, the decisions of buyers and sellers interact until the market reaches an **equilibrium price**—the price at which buyers are willing to buy the same amount that sellers are willing to sell.

10. There are three other types of competition in a free market system: monopolistic competition, oligopoly, and monopoly.
11. In **monopolistic competition,** there are still many sellers, but products are **differentiated,** e., differ slightly but serve similar purposes. By making consumers aware these differences, sellers exert some control over price.
12. In an **oligopoly**, a few sellers supply a sizable portion of products in the market. They exert some control over price, but because their products are similar, when one company lowers prices, the others follow.
13. In a **monopoly**, there is only one seller in the market. The "market" could be a specific geographical area, such as a city. The single seller is able to control prices.
14. All economies share three goals: growth, high employment, and price stability.
15. To get a sense of where the economy is headed in the future, we use statistics called **economic indicators**. Indicators that report the status of the economy a few months in the past are *lagging* Those that predict the status of the economy three to twelve months in the future are called *leading* indicators.

Chapter 3 Text References and Image Credits

Image Credits: Chapter 3

Figure 3.6: "The U.S. Unemployment Rate, 1970-2014." Data source: Bureau of Labor Statistics. Retrieved from: http://data.bls.gov/timeseries/LNS14000000.

Figure 3.7: "The U.S. Inflation Rate, 1960-2014." Data source: The World Bank. Retrieved from: http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG.

Figure 3.8: "Selected CPI Values, 1950-2014." Data source: U.S. Infaltion Calculator. Retrieved from: http://www.usinflationcalculator.com/inflation/consumer-price-index-and-annual-percent-changes-from-1913-to-2008/.

Figure 3.9: "The National Debt, 1940-2014." Data Source: Treasury Direct. Retrieved from: https://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt.htm.

Video Credits: Chapter 3

Seralius, Guyus. "Capitalism vs Socialism-A Balanced Approach." February 20, 2013. Retrieved from: https://www.youtube.com/watch?v=PBIXmXJwIuk

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4: Forms of Business Ownership

Learning Objectives

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

The Ice Cream Men

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

Figure 4.1: Ben Cohen and Jerry Greenfield in 2010

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

Factors to Consider

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

1. In setting up your business, do you want to minimize the costs of getting started? Do you hope to avoid complex government regulations and reporting requirements?
2. How much control would you like? How much responsibility for running the business are you willing to share? What about sharing the profits?
3. Do you want to avoid special taxes?
4. Do you have all the skills needed to run the business?

5. Are you likely to get along with your co-owners over an extended period of time?
6. Is it important to you that the business survive you?
7. What are your financing needs and how do you plan to finance your company?
8. How much personal exposure to liability are you willing to accept? Do you feel uneasy about accepting personal liability for the actions of fellow owners?

No single form of ownership will give you everything you desire. You'll have to make some trade-offs. Because each option has both advantages and disadvantages, your job is to decide which one offers the features that are most important to you. In the following sections we'll compare three ownership options (sole proprietorship, partnership, corporation) on these eight dimensions.

Sole Proprietorship and its Advantages

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

Disadvantages of Sole Proprietorships

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control is having to supply all the different talents that may be necessary to make the business a success. And when you're gone, the business dissolves. You also have to rely on your own resources for financing: in effect, you are the business and any money borrowed by the business is loaned to you personally. Even more important, the sole proprietor bears **unlimited liability** for any losses incurred by the business. The principle of unlimited personal liability means that if the business incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the owner is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.

Partnership

A **partnership** (or general partnership) is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships[2] and though the vast majority are small, some are quite large. For example, the big four public accounting firms are partnerships. Setting up a partnership is more complex than setting up a sole proprietorship, but it's still relatively easy and inexpensive. The cost varies according to size and complexity. It's possible to form a simple partnership without the help of a lawyer or an accountant, though it's usually a good idea to get professional advice.

Professionals can help you identify and resolve issues that may later create disputes among partners.

The Partnership Agreement

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

- Amount of cash and other contributions to be made by each partner
- Division of partnership income (or loss)
- Partner responsibilities—who does what
- Conditions under which a partner can sell an interest in the company
- Conditions for dissolving the partnership
- Conditions for settling disputes

Unlimited Liability and the Partnership

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

Limited Partnerships

The law permits business owners to form a **limited partnership** which has two types of partners: a single general partner who runs the business and is responsible for its liabilities, and any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

Advantages and Disadvantages of Partnerships

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

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

Corporation

A **corporation** (sometimes called a regular or C-corporation) differs from a sole proprietorship and a partnership because it's a legal entity that is entirely separate from the parties who own it. It can enter into binding contracts, buy and sell property, sue and be sued, be held responsible for its actions, and be taxed. Once businesses reach any substantial size, it is advantageous to organize as a corporation so that its owners can limit their liability. Corporations, then, tend to be far larger, on average, than businesses using other forms of ownership. As Figure 6.2 shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues.[3] Most large well-known businesses are corporations, but so are many of the smaller firms with which likely you do business.

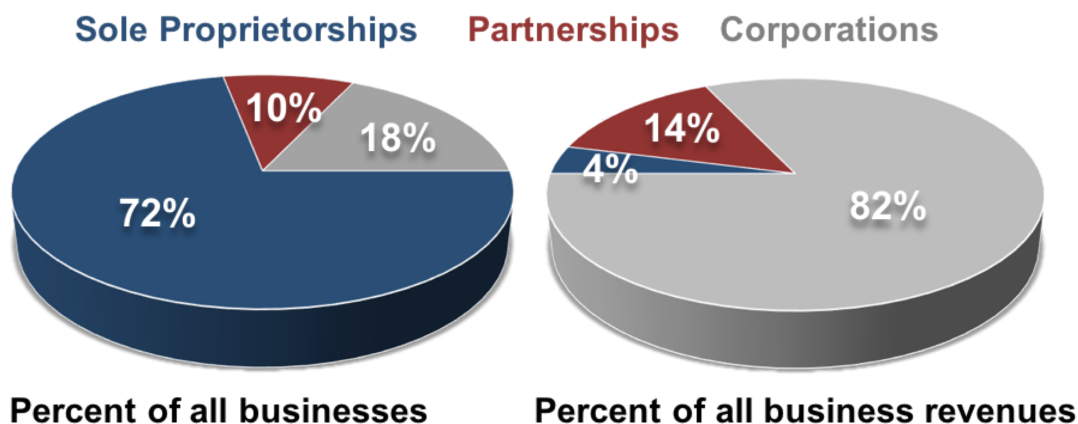


Figure 4.2: Types of U.S. Businesses

Ownership and Stock

Corporations are owned by **shareholders** who invest money in the business by buying shares of **stock**. The portion of the corporation they own depends on the percentage of stock they hold. For example, if a corporation has issued 100 shares of stock, and you own 30 shares, you own 30 percent of the company. The shareholders elect a **board of directors**, a group of people (primarily from outside the corporation) who are legally responsible for governing the corporation. The board oversees the major policies and decisions made by the corporation, sets goals and holds management accountable for achieving them, and hires and

evaluates the top executive, generally called the CEO (**chief executive officer**). The board also approves the distribution of income to shareholders in the form of cash payments called dividends.

Benefits of Incorporation

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

Limited Liability

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

Financial Resources

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

Specialized Management

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

Continuity and Transferability

Another advantage of incorporation is **continuity**. Because the corporation has a legal life separate from the lives of its owners, it can (at least in theory) exist forever.

Transferring ownership of a corporation is easy: shareholders simply sell their stock to others. Some founders, however, want to restrict the transferability of their stock and so choose to operate as a privately-held corporation. The stock in these corporations is held by only a few individuals, who are not allowed to sell it to the general public.

Companies with no such restrictions on stock sales are called public corporations; stock is available for sale to the general public.

Drawbacks to Incorporation

Like sole proprietorships and partnerships, corporations have both positive and negative aspects. In sole proprietorships and partnerships, for instance, the individuals who own and manage a business are the same people. Corporate managers, however, don't necessarily own stock, and shareholders don't necessarily work for the company. This situation can be troublesome if the goals of the two groups differ significantly.

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

Another drawback to incorporation—one that often discourages small businesses from incorporating—is the fact that corporations are more costly to set up. When you combine filing and licensing fees with accounting and attorney fees, incorporating a business could set you back by $1,000 to $6,000 or more depending on the size and scope of your business.[4] Additionally, corporations are subject to levels of regulation and governmental oversight that can place a burden on small businesses. Finally, corporations are subject to what's generally called "**double taxation**." Corporations are taxed by the federal and state governments on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends. Corporate profits are thus taxed twice—the corporation pays the taxes the first time and the shareholders pay the taxes the second time.

Five years after starting their ice cream business, Ben Cohen and Jerry Greenfield evaluated the pros and cons of the corporate form of ownership, and the "pros" won. The primary motivator was the need to raise funds to build a $2 million manufacturing

facility. Not only did Ben and Jerry decide to switch from a partnership to a corporation, but they also decided to sell shares of stock to the public (and thus become a public corporation). Their sale of stock to the public was a bit unusual: Ben and Jerry wanted the community to own the company, so instead of offering the stock to anyone interested in buying a share, they offered stock to residents of Vermont only. Ben believed that "business has a responsibility to give back to the community from which it draws its support."[5] He wanted the company to be owned by those who lined up in the gas station to buy cones. The stock was so popular that one in every hundred Vermont families bought stock in the company.[6] Eventually, as the company continued to expand, the stock was sold on a national level.

Other Types of Business Ownership

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

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

Limited-Liability Companies

How would you like a legal form of organization that provides the attractive features of the three common forms of organization (corporation, sole proprietorship and partnership) and avoids the unattractive features of these three organization forms? The **limited-liability company(LLC)** accomplishes exactly that. This form provides business owners with limited liability (a key advantage of corporations) and no "double taxation" (a key advantage of sole proprietorships and partnerships). Let's look at the LLC in more detail.

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

In a limited-liability company, owners (called members rather than shareholders) are not personally liable for debts of the company, and its earnings are taxed only once, at the personal level (thereby eliminating double taxation).

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

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

Not-for-Profit Corporations

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

There are more than 1.5 million not-for-profit organizations in the United States.[7] Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately $40 billion and has given away $36.7 billion since its inception.[8] Others are nationally recognized, such as United Way, Goodwill Industries, Habitat for Humanity, and the Red Cross. Yet the vast majority is neither rich nor famous, but nevertheless makes significant contributions to society.

Mergers and Acquisitions

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

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

Mergers and Acquisitions

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

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

Motives behind Mergers and Acquisitions

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

Gain Complementary Products

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

Attain New Markets or Distribution Channels

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

Realize Synergies

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

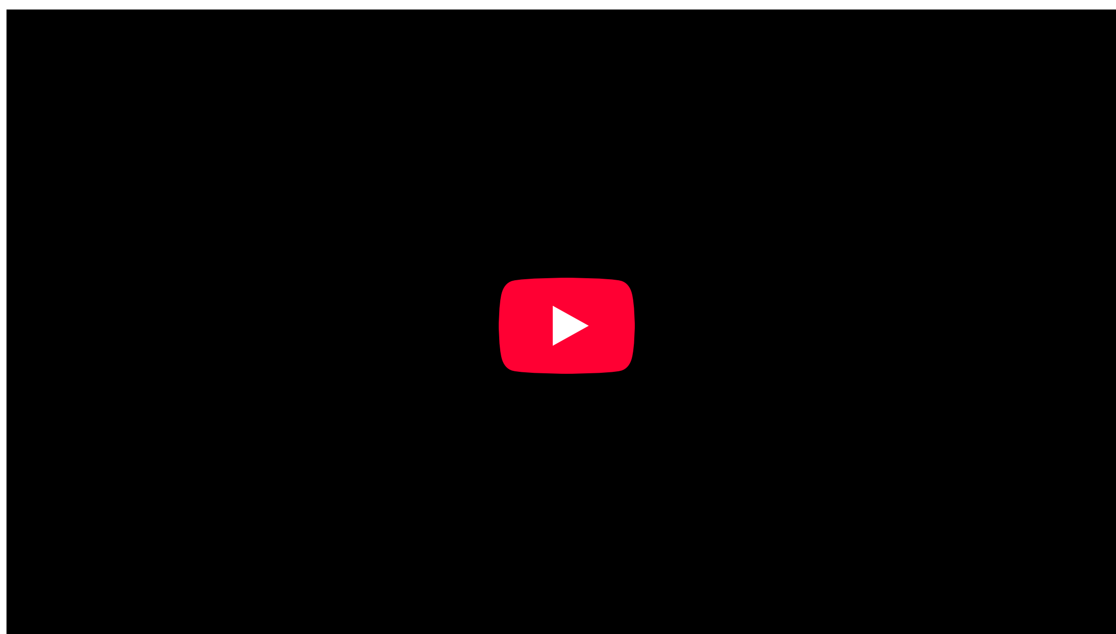
In pursuing these acquisitions, Pfizer likely identified many **synergies**: quite simply, a whole that is greater than the sum of its parts. There are many examples of synergies. A merger typically results in a number of redundant positions; the combined company does not likely need two vice-presidents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

Hostile Takeover

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

Chapter Video: Business Structures

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



Key Takeaways

1. A **soleproprietorship,** a business owned by only one person, accounts for 72% of all U.S. businesses.
2. Advantages include: complete control for the owner, easy and inexpensive to form, and owner gets to keep all of the profits.

3. Disadvantages include: unlimited liability for the owner, complete responsibility for talent and financing, and business dissolves if the owner dies.
4. A **general partnership** is a business owned jointly by two or more people, and accounts for about 10% of all U.S. businesses.
5. Advantages include: more resources and talents come with an increase in partners, and the business can continue even after the death of a partner.
6. Disadvantages include: partnership disputes, unlimited liability, and shared profits.
7. A **limited partnership** has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.
8. A **corporation** is a legal entity that's separate from the parties who own it, the shareholders who invest by buying shares of stock. Corporations are governed by a Board of Directors, elected by the shareholders.
9. Advantages include: limited liability, easier access to financing, and unlimited life for the corporation.
10. Disadvantages include: the agency problem, double taxation, and incorporation expenses and regulations.
11. A **limited-liabilitycompany** (LLC) is a business structure that combines the tax treatment of a partnership with the liability protection of a corporation.
12. A **not-for-profitcorporation** is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.
13. A **merger** occurs when two companies combine to form a new company.
14. An **acquisition** is the purchase of one company by another with no new company being formed. A hostile takeover occurs when a company is purchased even though the company's management and Board of Directors do not want to be acquired.

Chapter 4 Text References and Image Credits

Image Credits: Chapter 4

Figure 4.1: Dismas (2010).**"**Ben Cohen and Jerry Greenfield in 2010**."** CC by SA 3.0***Retrieved from:*** https://en.Wikipedia.org/wiki/Ben_%26_Jerry%27s – /media/File:Ben_and_Jerry.jpg**.**

Figure 4.2: "Types of U.S. Businesses." Data source: "Number of Tax Returns, Receipts, and Net Income by Type of Business." *Census.gov*. Retrieved from: www.census.gov/prod/2011pubs/12statab/business.pdf

Video Credits: Chapter 4

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

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5: Entrepreneurship - Starting a Business

Learning Objectives

1. Define entrepreneur and describe the three characteristics of entrepreneurial activity.
2. Identify five potential advantages to starting your own business
3. Define a small business and explain the importance of small businesses to the U.S. economy.
4. Explain why small businesses tend to foster innovation more effectively than large ones.
5. Describe the goods-producing and service-producing sectors of an economy.
6. Explain what it takes to start a business and evaluate the advantages and disadvantages starting a business from scratch, buying an existing business, or obtaining a franchise.
7. Explain why some businesses fail.
8. Identify sources of small business assistance from the Small Business Administration.

Cover Story: Build a Better "Baby" and They Will Come

One balmy San Diego evening in 1993, Mary and Rick Jurmain were watching a TV program about teenage pregnancy.[1] To simulate the challenge of caring for an infant, teens on the program were assigned to tend baby-size sacks of flour. Rick, a father of two young children, remarked that trundling around a sack of flour wasn't exactly a true- to-life experience. In particular, he argued, sacks of flour simulated only abnormally happy babies—babies who didn't cry, especially in the middle of the night. Half-seriously, Mary suggested that her husband—a between-jobs aerospace engineer— build a better baby, and within a couple of weeks, a prototype was born. Rick's brainchild was a bouncing 6.5-pound bundle of vinyl-covered joy with an internal computer to simulate infant crying at realistic, random intervals. He also designed a drug-affected model to simulate tremors from withdrawal, and each model monitored itself for neglect or ill treatment.

The Jurmains patented Baby Think It Over and started production in 1994 as Baby Think It Over Inc. Their first "factory" was their garage, and the "office" was the kitchen table—"a little business in a house," as Mary put it. With a boost from articles in USA Today, Newsweek, Forbes, and People—plus a "Product of the Year" nod from Fortune—news of the Jurmains' "infant simulator" eventually spread to the new company's targeted education market, and by 1998, some forty thousand simulators had been babysat by more than a million teenagers in nine countries. By that time, the company had moved to Wisconsin, where it had been rechristened BTIO Educational Products Inc. to reflect an expanded product line that now includes not only dolls and equipment, like the Shaken Baby Syndrome Simulator, but also simulator-based programs like START Addiction Education and Realityworks Pregnancy Profile. BTIO was retired and replaced by the new and improved RealCare Baby and, ultimately, by RealCare Baby II–Plus, which requires the participant to determine what the "baby" needs when it cries and downloads data to record misconduct. In 2003, the name of the Jurmains' company was changed once again, this time to Realityworks Inc.

In developing BTIO and Realityworks Inc., the Jurmains were doing what entrepreneurs do (and doing it very well). In fact, Mary was nominated three times for the Ernst & Young Entrepreneur of the Year Award and named 2001 Wisconsin Entrepreneurial Woman of the Year by the National Association of Women Business Owners. So what, exactly, is an entrepreneur and what does one do? According to one definition, an entrepreneur is an "individual who starts a new business" – and that's true. Another definition identifies an entrepreneur as someone who "uses resources to implement innovative ideas for new, thoughtfully planned ventures."[2] But an important component of a satisfactory definition is still missing. To appreciate fully what it is, let's go back to the story of the Jurmains. In 1993, the Jurmains were both unemployed—Rick had been laid off by General Dynamics Corp., and Mary by the San Diego Gas and Electric Company. While they were watching the show about teenagers and flour sacks, they were living off a loan from her father and the returns from a timely investment in coffee futures. Rick recalls that the idea for a method of creating BTIO came to him while "I was awake in bed, worrying about being unemployed." He was struggling to find a way to feed his family. He had to make the first forty simulators himself, and at the end of the first summer, BTIO had received about four hundred orders—a promising start, perhaps, but, at $250 per baby (less expenses), not exactly a windfall. "We were always about one month away from bankruptcy," recalls Mary.

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

risk. Risk taking is the missing component that we're looking for in a definition of entrepreneurship, and so we'll define an entrepreneur as someone who identifies a business opportunity and assumes the risk of creating and running a business to take advantage of it. To be successful, entrepreneurs must be comfortable accepting risk, and positive and confident that they can manage through it successfully.

The Nature of Entrepreneurship

If we look a little more closely at the definition of **entrepreneurship**, we can identify three characteristics of entrepreneurial activity:[3]

1. **Innovation**. Entrepreneurship generally means offering a new product, applying a new technique or technology, opening a new market, or developing a new form of organization for the purpose of producing or enhancing a product.
2. **Running a business**. A business, as we saw in Chapter 1 "The Foundations of Business," combines resources to produce goods or services. Entrepreneurship means setting up a business to make a profit.
3. **Risktaking**. 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 is easy to recognize 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 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 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

Mark Zuckerberg founded Facebook while a student at Harvard. By age 27 he built up a personal wealth of $13.5 billion. By age 31, his net worth was $37.5 billion.

Figure 5.1: Facebook founder Mark Zuckerberg

So what about you? Do you ever wonder what it would be like to start your own business? You might even turn into a "serial entrepreneur" like Marcia Kilgore.[4] After high school, she moved from Canada to New York City to attend Columbia University. But when her financial aid was delayed, Marcia 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 complexion and wanted to know how to treat it herself. She learned how to give facials and work with natural remedies. 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.[5]

But the story doesn't end here; 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. Oprah loves Kilgore's sandals and plugged them on her show.[6] You can't get a better endorsement than that. Kilgore never did finish college, but when asked if she would follow the same path again, she said, "If I had to decide what to do all over again, I would make the same choices…I found by accident what I'm good at, and I'm glad I did."

So, a few questions to consider if you want to go into business for yourself:

- 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?
- What steps are involved in developing a business plan?
- Where could I find help in getting my business started?
- How can I increase the likelihood that I'll succeed?

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

Why Start Your Own Business?

What sort of characteristics distinguishes those who start businesses from those who don't? Or, more to the point, why do some people actually follow through on the desire to start up their own businesses? The most common reasons for starting a business are the following:

- 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** (SBA) points out, though, that these are likely to be advantages only "for the right person." 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:[7]

- Am I a self-starter? You'll need to develop and follow through on your ideas.
- How well do I get along with different personalities? Strong working relationships with a variety of people are crucial.
- How good am I at making decisions? Especially under pressure…..
- Do I have the physical and emotional stamina? Expect six or seven work days of about twelve hours every week.
- How well do I plan and organize? Poor planning is the culprit in most business failures.
- How will my business affect my family? Family members need to know what to expect: long hours and, at least initially, a more modest standard of living.

Before we discuss why businesses fail we should consider why 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:[8]

- **Money**. Without cash, you can't get very far. What to do: line up initial financing early or at least have done enough research to have a plan to raise money.
- **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. Run the business part-time or connect with someone to help run your business – a "co-founder".
- **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. Find a solution to something that annoys you – entrepreneurs call this a "pain point" – and try to turn it into a business.

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

Sources of Early-Stage Financing

As noted above, many businesses fail, or never get started, due to a lack of funds. But where can an entrepreneur raise money to start a business? Many first-time entrepreneurs are financed by friends and family, at least in the very early stages. Others may borrow through their personal credit cards, though quite often, high interest rates make this approach unattractive or too expensive for the new business to afford.

An entrepreneur with a great idea may win funding through a pitch competition; localities and state agencies understand that economic growth depends on successful new businesses, and so they will often conduct such competitions in the hopes of attracting them.

Crowd funding has become more common as a means of raising capital. An entrepreneur using this approach would typically utilize a crowd-funding platform like Kickstarter to attract investors. The entrepreneur might offer tokens of appreciation in exchange for funds, or perhaps might offer an ownership stake for a substantial enough investment.

Some entrepreneurs receive funding from **angel investors**, affluent investors who provide capital to start-ups in exchange for an ownership position in the company. Many angels are successful entrepreneurs themselves and invest not only to make money, but also to help other aspiring business owners to succeed.

Venture capital firms also invest in start-up companies, although usually at a somewhat later stage and in larger dollar amounts than would be typical of angel investors. Like angels, venture firms also take an ownership position in the company. They tend to have a higher expectation of making a return on their money than do angel investors.

Distinguishing Entrepreneurs from Small Business Owners

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

In contrast, many people either start or buy small businesses for the sole purpose of providing an income for themselves and their families. They do not intend to be particularly innovative, nor do they plan to expand significantly. This desire to operate is what's sometimes called a "lifestyle business."[9] The neighborhood pizza parlor or beauty shop, the self-employed consultant who works out of the home, and even a local printing company—many of these are typically lifestyle businesses.

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, we first need to know what constitutes a small business. Let's start by looking at the criteria used by the Small Business Administration. According to the SBA, a **small business** is one that is independently owned and operated, exerts little influence in its industry, and (with a few exceptions) has fewer than five hundred employees.[10]

Why Are Small Businesses Important?

Small business constitutes a major force in the U.S. economy. There are more than 28 million small businesses in this country, and they generate about 54 percent of sales and 55 percent of jobs in the U.S.[11] 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), and Larry Page and Sergey Brin (Google), have changed the way business is done today.

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. Although the split between those working in small companies and those working in big companies is about even, small firms hire more frequently and fire more frequently than do big companies.[12] Why is this true? At any given point in time, lots of small companies are started and some expand. These small companies need workers and so hiring takes place. But the survival and expansion rates for small firms is poor, and so, again at any given point in time, many small businesses close or contract and workers lose their jobs. Fortunately, over time more jobs are added by small firms than are taken away, which results in a net increase in the number of workers, as seen in Figure 5.2.

Figure 5.2: Small Business Job Gains and Losses, 2000-2015 (in millions of jobs)

New business opening (closings)	Business expansions (contractions)	Total
34.3	237.5	
(33.1)	(233.9)	
+1.2	+3.6	+4.8

The size of the net increase in the number of workers for any given year depends on a number of factors, with the economy being at the top of the list. A strong economy encourages individuals to start small businesses and expand existing small companies, which adds to the workforce. A weak economy does just the opposite: discourages start-ups and expansions, which decreases the workforce through layoffs. Figure 7.4 reports the job gains from start-ups and expansions and job losses from business closings and contractions.

Innovation

Given the financial resources available to large businesses, you'd expect them to introduce virtually all the new products that hit the market. Yet 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, while small firms generated an impressive 26.5 patents per employee.[13] Over the years, the list of important innovations by small firms has included the airplane, air-conditioning, DNA "fingerprinting", and overnight national delivery.[14]

Figure 5.3: Amazon.com annual revenue growth (revenue shown in millions of dollars)

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' new company—Amazon.com—reached half a million dollars. In less than twenty years, annual sales had topped $107 billion.[15] Not only did his innovative approach to online retailing make Bezos enormously rich, but it also established a viable model for the e-commerce industry.

Why are small businesses so innovative? For one thing, they tend to offer environments that appeal to individuals with the talent to invent new products or improve the way things are done. Fast decision making is encouraged, their research programs tend to be focused, and their compensation structures typically reward top performers.

According to one SBA study, the supportive environments of small firms are roughly thirteen times more innovative per employee than the less innovation-friendly environments in which large firms traditionally operate.[16]

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

https://biz.libretexts.org/@go/page/90719

owned by women and minorities. Figure 5.4 gives you an idea of how many American businesses are owned by women and minorities, and indicates how much the numbers grew between 2007 and 2012.

Figure 5.4: Businesses Owned by Women and Minorities

Business Owners	2007 % of all Businesses	2012 % of all Businesses	Increase
Women	28.8	35.8	7.0
Hispanic Americans	8.3	12.0	3.7
African Americans	7.1	9.4	2.3
Asian Americans	5.7	6.9	1.2

What Industries Are Small Businesses In?

If you want to start a new business, you probably should avoid certain types of businesses. You'd have a hard time, for example, setting up a new company to make automobiles or aluminum, because you'd have to make tremendous investments in property, plant, and equipment, and raise an enormous amount of capital to pay your workforce. These large, up-front investments present barriers to entry.

Fortunately, plenty of opportunities are still available. Many types of businesses require reasonable initial investments, and not surprisingly, these are the ones that usually present attractive small business opportunities.

Industries by Sector

Let's define an **industry** as a group of companies that compete with one another to sell similar products. We'll focus on the relationship between a small business and the industry in which it operates, dividing businesses into two broad types of industries, or sectors: the goods-producing sector and the service-producing sector.

- The **goods-producing sector** includes all businesses that produce tangible goods. Generally speaking, companies in this sector are involved in manufacturing, construction, and agriculture.
- The **service-producing sector** includes all businesses that provide services but don't make tangible goods. They may be involved in retail and wholesale trade, transportation, finance, entertainment, recreation, accommodations, food service, and any number of other ventures.

About 20% of small businesses in the United States are concentrated in the goods-producing sector. The remaining 80% are in the service sector.[17] The high concentration of small businesses in the service-producing sector reflects the makeup of the overall U.S. economy. Over the past fifty years, the service-producing sector has been growing at an impressive rate. In 1960, for example, the goods-producing sector accounted for 38 percent of GDP, the service-producing sector for 62 percent. By 2015, the balance had shifted dramatically, with the goods-producing sector accounting for only about 21 percent of GDP.[18]

Goods-Producing Sector

The largest areas of the goods-producing sector are construction and manufacturing. Construction businesses are often started by skilled workers, such as electricians, painters, plumbers, and home builders, and they generally work on local projects. Though manufacturing is primarily the domain of large businesses, there are exceptions. BTIO/Realityworks, for example, is a manufacturing enterprise (components come from Ohio and China, and assembly is done in Wisconsin).

How about making something out of trash? Daniel Blake never followed his mother's advice at dinner when she told him to eat everything on his plate. When he served as a missionary in Puerto Rico, Aruba, Bonaire, and Curacao after his first year in college, he noticed that the families he stayed with didn't either. But they didn't throw their uneaten food into the trash. Instead they put it on a compost pile and used the mulch to nourish their vegetable gardens and fruit trees. While eating at an all-you-can-eat breakfast buffet back home at Brigham Young University, Blake was amazed to see volumes of uneaten food in the trash. This triggered an idea: why not turn the trash into money? Two years later, he was running his company—EcoScraps—collecting 40 tons of food scraps a day from 75 grocers and turning it into high-quality potting soil that he sells online and to nurseries. His profit has reach almost half a million dollars on sales of $1.5 million.[19]

Service-Producing Sector

Many small businesses in this sector are **retailers**—they buy goods from other firms and sell them to consumers, in stores, by phone, through direct mailings, or over the Internet. In fact, entrepreneurs are turning increasingly to the Internet as a venue for start-up ventures. Take Tony Roeder, for example, who had a fascination with the red Radio Flyer wagons that many of today's adults had owned as children. In 1998, he started an online store through Yahoo! to sell red wagons from his home. In three years, he turned his online store into a million-dollar business.[20]

Other small business owners in this sector are **wholesalers**—they sell products to businesses that buy them for resale or for company use. A local bakery, for example, is acting as a wholesaler when it sells desserts to a restaurant, which then resells them to its customers. A small business that buys flowers from a local grower (the manufacturer) and resells them to a retail store is another example of a wholesaler.

A high proportion of small businesses in this sector provide professional, business, or personal services. Doctors and dentists are part of the service industry, as are insurance agents, accountants, and lawyers. So are businesses that provide personal services, such as dry cleaning and hairdressing.

David Marcks, for example, entered the service industry about fourteen years ago when he learned that his border collie enjoyed chasing geese at the golf course where he worked. While geese are lovely to look at, they can make a mess of tees, fairways, and greens. That's where Marcks' company, Geese Police, comes in: Marcks employs specially trained dogs to chase the geese away. He now has twenty-seven trucks, thirty-two border collies, and five offices. Golf courses account for only about 5 percent of his business, as his dogs now patrol corporate parks and playgrounds as well.[21] Figure 5.5 provides a more detailed breakdown of small businesses by industry.

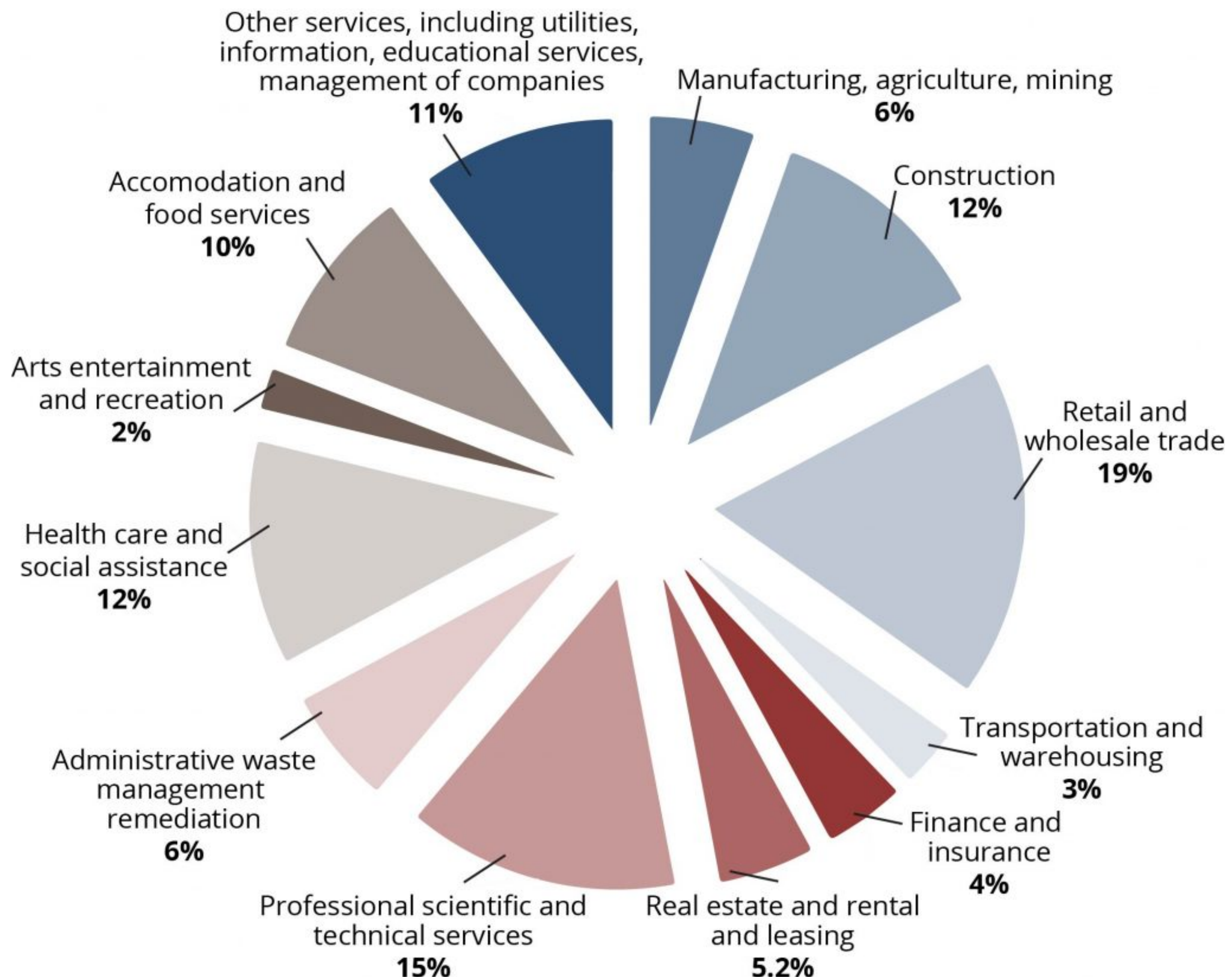

Figure 5.5: Small Businesses by Industry, 2012

Advantages and Disadvantages of Business Ownership

Do you want to be a business owner someday? Before deciding, you might want to consider the following advantages and disadvantages of business ownership.[22]

Advantages of Small Business Ownership

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

- **Independence**. As a business owner, you're your own boss. You can't get fired. More importantly, you have the freedom to make the decisions that are crucial to your own business success.
- **Lifestyle**. Owning a small business gives you certain lifestyle advantages. Because you're in charge, you decide when and where you want to work. If you want to spend more time on non-work activities or with your family, you don't have to ask for the time off. Given today's technology, if it's important that you be with your family all day, you can run your business from your home.
- **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, etc.. 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. 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.[23]

Starting a Business

Starting a business takes talent, determination, hard work, and persistence. It also requires a lot of research and planning. Before starting your business, you should appraise your strengths and weaknesses and assess your personal goals to determine whether business ownership is for you.[24]

Questions to Ask Before You Start a Business

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

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

- What, exactly, is my business idea? Is it feasible?
- What industry do I want to enter?
- What will be my competitive advantage?
- Do I want to start a new business, buy an existing one, or buy a franchise?
- What form of business organization do I want?

After making these decisions, you'll be ready to take the most important step in the entire process of starting a business: you must describe your future business in the form of a **business plan**—a document that identifies the goals of your proposed business and explains how these goals will be achieved. Think of a business plan as a blueprint for a proposed company: it shows how you intend to build the company and how you intend to make sure that it's sturdy. You must also take a second crucial step before you actually start up your business: You need to get **financing**—the money that you'll need to get your business off the ground.

The Business Idea

For some people, coming up with a great **business idea** is a gratifying adventure. For most, however, it's a daunting task. The key to coming up with a business idea is identifying something that customers want—or, perhaps more importantly, filling an **unmet need**. Your business will probably survive only if its purpose is to satisfy its customers—the ultimate users of its goods or services. In coming up with a business idea, don't ask, "What do we want to sell?" but rather, "What does the customer want to buy?"[25]

To come up with an innovative business idea, you need to be creative. If your idea is innovative enough, it may be considered **intellectualproperty,** a right that can be protected under the law. Prior **experience** accounts for the bulk of new business idea and also increases your chances of success. Take Sam Walton, the late founder of Wal-Mart. He began his retailing career at JCPenney and then became a successful franchiser of a Ben Franklin five-and-dime store. In 1962, he came up with the idea of opening large stores in rural areas, with low costs and heavy discounts. He founded his first Wal-Mart store in 1962, and when he died thirty years later, his family's net worth was $25 billion.[26]

Industry experience also gave Howard Schultz, a New York executive for a housewares company, his breakthrough idea. In 1981, Schultz noticed that a small customer in Seattle—Starbucks Coffee, Tea and Spice—ordered more coffeemaker cone filters than Macy's and many other large customers. So he flew across the country to find out why. His meeting with the owner-operators of the original Starbucks Coffee Co. resulted in his becoming part-owner of the company. Schultz's vision for the company far surpassed that of its other owners. While they wanted Starbucks to remain small and local, Schultz saw potential for a national business that not only sold world-class-quality coffee beans but also offered customers a European coffee-bar experience. After attempting unsuccessfully to convince his partners to try his experiment, Schultz left Starbucks and started his own chain of coffee bars, which he called Il Giornale (after an Italian newspaper). Two years later, he bought out the original owners and reclaimed the name Starbucks.[27]

Figure 5.6: The original Starbucks store in Seattle, Washington

Ownership Options

As we've already seen, you can become a small business owner in one of three ways— by starting a new business, buying an existing one, or obtaining a franchise. Let's look more closely at the advantages and disadvantages of each option.

Starting from Scratch

The most common—and the riskiest—option is **starting from scratch**. This approach lets you start with a clean slate and allows you to build the business the way you want. You select the goods or services that you're going to offer, secure your location, and hire your employees, and then it's up to you to develop your customer base and build your reputation. This was the path taken by Andres Mason who figured out how to inject hysteria into the process of bargain hunting on the Web. The result is an overnight success story called Groupon.[28] Here is how Groupon (a blend of the words "group" and "coupon") works: A daily email is sent to 6.5 million people in 70 cities across the United States offering a deeply discounted deal to buy something or to do something in their city. If the person receiving the email likes the deal, he or she commits to buying it. But, here's the catch, if not enough people sign up for the deal, it is cancelled. Groupon makes money by keeping half of the revenue from the deal. The company offering the product or service gets exposure. But stay tuned: the "daily deals website isn't just unprofitable—it's bleeding hundreds of millions of dollars."[29] As with all start-ups cash is always a challenge.

Buying an Existing Business

If you decide to **buy an existing business**, some things will be easier. You'll already have a proven product, current customers, active suppliers, a known location, and trained employees. You'll also find it much easier to predict the business's future success.

There are, of course, a few bumps in this road to business ownership. First, it's hard to determine how much you should pay for a business. You can easily determine how much things like buildings and equipment are worth, but how much should you pay for the fact that the business already has steady customers?

In addition, a business, like a used car, might have performance problems that you can't detect without a test drive (an option, unfortunately, that you don't get when you're buying a business). Perhaps the current owners have disappointed customers; maybe the location isn't as good as it used to be. You might inherit employees that you wouldn't have hired yourself. Careful study called due diligence is necessary before going down this road.

Getting a Franchise

Lastly, you can buy a **franchise**. A **franchiser** (the company that sells the franchise) grants the **franchisee** (the buyer—you) the right to use a brand name and to sell its goods or services. Franchises market products in a variety of industries, including food, retail, hotels, travel, real estate, business services, cleaning services, and even weight-loss centers and wedding services. Figure 5.7 lists the top ten franchises according to *Entrepreneur* magazine for 2015 and 2016.

Figure 5.7: Entrepreneur's Franchise 500 Top Franchises, 2015 and 2016

Ranking	2015	2016
1	Hampton by Hilton	Jimmy John's
2	Anytime Fitness	Hampton by Hilton
3	Subway	Supercuts
4	Jack in the Box	Servpro
5	Supercuts	Subway
6	Jimmy John's	McDonald's
7	Servpro	7-Eleven
8	Denny's	Dunkin Donuts
9	Pizza Hut	Denny's
10	7-Eleven	Anytime Fitness

As you can see from Figure 5.8 on the next page, the popularity of franchising has been growing quickly since 2011. Although the economic downturn decreased the number of franchises between 2008-11, note that the overall value of franchise outputs steadily increased. A new franchise outlet opens once every eight minutes in the United States, where one in ten businesses is now a franchise. Franchises employ eight million people (13 percent of the workforce) and account for 17 percent of all sales in the U.S. ($1.3 trillion).[30]

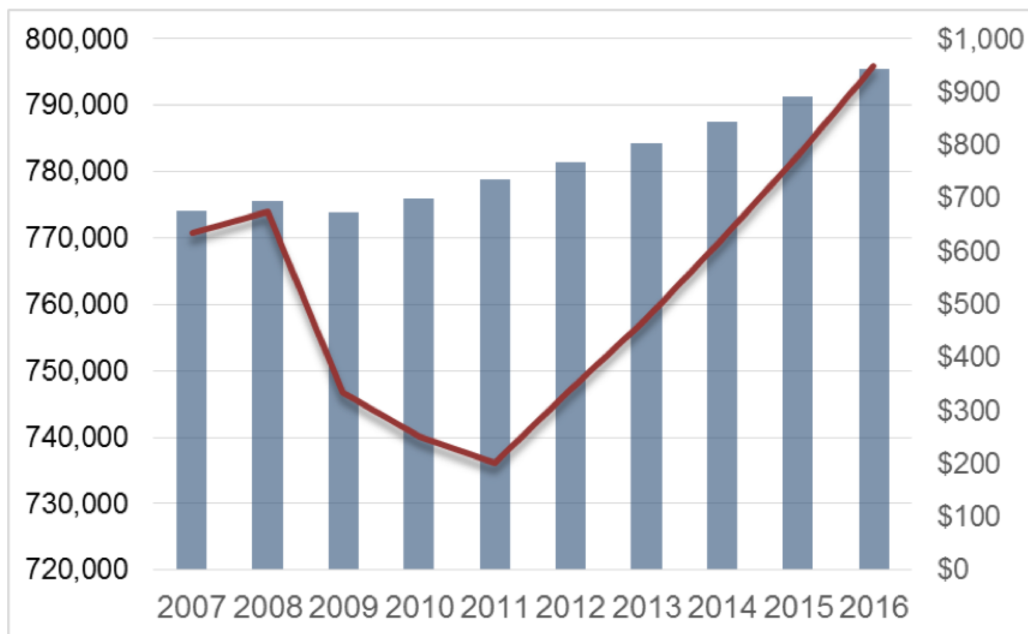

Figure 5.8: The growth of Franchising in the U.S.

In addition to the right to use a company's brand name and sell its products, the franchisee gets help in picking a location, starting and operating the business, and benefits from advertising done by the franchiser. Essentially, the franchisee buys into a ready-to-go business model that has proven successful elsewhere, also getting other ongoing support from the franchiser, which has a vested interest in her success.

Coming with so many advantages, franchises can be very expensive. KFC franchises, for example, require a total investment of $1.3 million to $2.5 million each. This fee includes the cost of the property, equipment, training, start-up costs, and the franchise fee—a one-time charge for the right to operate as a KFC outlet. McDonald's is in the same price range ($1 million to $2.3 million). SUBWAY sandwich shops offer a more affordable alternative, with expected total investment ranging from $116,000 to $263,000.[31]

In addition to your initial investment, you'll have to pay two other fees on a monthly basis—a **royalty fee** (typically from 3 to 12 percent of sales) for continued support from the franchiser and the right to keep using the company's trade name, plus an advertising fee to cover your share of national and regional advertising. You'll also be expected to buy your products from the franchiser.[32]

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

Launching a Business from the Inside

When someone mentions "entrepreneurship", many people equate the term to "start up", but entrepreneurial activity can also come from within established firms. However, it's often the case that the entrepreneurial spirit is not fully unleashed until an independent entity is formed around a venture.

That's exactly what happened in the case of Qualtrax, a company located in Blacksburg, Virginia.[33] The company was spawned from a need for customers of CCS, Inc. to become compliant with the requirements of the International Standards Organization. CCS (now known as Foxguard Solutions) employees developed a software tool to simplify ISO compliance audits, and the auditors were so impressed that they suggested marketing the tool more broadly. Over a period of nearly twenty years, the business grew to ten dedicated employees, but Foxguard did not invest heavily in the software because the product was essentially a sideline business. Qualtrax shared sales and marketing resources with other business lines, so its growth was not necessarily a focal point for the company.

Figure 5.9: Amy Ankrum at the Qualtrax headquarters in Blacksburg, Virginia

In 2011, CCS management appointed Amy Ankrum, an executive in their marketing department, to lead the Qualtrax business line with a simple mission in mind – determining whether Qualtrax could be scaled up or should be scaled down. Having the feeling that there was more to the business than had been achieved to date, Amy added Ryan Hagan as engineering manager for the software. Hagan quickly moved Qualtrax to an agile style of development, allowing for 5-6 new releases a year when annual releases had previously been the norm. This approach was much more responsive to customer needs, and in a business that depends on recurring revenue, it led to increased customer retention, which improved to over 95% each year. Revenue growth rates went up double digits.

In 2015, Qualtrax took its biggest leap of faith, moving out of Foxguard headquarters and becoming a separate legal entity. Ankrum located the offices near the campus of Virginia Tech, allowing the company to attract top-notch developers. The new location also allowed the company to take on its own culture – it's more like a start-up company now than it was 23 years ago when it started! Employees enjoy flexible hours, short walks to downtown lunches, and a brightly-lit, open, and collaborative space with the company values painted right on the walls.

The move to a separate entity also allowed the company to attract new investor funding which will be used to push the company into new markets, such as the utility industry. Much of the new investor group is local and made up of former executives with significant experience in Software-as-a-Service (SaaS) and Business-to-Business (B2B) relationships. These execs will offer expertise beyond what Qualtrax had in-house, and all involved share the objective of increasing job growth in the region.

Asked what was different before and after Qualtrax began its rapid growth, Ankrum said, "It takes focus for any business to reach its full potential." Since becoming its own company, Qualtrax has certainly enhanced that focus, and the new funding will allow them to offer ownership options to its now 26 employees. Qualtrax now dominates in quality and compliance software for a number of industries, including forensic crime labs. Thanks to the foresight of management, the company's best days most certainly lie ahead.

Why Some Businesses Fail and Where to Get Help

Why Do Some Businesses Fail?

If you've paid attention to the occupancy of shopping malls over a few years, you've noticed that retailers come and go with surprising frequency. The same thing happens with restaurants—indeed, with all kinds of businesses. By definition, starting a business—small or large—is risky, and though many businesses succeed, a large proportion of them don't. One-third of small businesses that have employees go out of business within the first two years. As shown in Figure 7.10, nearly half of small businesses have closed by the end of their fourth year, and 60-70 percent do not make it past their seventh year.[34]

As bad as these statistics on business survival are, some industries are worse than others. If you want to stay in business for a long time, you might want to avoid some of these risky industries. Even though your friends think you make the best pizza in the world, this doesn't mean you can succeed as a pizza parlor owner. Opening a restaurant or a bar is one of the riskiest ventures (and, therefore, start-up funding is hard to get).

You might also want to avoid the transportation industry. Owning a taxi might appear lucrative until you find out what a taxi license costs. It obviously varies by city, but in New York City the price tag is upward of $400,000. No wonder taxi companies are resisting Uber and Lyft with all the energy they can muster. And setting up a shop to sell clothing can be challenging. Your view of "what's in" may be off, and one bad season can kill your business. The same is true for stores selling communication devices: every mall has one or more cell phone stores so the competition is steep, and business can be very slow.[35]

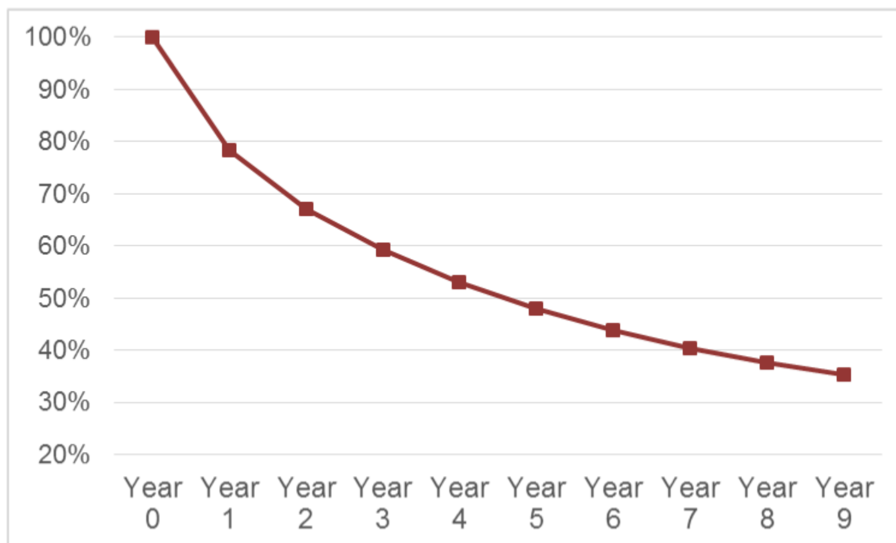

Figure 5.10: Survival rate of new businesses in the U.S., 2007-2015

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

- **Bad business idea**. Like any idea, a business idea can be flawed, either in the conception or in the execution.
- **Cash problems**. Too many new businesses are underfunded. The owner borrows enough money to set up the business but doesn't have enough extra cash to operate during the start-up phase, when very little money is coming in but a lot is going out.
- **Managerial inexperience or incompetence**. Many new business owners have no experience in running a business; many have limited management skills. Knowing how to make or market a product doesn't necessarily mean knowing how to manage people or retain talented employees.
- **Lack of customer focus**. A major advantage of a small business is the ability to provide special attention to customers. But some small businesses fail to seize this advantage. Perhaps the owner doesn't anticipate customers' needs or keep up with changing markets or the customer-focused practices of competitors.
- **Inability to handle growth**. Growing sales is usually a good thing, but sometimes it can be a major problem. When a company grows, the owner's role changes. He or she needs to delegate work to others and build a business structure that can handle the increase in volume. Some owners don't make the transition and find themselves overwhelmed. In such cases, expansion actually damages the company.
- **Failure to adapt**. The external environment for a company can change dramatically. Companies that fail to keep up will not be around for long.

Help from the Small Business Administration

If you had your choice, which cupcake would you pick—vanilla Oreo, triple chocolate, or latte? In the last few years, cupcake shops are popping up in almost every city. Perhaps the bad economy has put people in the mood for small, relatively inexpensive treats.

Whatever the reason, you're fascinated with the idea of starting a cupcake shop. You have a perfect location, have decided what equipment you need, and have tested dozens of recipes (and eaten lots of cupcakes). You are set to go with one giant exception: you don't have enough savings to cover your start-up costs. You have made the round of most local banks, but they are all unwilling to give you a loan. So what do you do? Fortunately, there is help available. It is through your local Small Business Administration (SBA), which offers an array of programs to help current and prospective small business owners. The SBA won't actually loan you the money, but it will increase the likelihood that you will get funding from a local bank by guaranteeing the loan.

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

Figure 5.11: Your new cupcake shop

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

This assistance is available through a number of channels, including the SBA's extensive website, online courses, and training programs. A full array of individualized services is also available. The Small Business Development Center (SBDC) assists current and prospective small business owners with business problems and provides free training and technical information on all aspects of small business management.

These services are available at approximately one thousand locations around the country, many housed at colleges and universities.[36]

If you need individualized advice from experienced executives, you can get it through the Service Corps of Retired Executives (SCORE). Under the SCORE program, a businessperson needing advice is matched with someone on a team of retired executives who work as volunteers. Together, the SBDC and SCORE help more than a million small businesspersons every year.[37]

Chapter Video

The video for this lesson features two VT students who were attempting to get funding for their business on the hit TV show Shark Tank. The VT students first appear at 13:25 and their segment runs about 10 minutes. You are free to fast forward to the 13:25 mark if you like.

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Key Takeaways

1. An **entrepreneur** is someone who identifies a **business opportunity** and assumes the **risk** of creating and running a business to take advantage of it.
2. The three characteristics of entrepreneurial activity are **innovating**, **running a business,** and **risk taking**.
3. A **small business** is independently owned and operated, exerts little influence in its industry, and has fewer than five hundred employees.
4. Small businesses in the United States generate about 50 percent of our GDP, create jobs, spark innovation, and provide opportunities for women and minorities.
5. An **industry** is a group of companies that compete with one another to sell similar products. There are two broad types of industries, or sectors: the **goods-producing sector** and the **service-producing sector**.
6. Once you decide to start a business, you'll need to create a **business plan—**a document that identifies the goals of your proposed business and explains how it will achieve them.
7. The SBA (**Small Business Administration**) is a government agency that provides many kinds of support for small businesses, including information and funding assistance.

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Figure 5.2: "Small Business Job Gains and Losses, 2000-2015." Data source: Bureau of Labor Statistics. Retrieved from: http://www.bls.gov/bdm/home.htm

Figure 5.3 : Data source: *Amazon.com* annual reports. Retrieved from: http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-reportsAnnual Amazon.com logo © Amazon.com, retrieved from: https://commons.wikimedia.org/wiki/File:Amazon.com-Logo.svg

Figure 5.4: "Businesses Owned by Women and Minorities." Data source: Census Bureau. Retrieved from: https://www.census.gov/content/dam/Census/newsroom/releases/2015/cb15-209_graphic.jpg

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Figure 5.11: Evan Amos (2011). "Crumbs Cupcakes in a display case." Public Domain. Retrieved from: https://commons.wikimedia.org/wiki/File:Crumbs-Bake-Shop-Cupcake-Display.jpg

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6: Management and Leadership

Learning Objectives

1. Identify the four interrelated functions of management: planning, organizing, leading, and controlling.
2. Understand the process by which a company develops and implements a strategic plan.
3. Explain how managers direct others and motivate them to achieve company goals.
4. Describe the process by which a manager monitors operations and assesses performance.
5. Explain what benchmarking is and its importance for managing organizations.
6. Describe the skills needed to be a successful manager.

Noteworthy Management

Consider this scenario: you're halfway through the semester and ready for midterms. You open your class notes and declare them "pathetic." You regret scribbling everything so carelessly and skipping class so many times. That's when it hits you: what if there was a note-taking service on campus? When you were ready to study for a big test, you could buy complete and legible class notes. You've heard that there are class-notes services at some larger schools, but there's no such thing on your campus. So you ask yourself, why don't I start a note-taking business? Your upcoming set of exams may not be salvageable, but after that, you'd always have great notes. And in the process, you could learn how to manage a business (isn't that what majoring in business is all about?).

You might begin by hiring a bunch of students to take class notes. Then the note takers will e-mail them to your assistant, who'll get them copied (on a special type of paper that can't be duplicated). The last step will be assembling packages of notes and, of course, selling them. You decide to name your company "Notes-4-You."

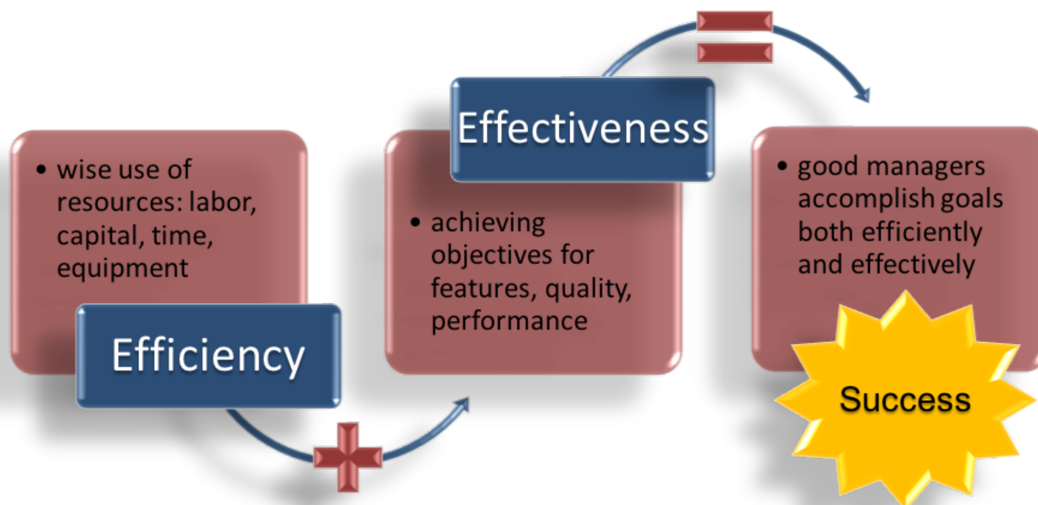


Figure 6.1: Management requires you to be both efficient and effective

It sounds like a great idea, but you're troubled by one question: why does this business need you? Do the note takers need a boss? Couldn't they just sell the notes themselves? This process could work, but it would work better if there was someone to oversee the operations: a manager—to make sure that the operations involved in preparing and selling notes were performed in both an effective and an efficient manner. You'd make the process **effective** by ensuring that the right things got done and that they all contributed to the success of the enterprise. You'd make the process **efficient** by ensuring that activities were performed in the right way and used the fewest possible resources.

What Do Managers Do?

The Management Process

The effective performance of your business will require solid **management**: the process of planning, organizing, leading, and controlling resources to achieve specific goals. A **plan** enables you to take your business concept beyond the idea stage. It does not, however, get the work done. For that to happen, you have to **organize** things effectively. You'll have to put people and other resources in place to make things happen. And because your note-taking venture is supposed to be better off with you in charge, you need to be a **leader** who can motivate your people to do well. Finally, to know whether things are in fact going well, you'll have to **control** your operations—that is, measure the results and compare them with the results that you laid out in your plan. Figure 6.2 summarizes the interrelationship between planning and the other functions that managers perform. This chapter will explore planning, leading, and controlling in some detail. Organizing is an especially complex topic, and will be discussed in Chapter 7.

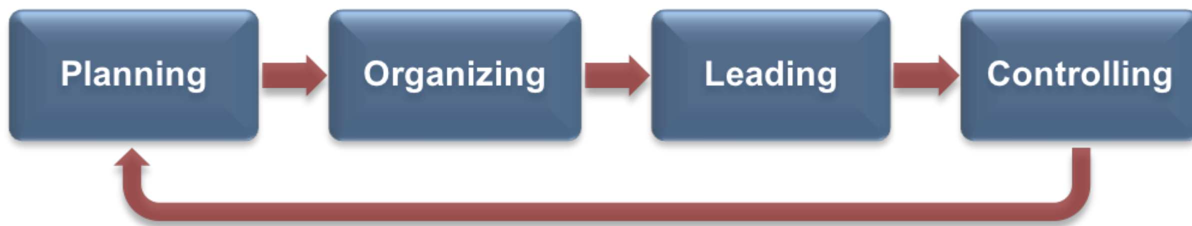


Figure 6.2: The Management Process

Planning

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

Developing a Strategic Plan

Coming up with an idea—say, starting a note-taking business—is a good start, but it's only a start. Planning for it is a step forward. Planning begins at the highest level and works its way down through the organization. Step one is usually called **strategic planning**: the process of establishing an overall course of action. To begin this process, you should ask yourself a couple of very basic questions: why, for example, does the organization exist? What value does it create? Sam Walton posed these questions in the process of founding Wal-Mart: his new chain of stores would exist to offer customers the lowest prices with the best possible service.[1]

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

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

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

Mission Statement

As we saw in an earlier chapter, the **mission statement** describes the purpose of your organization—the reason for its existence. It tells the reader what the organization is committed to doing. It can be very concise, like the one from Mary Kay Inc. (the cosmetics company): "To enrich the lives of women around the world."[2] Or it can be as detailed as the one from Harley-Davidson: "We fulfill dreams inspired by the many roads of the world by providing extraordinary motorcycles and customer experiences. We fuel the passion for freedom in our customers to express their own individuality."[3]

A mission statement for Notes-4-You could be the following: "To provide high-quality class notes to college students." On the other hand, you could prepare a more detailed statement that explains what the company is committed to doing, who its customers are, what its focus is, what goods or services it provides, and how it serves its customers.

It is worth noting that some companies no longer use mission statements, preferring to communicate their reason for being in other manners.

Core Values

Whether or not your company has defined a mission, it is important to identify what your organization stands for in terms of its values and the principles that will guide its actions. In Chapter 3 on Business Ethics and Social Responsibility, we explained that the small set of guiding principles that you identify as crucial to your company are known as **core values**—fundamental beliefs about what's important and what is and isn't appropriate in conducting company activities. Core values affect the overall planning processes and operations. At Volvo, three values— safety, quality, and environmental care—define the firm's "approach to product development, design and production."[4] Core values should also guide the behavior of every individual in the organization. At Coca-Cola, for instance, the values of leadership, collaboration, integrity, accountability, passion, diversity and quality tell employees exactly what behaviors are acceptable.[5] Companies communicate core values to employees and hold them accountable for putting them into practice by linking their values to performance evaluations and compensation.

In choosing core values for Notes-4-You, you're determined to be unique. After some thought, you settle on teamwork, trust, and dependability. Why these three? As you plan your business, you realize that it will need a workforce that functions as a team, trusts each other, and can be depended on to satisfy customers. In building your workforce, you'll seek employees who'll embrace these values.

Conduct a SWOT Analysis

The next step in the strategic-planning process is to assess your company's fit with its environment. A common approach to environmental analysis is matching the strengths of your business with the opportunities available to it. It's called **SWOT analysis** because it calls for analyzing an organization's Strengths, Weaknesses, Opportunities, and Threats. It begins with an examination of **external factors** that could influence the company in either a positive or a negative way. These could include economic conditions, competition, emerging technologies, laws and regulations, and customers' expectations.

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

The next step is to evaluate the company's strengths and weaknesses, **internal factors** that could influence company performance in either a positive or negative way. **Strengths** might include a motivated workforce, state-of-the-art technology, impressive managerial talent, or a desirable location. The opposite of any of these strengths could signal a potential **weakness** (poor workforce, obsolete technology, incompetent management, or poor location). Armed with a good idea of internal strengths and weaknesses, as well as external opportunities and threats, managers will be better positioned to capitalize on opportunities and strengths. Likewise, they want to improve on any weak areas and protect the organization from external threats.

For example, Notes-4-You might say that by providing excellent service at a reasonable price while we're still small, it can solidify its position on campus. When the market grows due to increases in student enrollment, the company will have built a strong reputation and be in a position to grow. So even if a competitor comes to campus (a threat), the company expects to be the preferred supplier of class notes. This strategy will work only if the note-takers are dependable and if the process does not alienate the faculty or administration.

Set Goals and Objectives

Your mission statement affirms what your organization is generally committed to doing, but it doesn't tell you how to do it. So the next step in the strategic-planning process is establishing goals and objectives. **Goals** are major accomplishments that the company wants to achieve over a long period. **Objectives** are shorter-term performance targets that direct the activities of the organization toward the attainment of a goal. They should be clearly stated, achievable, and measurable: they should give target dates for the completion of tasks and stipulate who's responsible for taking necessary actions.[6]

An organization will have a number of goals and related objectives. Some will focus on financial measures, such as profit maximization and sales growth. Others will target operational efficiency or quality control. Still others will govern the company's relationships with its employees, its community, its environment, or all three.

Finally, goals and objectives change over time. As a firm reassesses its place in its business environment, it rethinks not only its mission but also its approach to fulfilling it. The reality of change was a major theme when the late McDonald's CEO Jim Cantalupo explained his goal to revitalize the company:

> "The world has changed. Our customers have changed. We have to change too. Growth comes from being better, not just expanding to have more restaurants. The new McDonald's is focused on building sales at existing restaurants rather than on adding new restaurants. We are introducing a new level of discipline and efficiency to all aspects of the business and are setting a new bar for performance." [7]

This change in focus was accompanied by specific performance objectives—annual sales growth of 3 to 5 percent and income growth of 6 to 7 percent at existing restaurants, plus a five-point improvement (based on customer surveys) in speed of service, friendliness, and food quality.

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

- **Goal 1**: Achieve a 10 percent return on sales in your first five years.
- *Objective*: Sales of $20,000 and profit of $2,000 for the first 12 months of operation.
- **Goal 2**: Produce a high-quality product.
- *Objective*: First-year satisfaction scores of 90 percent or higher on quality of notes (based on survey responses on understandability, readability, and completeness).
- **Goal 3**: Attain 98 percent customer satisfaction by the end of your fifth year.
- *Objective*: Making notes available within two days after class, 95 percent of the time.

Tactical Plans

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

Operational Plans

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

Figure 6.3

Plan for Contingencies and Crises

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

Contingency Planning

With **contingency planning**, managers identify those aspects of the business that are most likely to be adversely affected by change. Then, they develop alternative courses of action in case an anticipated change does occur. You engage in contingency planning any time you develop a backup or fallback plan.

Crisis Management

Organizations also face the risk of encountering crises that require immediate attention. Rather than waiting until such a crisis occurs and then scrambling to figure out what to do, many firms practice **crisis management**. Some, for instance, set up teams trained to deal with emergencies. Members gather information quickly and respond to the crisis while everyone else carries out his or her normal duties. The team also keeps the public, the employees, the press, and government officials informed about the situation and the company's response to it.[8]

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

Wendy's accomplished this objective by giving out free milkshakes and discount coupons to customers in the affected regions and, to avoid calling attention to the missing finger, by making no changes in its national advertising. The crisis-management strategy worked and the story died down (though it flared up temporarily when the police arrested the woman's husband, who allegedly bought the finger from a coworker who had severed it in an accident months earlier).[9]

Figure 6.4: A Wendy's Restaurant

Even with crisis-management plans in place, however, it's unlikely that most companies will emerge from a potentially damaging episode as unscathed as Wendy's did. For one thing, the culprits in the Wendy's case were caught, and the public was willing to forgive an organization it viewed as a victim. Given the current public distrust of corporate behavior, however, companies whose reputations have suffered due to questionable corporate judgment usually don't fare as well. These companies include the international oil company, BP, whose CEO, Tony Hayward, did a disastrous job handling the Gulf of Mexico crisis. A BP-controlled oil rig exploded in the Gulf of Mexico, killing eleven workers and creating the largest oil spill in U.S. history. Hayward's lack of sensitivity will be remembered forever; particularly his response to a reporter's question on what he would tell those whose livelihoods were ruined: "We're sorry for the massive disruption it's caused their lives. There's no one who wants this over more than I do. I would like my life back." His comment was obviously upsetting to the families of the eleven men who lost their lives on the rig.[10] Then, there are the companies at which executives have crossed the line between the unethical to the downright illegal—Arthur Andersen, Enron, and Bernard L. Madoff Investment Securities, to name just a few. Given the high risk associated with a crisis, it should come as no surprise that contemporary managers spend more time anticipating crises and practicing their crisis-management responses.

Figure 6.5: BP's Deepwater Horizon oil rig on fire in the Gulf of Mexico in 2010

Leading

The third management function is **leading**—providing focus and direction to others and motivating them to achieve organizational goals. As owner and president of Notes-4-You, you might think of yourself as an orchestra leader. You have given your musicians (employees) their sheet music (plans). You've placed them in sections (departments) and arranged the sections (organizational structure) so the music will sound as good as possible. Now your job is to tap your baton and lead the orchestra so that its members make beautiful music together.[11]

Leadership Styles

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

Unfortunately, there are no definitive answers to questions like these. Over time, every manager refines his or her own **leadership style**, or way of interacting with and influencing others. Despite a vast range of personal differences, leadership styles tend to reflect one of the following approaches to leading and motivating people: the autocratic, the democratic (also known as participative), or the free rein.

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

At first glance, you'd probably not want to work for an autocratic leader. After all, most people don't like to be told what to do without having any input. Many like the idea of working for a democratic leader; it's flattering to be asked for your input. And though working in a free rein environment might seem a little unsettling at first, the opportunity to make your own decisions is appealing to many people. Each leadership style can be appropriate in certain situations.

To illustrate, let's say that you're leading a group of fellow students in a team project for your class. Are there times when it would be best for you to use an autocratic leadership style? What if your team was newly formed, unfamiliar with what needs to be done, under a tight deadline, and looking to you for direction? In this situation, you might find it appropriate to follow an autocratic leadership style (on a temporary basis) and assign tasks to each member of the group. In an emergency situation, such as a fire, or in the final seconds of a close ball game, there is generally not time for debate – the leader or coach must make a split second decision that demands an autocratic style.

But since most situations are non-emergency and most people prefer the chance to give input, the democratic leadership style is often favored. People are simply more motivated and feel more ownership of decisions (i.e., buy-in) when they have had a chance to offer input. Note that when using this style, the leader will still make the decision in most cases. As long as their input is heard, most people accept that it is the leader's role to decide in cases where not everyone agrees.

How about free rein leadership? Many people function most effectively when they can set their own schedules and do their work in the manner they prefer. It takes a great deal of trust for a manager to employ this style. Some managers start with an assumption of trust that is up to the employee to maintain through strong performance. In other cases, this trust must be earned over a period of time. Would this approach always work with your study group? Obviously not. It will work if your team members are willing and able to work independently and welcome the chance to make decisions. On the other hand, if people are not ready to work responsibly to their best of their abilities, using the free rein style could cause the team to miss deadlines or do poorly on the project.

The point being made here is that no one leadership style is effective all the time for all people or in all corporate cultures. While the democratic style is often viewed as the most appropriate (with the free rein style a close second), there are times when following an autocratic style is essential. Good leaders learn how to adjust their styles to fit both the situation and the individuals being directed.

Transformational Leadership

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

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

relationships with subordinates and motivate employees to focus on the interests of the organization. Leaders who can be both transactional and transformational are rare, and those few who have both capacities are very much in demand.[12]

Controlling

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

A Five-Step Control Process

You can think of the **control function** as the five-step process outlined in Figure 8.7. Let's see how this process might work at Notes-4-You. Let's assume that, after evaluating class enrollments, you estimate that you can sell one hundred notes packages per month to students taking a popular sophomore-level geology course. So you set your standard at a hundred units. At the end of the month, however, you look over your records and find that you sold only eighty. In talking with your salespeople, you learn why you came up twenty packages short: it turns out that the copy machine broke down so often that packages frequently weren't ready on time. You immediately take corrective action by increasing maintenance on the copy machine.

Figure 6.6

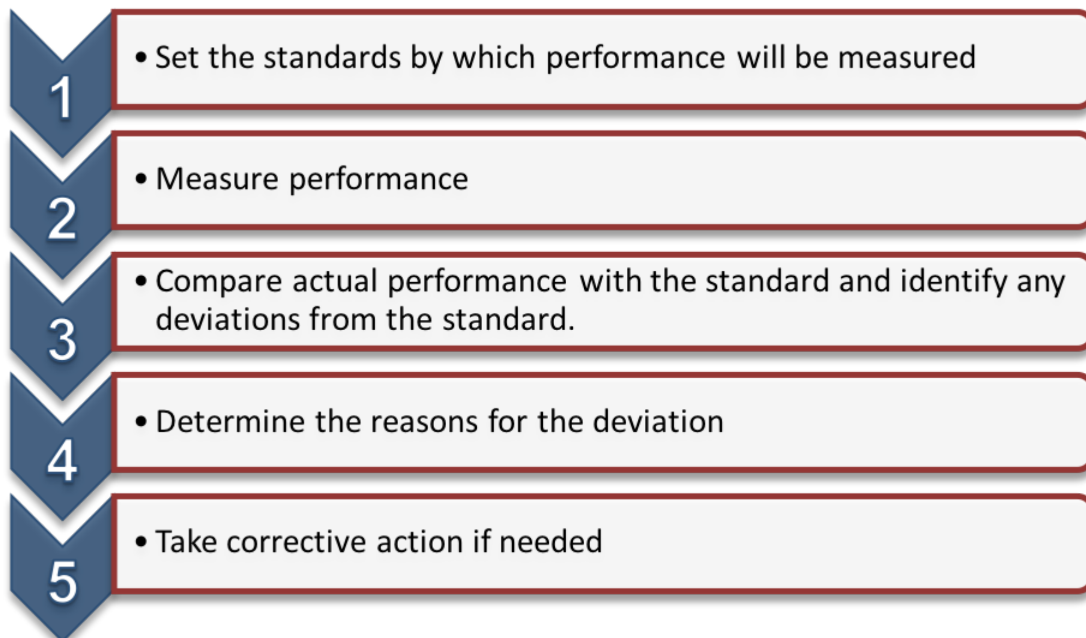


Figure 6.7: The Control Process

https://biz.libretexts.org/@go/page/90725

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

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

Benchmarking

Benchmarking could be considered as a specialized kind of control activity. Rather than controlling a particular aspect of performance (say, defects for a specific product), benchmarking aims to improve a firm's overall performance. The process of benchmarking involves comparisons to other organizations' practices and processes with the objective of learning and improvement in both efficiency and effectiveness. Benchmarking exercises can be conducted in a number of ways:

- Organizations often monitor publicly available information to keep tabs on the competition. Annual reports, news articles, and other sources are monitored closely in order to stay aware of the latest developments. In academia, universities often use published rankings tables to see how their programs compare on the basis of standardized test scores, salaries of graduates, and other important dimensions.
- Organizations may also work directly with companies in unrelated industries in order to compare those functions of the business which are similar. A manufacture of aircraft would not likely have a great deal in common with a company making engineered plastics, yet both have common functions such as accounting, finance, information technology, and human resources. Companies can exchange ideas that help each other improve efficiency, and often at a very low cost to either.
- In order to compare more directly to competition without relying solely on publicly available data, companies may enter into benchmarking consortiums in which an outside consultant would collect key data from all participants, anonymize it, and then share the results with all participants. Companies can then gauge how they compare to others in the industry without revealing their own performance to others.

Managerial Skills

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

Throughout your career, you'll also be expected to communicate ideas clearly, use your time efficiently, and reach sound decisions.

Technical Skills

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

Interpersonal Skills

As you move up the corporate ladder, you'll find that you can't do everything yourself: you'll have to rely on other people to help you achieve the goals for which you're responsible. That's why **interpersonal skills**, also known as relational skills—the ability to get along with and motivate other people—are critical for managers in mid-level positions. These managers play a pivotal role because they report to top-level managers while overseeing the activities of first-line managers. Thus, they need strong working relationships with individuals at all levels and in all areas. More than most other managers, they must use "people skills" to foster teamwork, build trust, manage conflict, and encourage improvement.[13]

Conceptual Skills

Managers at the top, who are responsible for deciding what's good for the organization from the broadest perspective, rely on **conceptual skills**—the ability to reason abstractly and analyze complex situations. Senior executives are often called on to "think

outside the box"—to arrive at creative solutions to complex, sometimes ambiguous problems. They need both strong analytical abilities and strong creative talents.

Communication Skills

Effective **communication skills** are crucial to just about everyone. At all levels of an organization, you'll often be judged on your ability to communicate, both orally and in writing. Whether you're talking informally or making a formal presentation, you must express yourself clearly and concisely. Talking too loudly, rambling, and using poor grammar reduce your ability to influence others, as does poor written communication. Confusing and error-riddled documents (including e-mails) don't do your message any good, and they will reflect poorly on you.[14]

Time-Management Skills

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

- Prioritize tasks, focusing on the most important things first.
- Set aside a certain time each day to return phone calls and answer e-mail.
- Delegate routine tasks.
- Don't procrastinate.
- Insist that meetings start and end on time, and stick to an agenda.
- Eliminate unnecessary paperwork.[15]

Decision-Making Skills

Every manager is expected to make decisions, whether alone or as part of a team. Drawing on your **decision-making skills** is often a process in which you must define a problem, analyze possible solutions, and select the best outcome. As luck would have it, because the same process is good for making personal decisions, we'll use a personal example to demonstrate the process approach to decision making. Consider the following scenario: you're upset because your midterm grades are much lower than you'd hoped. To make matters worse, not only are you in trouble academically, but also the other members of your business-project team are annoyed because you're not pulling your weight. Your lacrosse coach is very upset because you've missed too many practices, and members of the mountain-biking club of which you're supposed to be president are talking about impeaching you if you don't show up at the next meeting. And your significant other is feeling ignored.

A Six-Step Approach to Decision Making

Assuming that your top priority is salvaging your GPA, let's tackle your problem by using a six-step approach to solving problems that don't have simple solutions. We've summarized this model in Figure 6.8[16]

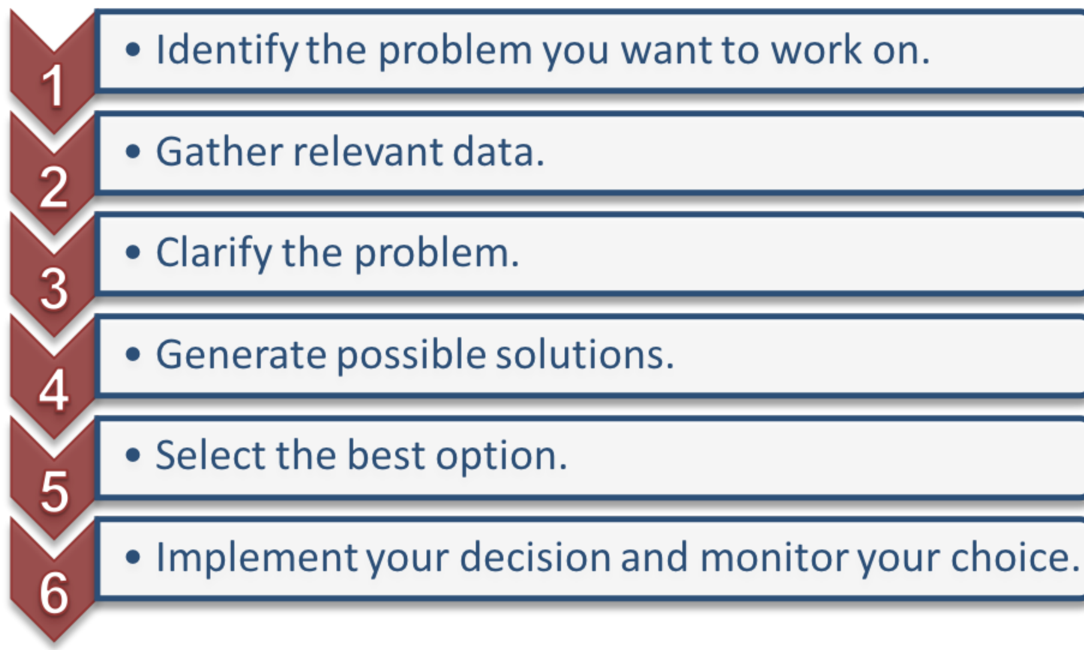


Figure 6.8: The problem solving and decision making process

Identify the problem you want to work on

Step one is getting to know your problem, which you can formulate by asking yourself a basic question: how can I improve my grades?

Gather relevant data

Step two is gathering information that will shed light on the problem. Let's rehash some of the relevant information that you've already identified: (a)you did poorly on your finals because you didn't spend enough time studying; (b) you didn't study because you went to see your girlfriend (who lives about three hours from campus) over the weekend before your exams (and on most other weekends, as a matter of fact); (c) what little studying you got in came at the expense of your team project and lacrosse practice; and (d) while you were away for the weekend, you forgot to tell members of the mountain-biking club that you had to cancel the planned meeting.

Clarify the problem

Once you review all the given facts, you should see that your problem is bigger than simply getting your grades up; your life is pretty much out of control. You can't handle everything to which you've committed yourself. Something has to give. You clarify the problem by summing it up with another basic question: what can I do to get my life back in order?

Generate possible solutions

Let's say that you've come up with the following possible solutions to your problem: (a) quit the lacrosse team, (b) step down as president of the mountain-biking club, (c) let team members do your share of work on the business project, and (d) stop visiting your significant other so frequently. The solution to your main problem—how to get your life back in order—will probably require multiple actions.

Select the best option

This is clearly the toughest part of the process. Working your way through your various options, you arrive at the following conclusions: (a) you can't quit the lacrosse team because you'd lose your scholarship; (b) you can resign your post in the mountain-biking club, but that won't free up much time; (c) you can't let your business-project team down (and besides, you'd just get a low grade); and (d) she wouldn't like the idea, but you could visit your girlfriend, say, once a month rather than once a week. So what's the most feasible (if not necessarily perfect) solution? Probably visiting your significant other once a month and giving up the presidency of the mountain-biking club.

Implement your decision and monitor your choice

When you call your girlfriend, you're pleasantly surprised to find that she understands. The vice president is happy to take over the mountain-biking club. After the first week, you're able to attend lacrosse practice, get caught up on your team business project, and catch up in all your other classes. The real test of your solution will be the results of the semester's finals.

Revisiting Qualtrax

In a previous chapter, we described the decisions made by Foxguard Solutions about its Qualtrax business, a new business venture developed inside the company. The decisions Foxguard made track quite well with the process described above. Consider the following:

Problem Identification— Foxguard had a business line that wasn't an exact fit with its other business and was not performing up to the potential management believed it held.

Gather Relevant Data— When Amy Ankrum was promoted, one of her first priorities was to determine what information would help her to understand the potential for the business and the resources needed to improve it.

Clarify the Problem— Qualtrax had a definite market and potential to grow, but the parent company hadn't invested time/energy into doing that. Would more focus grow the business?

Generate Possible Solutions— Management could have continued to try to grow the business in-house, sell it to another company, or spin it off

Select Best Option— After a careful evaluation, management decided the spin-off was the best option to unleash the full potential of Qualtrax

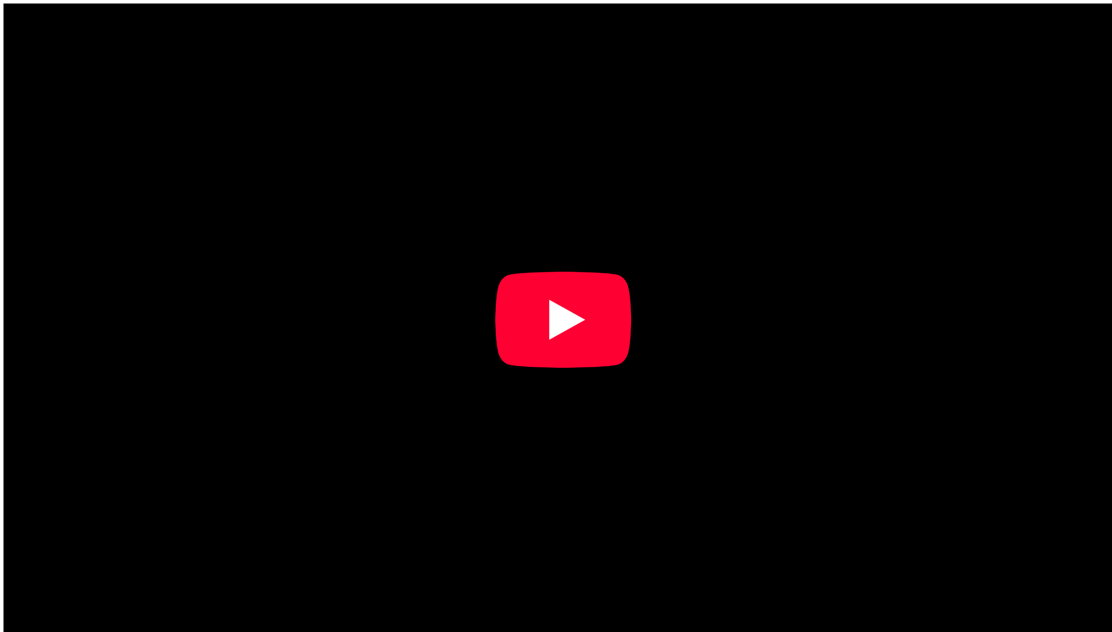
Implement and Monitor— The decision to spin-off Qualtrax could be measured on metrics such as growth in revenue, profits, and employee satisfaction. Based on the results to-date, it certainly seems like they made the right decision.

Applying Your Skills at Notes-4-You

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

Chapter Video

Roselinde Torres is an extremely accomplished leadership expert, and her TED Talk shares her insights on what it takes to be a great leader. If you have not seen TED Talks before, you will likely see a great many more before you graduate.



Key Takeaways

1. **Management** must include both **efficiency** (accomplishing goals using the fewest resources possible) and **effectiveness** (accomplishing goals as accurately as possible).
2. The management process has four **functions**: **planning**, **organizing**, **leading**, and **controlling**.
3. **Planning** for a business starts with **strategic planning**—the process of establishing an overall course of action.
4. Management first identifies its **purposes**, creates a **mission statement**, and defines its **core values**.
5. A **SWOT analysis** assesses the company's strengths and weaknesses and its fit with the external environment.
6. **Goals and objectives**, or performance targets, are established to direct company actions, and **tactical plans** and **operational plans** implement objectives.
7. A manager's **leadership style** varies depending on the manager, the situation, and the people being directed. There are several management styles.
    1. An **autocratic** manager tends to make decisions without input and expects subordinates to follow instructions.
    2. Managers who prefer a **democratic** style seek input into decisions.
    3. A **free rein** manager provides no more guidance than necessary and lets subordinates make decisions and solve problems.
    4. **Transactional** style managers exercise authority according to their rank in the organization, let subordinates know what's expected of them, and step in when mistakes are made.
    5. **Transformational** style managers mentor and develop subordinates and motivate them to achieve organizational goals.
8. The **control process** can be viewed as a five-step process: (1) establish standards, (2) **measure** performance, (3) **compare** actual performance with standards and identify any deviations, (4) **determine the reason** for deviations, and (5) **take**

corrective action if needed.

9. **Benchmarking** is a process for improving overall company efficiency and effectiveness by comparing performance to competitors.
10. Top managers need strong **conceptualskills**, while those at midlevel need good **interpersonal skills** and those at lower levels need **technical skills**.
11. All managers need strong c**ommunication, decision-making,** and **time- management skills**.

Chapter 6 Text References and Image Credits

Image Credits: Chapter 6

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Figure 6.6: Luis Dantas (2007). "A Samsung desktop SOHO MFP." Public domain. Retrieved from: en.Wikipedia.org/wiki/Multi-function_printer#/media/File:Multifunctional_Samsung.jpg

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7: Structuring Organizations

Learning Objectives

1. Identify the three levels of management and the responsibilities at each level.
2. Discuss various options for organizing a business, and create an organization chart.
3. Understand how specialization helps make organizations more efficient.
4. Discuss the different ways that an organization can departmentalize.
5. Explain other key terms related to this chapter such as chain of command, delegation of authority, and span of control.

Organizing

If you read our chapter on Management and Leadership, you will recall developing a strategic plan for your new company, Notes-4-You. Once a business has completed the planning process, it will need to organize the company so that it can implement that plan. A manager engaged in organizing allocates **resources** (people, equipment, and money) to achieve a company's **objectives**. Successful managers make sure that all the activities identified in the planning process are assigned to some person, department, or team and that everyone has the resources needed to perform assigned activities.

Levels of Management: How Managers Are Organized

A typical organization has several **layers of management**. Think of these layers as forming a pyramid like the one in Figure 9.1, with top managers occupying the narrow space at the peak, first-line managers the broad base, and middle-managers the levels in between. As you move up the pyramid, management positions get more demanding, but they carry more authority and responsibility (along with more power, prestige, and pay). Top managers spend most of their time in planning and decision making, while first-line managers focus on day-to-day operations. For obvious reasons, there are far more people with positions at the base of the pyramid than there are at the other two levels. Let's look at each management level in more detail.

Figure 7.1: Levels of Management

Top Managers

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

Middle Managers

Middle managers are in the center of the management hierarchy: they report to top management and oversee the activities of first-line managers. They're responsible for developing and implementing activities and allocating the resources needed to achieve the objectives set by top management. Common job titles include operations manager, division manager, plant manager, and branch manager.

First-Line Managers

First-line managers supervise employees and coordinate their activities to make sure that the work performed throughout the company is consistent with the plans of both top and middle management. It's at this level that most people acquire their first managerial experience. The job titles vary considerably but include such designations as manager, group leader, office manager, foreman, and supervisor.

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

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

Building an organizational structure engages managers in two activities: **job specialization** (dividing tasks into jobs) and **departmentalization** (grouping jobs into units). An organizational structure outlines the various roles within an organizational, which positions report to which, and how an organization will departmentalize its work. Take note than an organizational structure is an arrangement of positions that's most appropriate for your company at a specific point in time. Given the rapidly changing environment in which businesses operate, a structure that works today might be outdated tomorrow. That's why you hear so often about companies **restructuring**—altering existing organizational structures to become more competitive once conditions have changed. Let's now look at how the processes of specialization and departmentalization are accomplished.

Specialization

Organizing activities into clusters of related tasks that can be handled by certain individuals or groups is called **specialization**. This aspect of designing an organizational structure is twofold:

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

Specialization has several advantages. First and foremost, it leads to **efficiency**. Imagine a situation in which each department was responsible for paying its own invoices; a person handling this function a few times a week would likely be far less efficient than someone whose job was to pay the bills. In addition to increasing efficiency, specialization results in jobs that are easier to learn and roles that are clearer to employees. But the approach has disadvantages, too. Doing the same thing over and over sometimes leads to boredom and may eventually leave employees dissatisfied with their jobs. Before long, companies may notice decreased performance and increased absenteeism and turnover (the percentage of workers who leave an organization and must be replaced).

Departmentalization

The next step in designing an organizational structure is **departmentalization**—grouping specialized jobs into meaningful units. Depending on the organization and the size of the work units, they may be called divisions, departments, or just plain groups.

Traditional groupings of jobs result in different organizational structures, and for the sake of simplicity, we'll focus on two types—functional and divisional organizations.

Functional Organizations

A **functional organization** groups together people who have comparable skills and perform similar tasks. This form of organization is fairly typical for small to medium-size companies, which group their people by business functions: accountants are grouped together, as are people in finance, marketing and sales, human resources, production, and research and development. Each unit is headed by an individual with expertise in the unit's particular function. Examples of typical functions in a business

enterprise include human resources, operations, marketing, and finance. Also, business colleges will often organize according to functions found in a business.

There are a number of advantages to the functional approach. The structure is simple to understand and enables the staff to specialize in particular areas; everyone in the marketing group would probably have similar interests and expertise. But homogeneity also has drawbacks: it can hinder communication and decision making between units and even promote interdepartmental conflict. The marketing department, for example, might butt heads with the accounting department because marketers want to spend as much as possible on advertising, while accountants want to control costs.

Divisional Organizations

Large companies often find it unruly to operate as one large unit under a functional organizational structure. Sheer size makes it difficult for managers to oversee operations and serve customers. To rectify this problem, most large companies are structured as **divisional organizations**. They are similar in many respects to stand-alone companies, except that certain common tasks, like legal work, tends to be centralized at the headquarters level. Each division functions relatively autonomously because it contains most of the functional expertise (production, marketing, accounting, finance, human resources) needed to meet its objectives. The challenge is to find the most appropriate way of structuring operations to achieve overall company goals. Toward this end, divisions can be formed according to products, customers, processes, or geography.

Product Divisions

Product division means that a company is structured according to its product lines. General Motors, for example, has four product-based divisions: Buick, Cadillac, Chevrolet, and GMC.[1] Each division has its own research and development group, its own manufacturing operations, and its own marketing team. This allows individuals in the division to focus all their efforts on the products produced by their division. A downside is that it results in higher costs as corporate support services (such as accounting and human resources) are duplicated in each of the four divisions.

Customer Divisions

Some companies prefer a **customer division** structure because it enables them to better serve their various categories of customers. Thus, Johnson & Johnson's two hundred or so operating companies are grouped into three customer-based business segments: consumer business (personal-care and hygiene products sold to the general public), pharmaceuticals (prescription drugs sold to pharmacies), and professional business (medical devices and diagnostics products used by physicians, optometrists, hospitals, laboratories, and clinics).[2]

Process Divisions

If goods move through several steps during production, a company might opt for a **process division** structure. This form works well at Bowater Thunder Bay, a Canadian company that harvests trees and processes wood into newsprint and pulp. The first step in the production process is harvesting and stripping trees. Then, large logs are sold to lumber mills and smaller logs are chopped up and sent to Bowater's mills. At the mill, wood chips are chemically converted into pulp. About 90 percent is sold to other manufacturers (as raw material for home and office products), and the remaining 10 percent is further processed into newspaper print. Bowater, then, has three divisions: tree cutting, chemical processing, and finishing (which makes newsprint).[3]

Geographical Divisions

Geographical division enables companies that operate in several locations to be responsive to customers at a local level. Adidas, for example, is organized according to the regions of the world in which it operates. They have eight different regions, and each one reports its performance separately in their annual reports.[4]

Figure 7.2: Adidas Group geographic divisions

Summing Up Divisional Organizations

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

The Organization Chart

Once an organization has set its structure, it can represent that structure in an **organization chart**: a diagram delineating the interrelationships of positions within the organization. An example organization chart is shown in Figure 7.3, using our "Notes-4-You" example from Chapter 6.

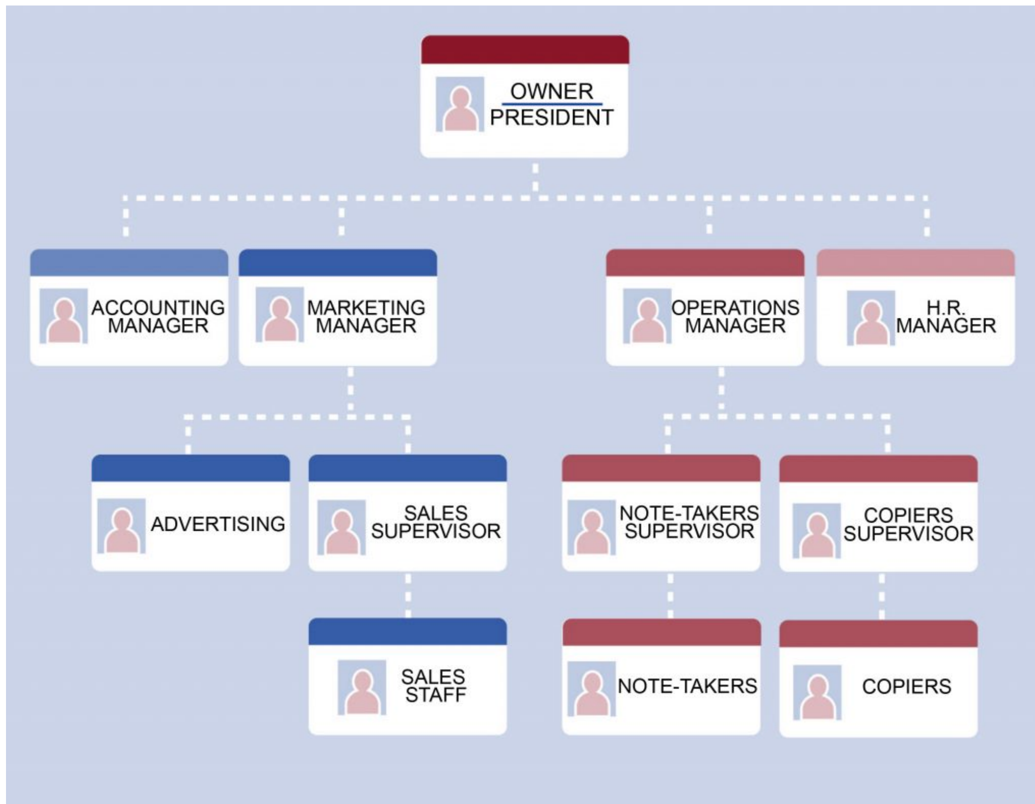

Figure 7.3: An organizational chart for "Notes-4-Youg"

Imagine putting yourself at the top of the chart, as the company's president. You would then fill in the level directly below your name with the names and positions of the people who work directly for you—your accounting, marketing, operations, and human resources managers. The next level identifies the people who work for these managers. Because you've started out small, neither your accounting manager nor your human resources manager will be currently managing anyone directly. Your marketing manager, however, will oversee one person in advertising and a sales supervisor (who, in turn, oversees the sales staff). Your operations manager will oversee two individuals—one to supervise note-takers and one to supervise the people responsible for making copies. The lines between the positions on the chart indicate the **reporting relationships**; for example, the Note-Takers Supervisor reports directly to the Operations Manager.

Although the structure suggests that you will communicate only with your four direct reports, this isn't the way things normally work in practice. Behind every formal communication network there lies a network of **informal communications**—unofficial relationships among members of an organization. You might find that over time, you receive communications directly from members of the sales staff; in fact, you might encourage this line of communication.

Now let's look at the chart of an organization that relies on a divisional structure based on goods or services produced—say, a theme park. The top layers of this company's organization chart might look like the one in Figure 9.4a (left side of the diagram). We see that the president has two direct reports—a vice president in charge of rides and a vice president in charge of concessions. What about a bank that's structured according to its customer base? The bank's organization chart would begin like the one in Figure 7.4b. Once again, the company's top manager has two direct reports, in this case a VP of retail-customer accounts and a VP of commercial-customer accounts.

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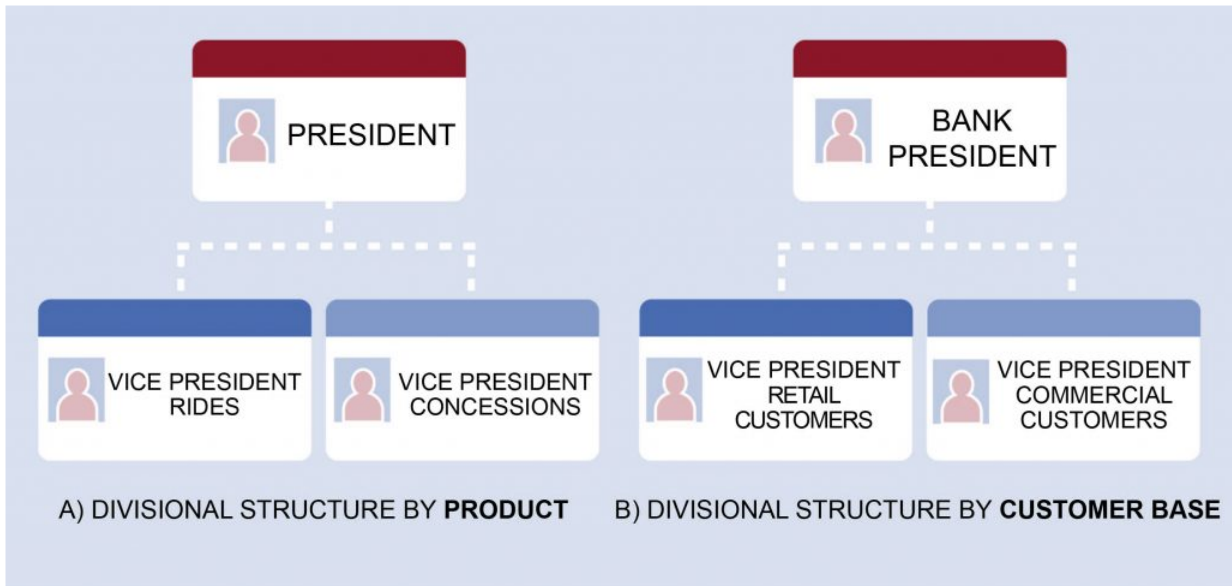

Figure 7.4a-b: Organizational charts for divisional structures

Over time, companies revise their organizational structures to accommodate growth and changes in the external environment. It's not uncommon, for example, for a firm to adopt a functional structure in its early years. Then, as it becomes bigger and more complex, it might move to a divisional structure—perhaps to accommodate new products or to become more responsive to certain customers or geographical areas. Some companies might ultimately rely on a combination of functional and divisional structures. This could be a good approach for a credit card company that issues cards in both the United States and Europe. An outline of this firm's organization chart might look like the one in Figure 7.5.

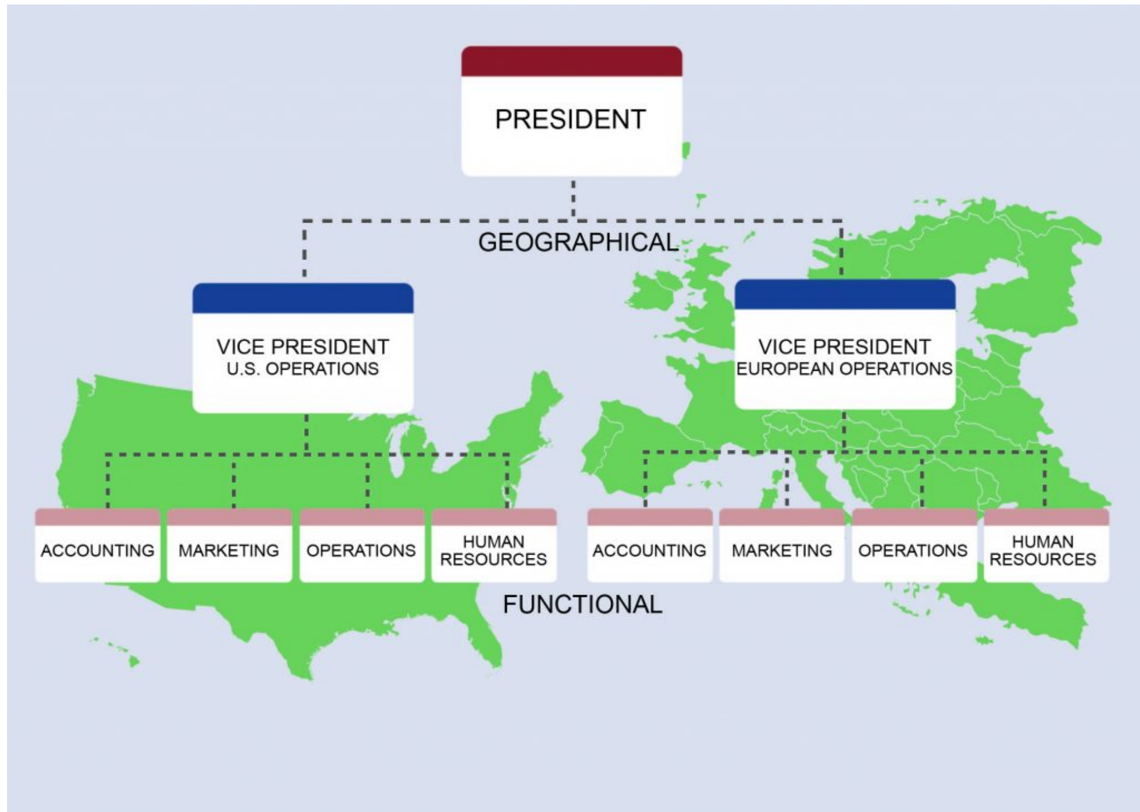

Figure 7.5: An organization with a combination of functional and divisional structures

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Chain of Command

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

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

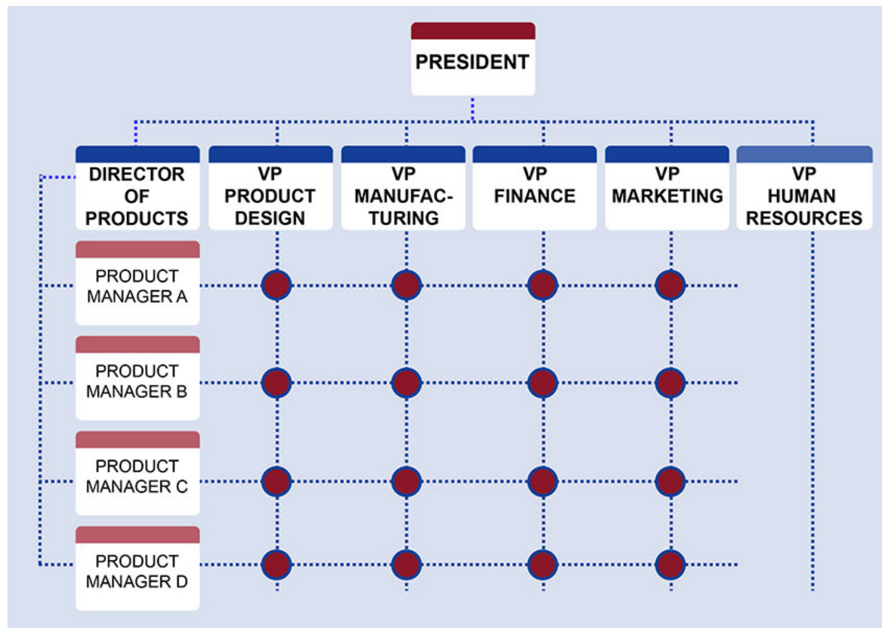

Figure 7.6: A chart of a matrix structure

Nike sometimes uses this type of arrangement. To design new products, the company may create product teams made up of designers, marketers, and other specialists with expertise in particular sports categories—say, running shoes or basketball shoes. Each team member would be evaluated by both the team manager and the head of his or her functional department.

Span of Control

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

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

There are trade-offs between the advantages and disadvantages of flat and tall organizations. Companies determine which trade-offs to make according to a principle called **span of control**, which measures the number of people reporting to a particular manager. If, for example, you remove layers of management to make your organization flatter, you end up increasing the number of people reporting to a particular supervisor. If you refer back to the organization chart for Notes-4-You, you'll recall that, under your present structure, four managers report to you as the president: the heads of accounting, marketing, operations, and human resources. In turn, two of these managers have positions reporting to them: the advertising manager and sales supervisor report to the marketing manager, while the notetakers supervisor and the copiers supervisor report to the operations manager. Let's say that

you remove a layer of management by getting rid of the marketing and operations managers. Your organization would be flatter, but what would happen to your workload? As president, you'd now have six direct reports rather than four: accounting manager, advertising manager, sales manager, notetaker supervisor, copier supervisor, and human resources manager.

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

Delegating Authority

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

Responsibility and Authority

As owner of Notes-4-You, you'll probably want to control every aspect of your business, especially during the start-up stage. But as the organization grows, you'll have to assign responsibility for performing certain tasks to other people. You'll also have to accept the fact that **responsibility** alone—the duty to perform a task—won't be enough to get the job done. You'll need to grant subordinates the **authority** they require to complete a task—that is, the power to make the necessary decisions. (And they'll also need sufficient resources.) Ultimately, you'll also hold your subordinates accountable for their performance.

Centralization and Decentralization

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

Centralization has the advantage of consistency in decision-making. Since in a centralized model, key decisions are made by the same top managers, those decisions tend to be more uniform than if decisions were made by a variety of different people at lower levels in the organization. In most cases, decisions can also be made more quickly provided that top management does not try to control too many decisions. However, centralization has some important disadvantages. If top management makes virtually all key decisions, then lower-level managers will feel under-utilized and will not develop decision-making skills that would help them become promotable. An overly centralized model might also fail to consider information that only front-line employees have or might actually delay the decision-making process. Consider a case where the sales manager for an account is meeting with a customer representative who makes a request for a special sale price; the customer offers to buy 50% more product if the sales manager will reduce the price by 5% for one month. If the sales manager had to obtain approval from the head office, the opportunity might disappear before she could get approval – a competitor's sales manager might be the customer's next meeting.

An overly decentralized decision model has its risks as well. Imagine a case in which a company had adopted a geographically-based divisional structure and had greatly decentralized decision making. In order to expand its business, suppose one division decided to expand its territory into the geography of another division. If headquarters approval for such a move was not required, the divisions of the company might end up competing against each other, to the detriment of the organization as a whole. Companies that wish to maximize their potential must find the right balance between centralized and decentralized decision making.

Key Takeaways

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

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

Figure 7.2: "Adidas Group geographic divisions." Data source: *Adidas Group Annual Report 2015*. Retrieved from: www.adidas-group.com/en/investors/financial-reports/#/2015/ World map source: Mmikle. CC-BY-2.0. Retrieved from: https://commons.wikimedia.org/wiki/File:A_large_blank_world_map_with_oceans_marked_in_blue-edited.png Adidas logo © Adidas group. Retrieved from: https://commons.wikimedia.org/wiki/File:Adidas_Logo.svg

Figures 7.3 "An organizational chart for "Notes-4-Young." Designed for Virginia Tech Libraries by Brian Craig. commons.wikimedia.org/wiki/Category:Figures_from_Fundamentals_of_Business_by_Skripak. Licensed CC BY 4.0.

Figure 7.4a-b "Organizational charts for divisional structures" Designed for Virginia Tech Libraries by Brian Craig. commons.wikimedia.org/wiki/Category:Figures_from_Fundamentals_of_Business_by_Skripak. Licensed CC BY 4.0.

Figure 7.5 "An organization with a combination of functional and divisional structures" Designed for Virginia Tech Libraries by Brian Craig. https://commons.wikimedia.org/wiki/Category:Figures_from_Fundamentals_of_Business_by_Skripak. Licensed CC BY 4.0.

Figure 7.6 "A chart of a matrix structure" Designed for Virginia Tech Libraries by Brian Craig. https://commons.wikimedia.org/wiki/Category:Figures_from_Fundamentals_of_Business_by_Skripak. Licensed CC BY 4.0.

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8: Managing Human Resources

Learning Objectives

1. Define human resource management and explain how managers develop and implement a human resource plan.
2. Explain how companies train and develop employees, and discuss the importance of a diverse workforce.
3. Identify factors that make an organization a good place to work, including competitive compensation and benefits packages.
4. Explain how managers evaluate employee performance and retain qualified employees.

The Grounds of a Great Work Environment

Howard Schultz has vivid memories of his father slumped on the couch with his leg in a cast.[1] The ankle would heal, but his father had lost another job—this time as a driver for a diaper service. It was a crummy job; still, it put food on the table, and if his father couldn't work, there wouldn't be any money. Howard was seven, but he understood the gravity of the situation, particularly because his mother was seven months pregnant, and the family had no insurance.

Figure 8.1: Starbucks founder Howard Schultz

This was just one of the many setbacks that plagued Schultz's father throughout his life—an honest, hard-working man frustrated by a system that wasn't designed to cater to the needs of common workers. He'd held a series of blue-collar jobs (cab driver, truck driver, factory worker), sometimes holding two or three at a time. Despite his willingness to work, he never earned enough money to move his family out of Brooklyn's federally-subsidized housing projects. Schultz's father died never having found fulfillment in his work life—or even a meaningful job. It was the saddest day of Howard's life.

As a kid, did Schultz ever imagine that one day he'd be the founder and chairman of Starbucks Coffee Company? Of course not. But he did decide that if he was ever in a position to make a difference in the lives of people like his father, he'd do what he could. Remembering his father's struggles and disappointments, Schultz has tried to make Starbucks the kind of company where he wished his father had worked. "Without even a high school diploma," Schultz admits, "my father probably could never have been an executive. But if he had landed a job in one of our stores or roasting plants, he wouldn't have quit in frustration because the company didn't value him. He would have had good health benefits, stock options, and an atmosphere in which his suggestions or complaints would receive a prompt, respectful response."[2]

Schultz is motivated by both personal and business considerations: "When employees have self-esteem and self-respect," he argues, "they can contribute so much more: to their company, to their family, to the world."[3] His commitment to his employees is embedded in Starbuck's mission statement, whose first objective is to "provide a great work environment and treat each other with respect and dignity."[4] Those working at Starbucks are called partners because Schultz believes working for his company is not just a job, it's a passion.[5]

Human Resource Management

Employees at Starbucks are vital to the company's success. They are its public face, and every dollar of sales passes through their hands.[6] According to Howard Schultz, they can make or break the company. If a customer has a positive interaction with an employee, the customer will come back. If an encounter is negative, the customer is probably gone for good. That's why it's crucial for Starbucks to recruit and hire the right people, train them properly, motivate them to do their best, and encourage them to stay with the company. Thus, the company works to provide satisfying jobs, a positive work environment, appropriate work schedules,

and fair compensation and benefits. These activities are part of Starbucks's strategy to deploy human resources in order to gain competitive advantage. The process is called **human resource management** (HRM), which consists of all actions that an organization takes to attract, develop, and retain quality employees. Each of these activities is complex. Attracting talented employees involves the recruitment of qualified candidates and the selection of those who best fit the organization's needs. Development encompasses both new-employee orientation and the training and development of current workers. Retaining good employees means motivating them to excel, appraising their performance, compensating them appropriately, and doing what's possible to keep them.

Figure 8.2: A Starbucks barista serving a customer

Human Resource Planning

How does Starbucks make sure that its worldwide retail locations are staffed with just the right number of committed employees? How does Norwegian Cruise Lines make certain that when the Norwegian Dawn pulls out of New York harbor, it has a complete, fully trained crew on board to feed, entertain, and care for its passengers? Managing these tasks is a matter of **strategic human resource planning**—the process of developing a plan for satisfying an organization's human resources (HR) needs.

A strategic HR plan lays out the steps that an organization will take to ensure that it has the right number of employees with the right skills in the right places at the right times. HR managers begin by analyzing the company's mission, objectives, and strategies. Starbucks's objectives, for example, include the desire to "develop enthusiastically satisfied customers" as well as to foster an environment in which employees treat both customers and each other with respect.[7] Thus, the firm's HR managers look for people who are "adaptable, self-motivated, passionate, creative team members."[8] The main goal of Norwegian Cruise Lines—to lavish passengers with personal attention—determines not only the type of employee desired (one with exceptionally good customer-relation skills and a strong work ethic) but also the number needed (one for every two passengers on the Norwegian Dawn).[9]

Job Analysis

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

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

HR Supply and Demand Forecasting

Once they've analyzed the jobs within the organization, HR managers must **forecast** future hiring (or firing) needs. This is the three-step process summarized below.

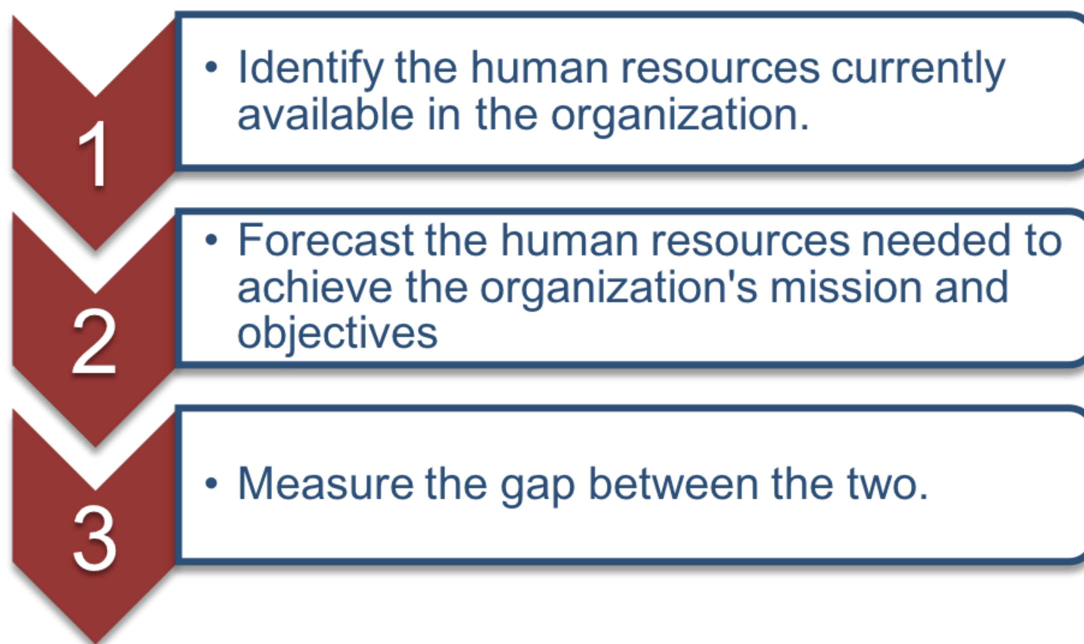

Figure 8.3: How to Forecast Hiring (and Firing) Needs

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

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

Recruiting Qualified Employees

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

Before going any further, we should point out that in recruiting and hiring, managers must comply with antidiscrimination laws; violations can have legal consequences. **Discrimination** occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability. Under federal law, it's illegal to discriminate in recruiting and hiring on the basis of race, color, religion, sex, national origin, age, or disability. (The same rules apply to other employment activities, such as promoting, compensating, and firing.)[10] The Equal Employment Opportunity Commission (EEOC) enforces a number of federal employment laws, including the following:

- Title VII of the Civil Rights Act of 1964, which prohibits employment discrimination based on race, color, religion, sex, or national origin. Sexual harassment is also a violation of Title VII.
- The Equal Pay Act of 1963, which protects both women and men who do substantially equal work from sex-based pay discrimination.
- The Age Discrimination in Employment Act of 1964, which protects individuals who are forty or older.
- Title I and Title V of the Americans with Disabilities Act of 1990, which prohibits employment discrimination against individuals with disabilities.[11]

Where to Find Candidates

The first step in recruiting is to find qualified candidates. Where do you look for them, and how do you decide whether they're qualified? Companies must assess not only the ability of a candidate to perform the duties of a job, but also whether he or she is a good "fit" for the company– i.e., how well the candidate's values and interpersonal style match the company's values and culture.

Internal versus External Recruiting

Where do you find people who satisfy so many criteria? Basically, you can look in two places: inside and outside your own organization. Both options have pluses and minuses. Hiring internally sends a positive signal to employees that they can move up in the company—a strong motivation tool and a reward for good performance. In addition, because an internal candidate is a known quantity, it's easier to predict his or her success in a new position. Finally, it's cheaper to recruit internally. On the other hand, you'll probably have to fill the promoted employee's position. Going outside gives you an opportunity to bring fresh ideas and skills into the company. In any case, it's often the only alternative, especially if no one inside the company has just the right combination of skills and experiences. Entry-level jobs are usually filled from the outside.

How to Find Candidates

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

Recruiting people from outside is more complicated. It's a lot like marketing a product to buyers: in effect, you're marketing the virtues of working for your company. Starbucks uses the following outlets to advertise openings:

- A dedicated section of the **corporate web site** ("Job Center," which lists openings, provides information about the Starbucks experience, and facilitates the submission of online applications)
- **College campus recruiting** (holding on-campus interviews and information sessions and participating in career fairs)
- **Internships** designed to identify future talent among college students
- Announcements on **employment web sites** like Monster.com, Vault.com, Glassdoor.com, and SimplyHired.com
- Newspaper **classified ads**
- Facebook and Twitter
- Local **job fairs**
- In-store recruiting posters
- Informative "business cards" for distribution to customers[12]

When asked what it takes to attract the best people, Starbucks's senior executive Dave Olsen replied, "Everything matters." Everything Starbucks does as a company bears on its ability to attract talent. Accordingly, everyone is responsible for recruiting, not just HR specialists. In fact, the best source of quality applicants is often the company's own labor force.[13]

Figure 8.4: Students talking to a recruiter at a college campus job fair

The Selection Process

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

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

Let's examine the selection process more closely by describing the steps that you'd take to become a special agent for the Federal Bureau of Investigation (FBI).[14] Most business students don't generally aspire to become FBI agents, but the FBI is quite interested in business graduates—especially if you have a major in accounting or finance. With one of these backgrounds, you'll be given priority in hiring. Why?

Unfortunately, there's a lot of white-collar crime that needs to be investigated, and people who know how to follow the money are well suited for the task.

Application

The first step in a new graduate being hired as an FBI accountant is applying for the job. Make sure you meet the minimum qualifications they advertise. To provide factual information on your education and work background, you'll submit an application, which the FBI will use as an initial screening tool.

Employment Tests

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

Interview

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

Physical Exam and Reference Checks

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

Final Decision

The last stage in the process is out of your control. Will you be hired or not? This decision is made by one or more people who work for the prospective employer. For a business, the decision maker is generally the line manager who oversees the position being filled. At the FBI, the decision is made by a team at FBI headquarters.

Contingent Workers

Though most people hold permanent, full-time positions, there's a growing number of individuals who work at temporary or part-time jobs. Many of these are contingent workers hired to supplement a company's permanent workforce. Most of them are independent contractors, consultants, or freelancers who are paid by the firms that hire them. Others are on-call workers who work only when needed, such as substitute teachers. Still others are temporary workers (or "temps") who are employed and paid by outside agencies or contract firms that charge fees to client companies.

The Positives and Negatives of Temp Work

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

Developing Employees

Because companies can't survive unless employees do their jobs well, it makes economic sense to train them and develop their skills. This type of support begins when an individual enters the organization and continues as long as he or she stays there.

New-Employee Orientation

Have you ever started your first day at a new job feeling upbeat and optimistic only to walk out at the end of the day thinking that maybe you've taken the wrong job? If this happens too often, your employer may need to revise its approach to orientation—the way it introduces new employees to the organization and their jobs. Starting a new job is a little like beginning college; at the outset, you may be experiencing any of the following feelings:

- Somewhat nervous but enthusiastic
- Eager to impress but not wanting to attract too much attention
- Interested in learning but fearful of being overwhelmed with information
- Hoping to fit in and worried about looking new or inexperienced[15]

The employer who understands how common such feelings are is more likely not only to help newcomers get over them but also to avoid the pitfalls often associated with new-employee orientation:

- Failing to have a workspace set up for you
- Ignoring you or failing to supervise you
- Neglecting to introduce you to coworkers
- Swamping you with facts about the company[16]

A good employer will take things slowly, providing you with information about the company and your job on a need-to-know basis while making you feel as comfortable as possible. You'll get to know the company's history, traditions, policies, and culture over time. You'll learn more about salary and benefits and how your performance will be evaluated. Most importantly, you'll find out how your job fits into overall operations and what's expected of you.

Training and Development

It would be nice if employees came with all the skills they need to do their jobs. It would also be nice if job requirements stayed the same: once you've learned how to do a job, you'd know how to do it forever. In reality, new employees must be trained; moreover, as they grow in their jobs or as their jobs change, they'll need additional training. Unfortunately, training is costly and time-consuming.

How costly? *Training* magazine reported that businesses spent over $55 billion on training in 2013.[17] At Darden Restaurants, the parent company to restaurants such as Olive Garden and Red Lobster, training focuses on diversity skills.[18] What's the payoff? Why are such companies willing to spend so much money on their employees? Darden has been recognized by *Fortune* magazine as a "Diversity Champion," ranking it as one of the Top 20 employers on their list of diverse workforces.[19] At Booz Allen Hamilton, consultants specialize in finding innovative solutions to client problems, and their employer makes sure that they're up-to-date on all the new technologies by maintaining a "technology petting zoo" at its training headquarters. It's called a "petting zoo" because employees get to see, touch, and interact with new and emerging technologies. For example, a *Washington Post* reporter visiting the "petting zoo" in 2007 saw fabric that could instantly harden if struck by a knife or bullet, and "smart" clothing that could monitor a wearer's health or environment.[20]

At Booz Allen Hamilton's technology "petting zoo," employees are receiving off-the-job training. This approach allows them to focus on learning without the distractions that would occur in the office. More common, however, is informal on-the-job training, which may be supplemented with formal training programs. This is the method, for example, by which you'd move up from mere coffee maker to a full-fledged "barista" if you worked at Starbucks.[21] You'd begin by reading a large spiral book (titled Starbucks University) on the responsibilities of the barista, pass a series of tests on the reading, then get hands-on experience in making drinks, mastering one at a time.[22] Doing more complex jobs in business will likely require even more training than is required to be a barista.

Diversity in the Workplace

The makeup of the U.S. workforce has changed dramatically over the past 50 years. In the 1950s, more than 60 percent was composed of white males.[23] Today's workforce reflects the broad range of differences in the population—differences in gender, race, ethnicity, age, physical ability, religion, education, and lifestyle. As you can see in Figure 8.5, more women and minorities have entered the workforce, and white males now make up only 36 percent of the workforce.[24]

Figure 8.5: Employment by Gender and Ethnic Group, 2015

Group	Total	Males	Females

Group	Total	Males	Females
All employees	100%	53%	47%
White	79%	54%	46%
African American	12%	47%	53%
Asian/Pacific Islander/Other	9%	53%	47%
Hispanic/Latino Ethnicity	16%	58%	42%

Most companies today strive for diverse workforces. HR managers work hard to recruit, hire, develop, and retain a diverse workforce. In part, these efforts are motivated by legal concerns: discrimination in recruiting, hiring, advancement, and firing is illegal under federal law and is prosecuted by the EEOC.[25] Companies that violate antidiscrimination laws are subject to severe financial penalties and also risk reputational damage. In November 2004, for example, the EEOC charged that recruiting policies at Abercrombie & Fitch, a national chain of retail clothing stores, had discriminated against minority and female job applicants between 1999 and 2004. The EEOC alleged that A&F had hired a disproportionate number of white salespeople, placed minorities and women in less visible positions, and promoted a virtually all-white image in its marketing efforts. Six days after the EEOC filed a lawsuit, the company settled the case at a cost of $50 million, but the negative publicity may hamper both recruitment and sales for some time.[26]

Figure 8.6: Models pose at the grand opening of an Abercrombie and Fitch store in Ireland, 2012

Reasons for building a diverse workforce go well beyond mere compliance with legal standards. It even goes beyond commitment to ethical standards. It's good business. People with diverse backgrounds bring fresh points of view that can be invaluable in generating ideas and solving problems. In addition, they can be the key to connecting with an ethnically diverse customer base. If a large percentage of your customers are Hispanic, it might make sense to have a Hispanic marketing manager. In short, capitalizing on the benefits of a diverse workforce means that employers should view differences as assets rather than liabilities.

What Makes a Great Place to Work?

Every year, the Great Places to Work Institute analyzes comments from thousands of employees and compiles a list of "The 100 Best Companies to Work for in America®," which is published in *Fortune* magazine. Having compiled its list for more than twenty years, the institute concludes that the defining characteristic of a great company to work for is trust between managers and employees. Employees overwhelmingly say that they want to work at a place where employees "trust the people they work for, have pride in what they do, and enjoy the people they work with."[27] They report that they're motivated to perform well because they're challenged, respected, treated fairly, and appreciated. They take pride in what they do, are made to feel that they make a difference, and are given opportunities for advancement.[28] The most effective motivators, it would seem, are closely aligned with Maslow's higher-level needs and Herzberg's motivating factors. The top ten companies are listed in Figure 8.7.

Figure 8.7: The top ten from the 2016 Fortune Best Companies to Work For®. Each name is a link to that company's career page.

Rank	Company
1	Google
2	Acuity Insurance
3	Boston Consulting Group
4	Wegman's Food Markets
5	Quicken Loans

Rank	Company
6	Robert W. Baird & Co.
7	Kimley-Horn
8	SAS Institute
9	Camden Property Trust
10	Edward Jones

Job Redesign

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

Job Rotation

Specialization promotes efficiency because workers get very good at doing particular tasks. The drawback is the tedium of repeating the same task day in and day out. The practice of job rotation allows employees to rotate from one job to another on a systematic basis, often but not necessarily cycling back to their original tasks. A computer maker, for example, might rotate a technician into the sales department to increase the employee's awareness of customer needs and to give the employee a broader understanding of the company's goals and operations. A hotel might rotate an accounting clerk to the check- in desk for a few hours each day to add variety to the daily workload. Through job rotation, employees develop new skills and gain experience that increases their value to the company. So great is the benefit of this practice that many companies have established rotational training programs that include scheduled rotations during the first 2-3 years of employment. Companies benefit because cross-trained employees can fill in for absentees, thus providing greater flexibility in scheduling, offer fresh ideas on work practices, and become promotion-ready more quickly.

Job Enlargement

Instead of a job in which you performed just one or two tasks, wouldn't you prefer a job that gave you many different tasks? In theory, you'd be less bored and more highly motivated if you had a chance at job enlargement—the policy of enhancing a job by adding tasks at similar skill levels. The job of sales clerk, for example, might be expanded to include gift-wrapping and packaging items for shipment. The additional duties would add variety without entailing higher skill levels.

Job Enrichment

Merely expanding a job by adding similar tasks won't necessarily "enrich" it by making it more challenging and rewarding. Job enrichment is the practice of adding tasks that increase both responsibility and opportunity for growth. It provides the kinds of benefits that, according to Maslow and Herzberg, contribute to job satisfaction: stimulating work, sense of personal achievement, self-esteem, recognition, and a chance to reach your potential.

Consider, for example, the evolving role of support staff in the contemporary office. Today, employees who used to be called "secretaries" assume many duties previously in the domain of management, such as project coordination and public relations. Information technology has enriched their jobs because they can now apply such skills as word processing, desktop publishing, creating spreadsheets, and managing databases. That's why we now use a term such as administrative assistant instead of secretary.[29]

Work/Life Quality

Building a career requires a substantial commitment in time and energy, and most people find that they aren't left with much time for non-work activities. Fortunately, many organizations recognize the need to help employees strike a balance between their work and home lives.[30] By helping employees combine satisfying careers and fulfilling personal lives, companies tend to end up with a happier, less-stressed, and more productive workforce. The financial benefits include lower absenteeism, turnover, and health care costs.

Alternative Work Arrangements

The accounting firm KPMG, which has made the list of the “100 Best Companies for Working Mothers” for nineteen years,[31] is committed to promoting a balance between its employees’ work and personal lives. KPMG offers a variety of work arrangements designed to accommodate different employee needs and provide scheduling flexibility.[32]

Flextime

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

Compressed Workweeks

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

Job Sharing

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

Telecommuting

Telecommuting means that you regularly work from home (or from some other non-work location). You’re connected to the office by computer, fax, and phone. You save on commuting time, enjoy more flexible work hours, and have more opportunity to spend time with your family. A study of 5,500 IBM employees (one-fifth of whom telecommute) found that those who worked at home not only had a better balance between work and home life but also were more highly motivated and less likely to leave the organization.[33]

Though it’s hard to count telecommuters accurately, Global Workplace Analytics estimates that, in 2016, “at least 3.7 million people (2.8 percent of the workforce) work from home at least half the time.”[34] Telecommuting isn’t for everyone. Working at home means that you have to discipline yourself to avoid distractions, such as TV, personal phone calls, and home chores and also not be impacted by feeling isolated from the social interaction in the workplace.

Family-Friendly Programs

In addition to alternative work arrangements, many employers, including KPMG, offer programs and benefits designed to help employees meet family and home obligations while maintaining busy careers. KPMG offers each of the following benefits.[35]

Dependent Care

Caring for dependents—young children and elderly parents—is of utmost importance to some employees, but combining dependent-care responsibilities with a busy job can be particularly difficult. KPMG provides on-site child care during tax season (when employees are especially busy) and offers emergency backup dependent care all year round, either at a provider’s facility or in the employee’s home. To get referrals or information, employees can call KPMG’s LifeWorks Resource and Referral Service.

KPMG is by no means unique in this respect: more than 7 percent of U.S. companies maintained on-site day care in 2012,[36] and 17 percent of all U.S. companies offered child-care resources or referral services.[37]

Paid Parental Leave

The United States is one of only two countries in the world that does not guarantee paid leave to new mothers (or fathers), although California, Rhode Island and New Jersey are implementing state programs, and many employers offer paid parental leave as an employee benefit.[38] Any KPMG employee (whether male or female) who becomes a parent can take two weeks of paid leave. New mothers may also get time off through short-term disability benefits.

Caring for Yourself

Like many companies, KPMG allows employees to aggregate all paid days off and use them in any way they want. In other words, instead of getting, say, ten sick days, five personal days, and fifteen vacation days, you get a total of thirty days to use for anything.

If you're having personal problems, you can contact the Employee Assistance Program. If staying fit makes you happier and more productive, you can take out a discount membership at one of more than nine thousand health clubs. In fact, many employers, like North Carolina software company SAS, now have on-site fitness centers for employee use.[39]

Unmarried without Children

You've undoubtedly noticed by now that many programs for balancing work and personal lives target married people, particularly those with children. Single individuals also have trouble striking a satisfactory balance between work and non-work activities, but many single workers feel that they aren't getting equal consideration from employers.[40] They report that they're often expected to work longer hours, travel more, and take on difficult assignments to compensate for married employees with family commitments.

Needless to say, requiring singles to take on additional responsibilities can make it harder for them to balance their work and personal lives. It's harder to plan and keep personal commitments while meeting heavy work responsibilities. Frustration can lead to increased stress and job dissatisfaction. In several studies of stress in the accounting profession, unmarried workers reported higher levels of stress than any other group, including married people with children.[41]

With singles, as with married people, companies can reap substantial benefits from programs that help employees balance their work and non-work lives. PepsiCo, for example, offers a "concierge service," which maintains a dry cleaner, travel agency, convenience store, and fitness center on the premises of its national office in Somers, New York.[42] Single employees seem to find these services helpful, but what they value most of all is control over their time. In particular, they want predictable schedules that allow them to plan social and personal activities. They don't want employers assuming that being single means that they can change plans at the last minute. It's often more difficult for singles to deal with last-minute changes because, unlike married coworkers, they don't have the at-home support structure to handle such tasks as tending to elderly parents or caring for pets.

Compensation and Benefits

Though paychecks and benefits packages aren't the only reasons why people work, they do matter. Competitive pay and benefits also help organizations attract and retain qualified employees. Companies that pay their employees more than their competitors generally have lower turnover. Consider, for example, The Container Store, which regularly appears on Fortune magazine's list of "The 100 Best Companies to Work For."[43] The retail chain staffs its stores with fewer employees than its competitors but pays them more—in some cases, three times the industry average for retail workers. This strategy allows the company to attract extremely talented workers who, moreover, aren't likely to leave the company. Low turnover is particularly valuable in the retail industry because it depends on service-oriented personnel to generate repeat business. In addition to salary and wages, compensation packages often include other financial incentives, such as bonuses and profit-sharing plans, as well as benefits, such as medical insurance, vacation time, sick leave, and retirement accounts.

Wages and Salaries

The largest, and most important, component of a compensation package is the payment of wages or salary. If you're paid according to the number of hours you work, you're earning wages. Counter personnel at McDonald's, for instance, get wages, which are determined by multiplying an employee's hourly wage rate by the number of hours worked during the pay period. On the other hand, if you're paid for fulfilling the responsibilities of a position—regardless of the number of hours required to do it— you're earning a salary. The McDonald's manager gets a salary for overseeing the operations of the restaurant. He or she is expected to work as long as it takes to get the job done, without any adjustment in compensation.

Piecework and Commissions

Sometimes it makes more sense to pay workers according to the quantity of product that they produce or sell. Byrd's Seafood, a crab-processing plant in Crisfield, Maryland, pays workers on **piecework**: workers' pay is based on the amount of crabmeat that's picked from recently cooked crabs. (A good picker can produce fifteen pounds of crabmeat an hour and earn about $100 a day.)[44] On the other hand, if you're working on **commission**, you're probably getting paid a percentage of the total dollar amount you sell. If you were a sales representative for an insurance company, like The Hartford, you'd get a certain amount of money for each automobile or homeowner policy you sold.[45]

Incentive Programs

In addition to regular paychecks, many people receive financial rewards based on performance, whether their own, their employer's, or both. Other incentive programs designed to reward employees for good performance include bonus plans and stock

options.

Bonus Plans

Texas Instruments' (TI) year-end bonuses—annual income given in addition to salary—are based on individual and company-wide performance. If the company has a profitable year, and if you contributed to that success, you'll get a bonus.[46] If the company doesn't do well, you may be out of luck – regardless of your personal performance, you might not receive a bonus.

Bonus plans have become quite common, and the range of employees eligible for bonuses has widened in recent years. In the past, bonus plans were usually reserved for managers above a certain level. Today, companies have realized the value of extending plans to include employees at virtually every level. The magnitude of bonuses still favors those at the top. High-ranking officers often get bonuses ranging from 30 percent to 50 percent of their salaries. Upper-level managers may get from 15 percent to 25 percent and middle managers from 10 percent to 15 percent. At lower levels, employees may expect bonuses from 3 percent to 5 percent of their annual compensation.[47]

Profit-Sharing Plans

Delta Airlines[48] and General Motors[49] both have profit-sharing arrangements with employees. Today, about 40% of all U.S. companies offer some type of profit-sharing program.[50]

TI's plan is also pretty generous—as long as the company has a good year. Here's how it works. An employee's profit share depends on the company's operating profit for the year. If profits from operations reach 10 percent of sales, the employee gets a bonus worth 2 percent of his or her salary. In 2011, TI's operating profit was 22 percent, and employee bonuses were 7.9 percent of salary. But if operating profits are below 10 percent, nobody gets anything.[51]

Stock-Option Plans

The TI compensation plan also gives employees the right to buy shares of company stock at a 15% discount four times a year.[52] So, if the price of the stock goes up, the employee benefits. Say, for example, that the stock was selling for $30 a share when the option was granted in 2007. The employee would be entitled to buy shares at a price of $25.50, earning them an immediate 15% gain in value. Any increase in share price would add to that gain.[53]

At TI, stock options are used as an incentive to attract and retain top people.[54] Starbucks, by contrast, isn't nearly as selective in awarding stock options. At Starbucks, all employees can earn "Bean Stock"—the Starbucks employee stock-option plan. Both full- and part-time employees get Starbucks shares based on their earnings and their time with the company. If the company does well and its stock goes up, employees make a profit. CEO Howard Schultz believes that Bean Stock pays off because employees are rewarded when the company does well, they have a stronger incentive to add value to the company (and so drive up its stock price). Starbucks has a video explaining their employee stock option program on this webpage.[55]

Benefits

Another major component of an employee's compensation package is benefits— compensation other than salaries, hourly wages, or financial incentives. Types of benefits include the following:

- Legally required benefits (Social Security and Medicare, unemployment insurance, workers' compensation)
- Paid time off (vacations, holidays, sick leave)
- Insurance (health benefits, life insurance, disability insurance)
- Retirement benefits

The cost of providing benefits is staggering. According to the U.S. Bureau of Labor Statistics, it costs an average employer about 30 percent of a worker's salary to provide the same worker with benefits. If you include pay for time not worked (while on vacation or sick and so on), the percentage increases to 37 percent. The most money goes for paid time off (6.9% of salary costs), health care (8.1%), and retirement benefits (3.8%).[56]

Some workers receive only the benefits required by law while part-timers often receive no benefits at all.[57] Again, Starbucks is generous in offering benefits. The company provides benefits even to the part-timers who make up two-thirds of the company's workforce; anyone working at least twenty hours a week is eligible to participate in group medical coverage.[58]

Performance Appraisal

Employees generally want their managers to tell them three things: what they should be doing, how well they're doing it, and how they can improve their performance. Good managers address these issues on an ongoing basis. On a semiannual or annual basis,

they also conduct formal performance appraisals to discuss and evaluate employees' work performance.

The Basic Three-Step Process

Appraisal systems vary both by organization and by the level of the employee being evaluated, but as you can see in Figure 8.8, it's generally a three-step process:

1. Before managers can measure performance, they must set goals and performance expectations and specify the criteria (such as quality of work, quantity of work, dependability, initiative) that they'll use to measure performance.
2. At the end of a specified time period, managers complete written evaluations that rate employee performance according to the predetermined criteria.
3. Managers then meet with each employee to discuss the evaluation. Jointly, they suggest ways in which the employee can improve performance, which might include further training and development.

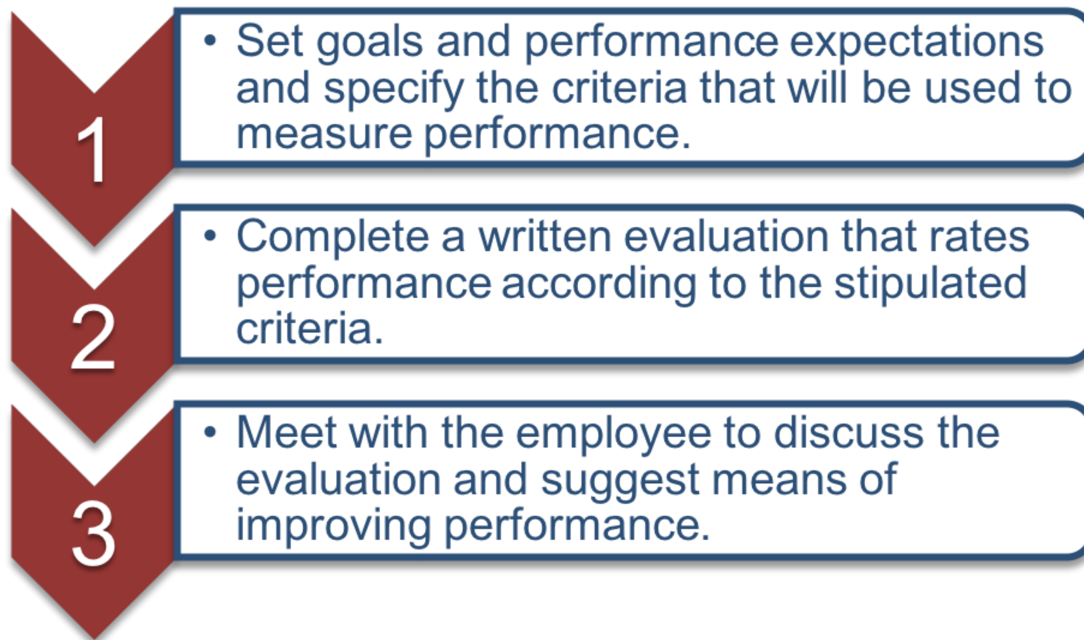

Figure 8.8: The three steps in the performance appraisal process

It sounds fairly simple, but why do so many managers report that, except for firing people, giving performance appraisals is their least favorite task?[59] To get some perspective on this question, we'll look at performance appraisals from both sides, explaining the benefits and identifying potential problems with some of the most common practices.

Among other benefits, formal appraisals provide the following:

- An opportunity for managers and employees to discuss an employee's performance and to set future goals and performance expectations
- A chance to identify and discuss appropriate training and career-development opportunities for an employee
- Formal documentation of the evaluation that can be used for salary, promotion, demotion, or dismissal purposes[60]

As for disadvantages, most stem from the fact that appraisals are often used to determine salaries for the upcoming year. Consequently, meetings to discuss performance tend to take on an entirely different dimension: the manager may appear judgmental (rather than supportive), and the employee may get defensive. This adversarial atmosphere can make many managers not only uncomfortable with the task but also less likely to give honest feedback. (They may give higher marks in order to avoid delving into critical evaluations.) HR professionals disagree about whether performance appraisals should be linked to pay increases. Some experts argue that the connection eliminates the manager's opportunity to use the appraisal to improve an employee's performance. Others maintain that it increases employee satisfaction with the process and distributes raises on the basis of effort and results.[61]

360-Degree and Upward Feedback

Instead of being evaluated by one person, how would you like to be evaluated by several people—not only those above you in the organization but those below and beside you? The approach is called 360-degree feedback, and the purpose is to ensure that employees (mostly managers) get feedback from all directions—from supervisors, reporting subordinates, coworkers, and even customers. If it's conducted correctly, this technique furnishes managers with a range of insights into their performance in a number of roles.

Some experts, however, regard the 360-degree approach as too cumbersome. An alternative technique, called upward feedback, requires only the manager's subordinates to provide feedback. Computer maker Dell uses this approach as part of its manager-development plan. Every year, forty thousand Dell employees complete a survey in which they rate their supervisors on a number of dimensions, such as practicing ethical business principles and providing support in balancing work and personal life. Dell uses survey results for development purposes only, not as direct input into decisions on pay increases or promotions.[62]

Retaining Valuable Employees

When a valued employee quits, the loss to the employer can be serious. Not only will the firm incur substantial costs to recruit and train a replacement, but it also may suffer temporary declines in productivity and lower morale among remaining employees who have to take on heavier workloads. Given the negative impact of turnover—the permanent separation of an employee from a company—most organizations do whatever they can to retain qualified employees. Compensation plays a key role in this effort: companies that don't offer competitive compensation packages tend to lose employees. Other factors also come into play, such as training and development, as well as helping employees achieve a satisfying work/non-work balance. In the following sections, we'll look at a few other strategies for reducing turnover and increasing productivity.[63]

Creating a Positive Work Environment

Employees who are happy at work are more productive, provide better customer service, and are more likely to stay with the company. A study conducted by Sears, for instance, found a positive relationship between customer satisfaction and employee attitudes on ten different issues: a 5 percent improvement in employee attitudes results in a 1.3 percent increase in customer satisfaction and a 0.5 percent increase in revenue.[64]

The Employee-Friendly Workplace

What sort of things improve employee attitudes? The 12,000 employees of software maker SAS Institute fall into the category of "happy workers." They choose the furniture and equipment in their offices, eat subsidized meals at one of three on-site restaurants, and enjoy other amenities like a 77,000 square-foot fitness center. They also have job security: no one's ever been laid off because of an economic downturn. The employee-friendly work environment helps SAS employees focus on their jobs and contribute to the attainment of company goals.[65] Not surprisingly, it also results in very low 3 percent turnover.

Recognizing Employee Contributions

Thanking people for work done well is a powerful motivator. People who feel appreciated are more likely to stay with a company than those who don't.[66] While a personal thank-you is always helpful, many companies also have formal programs for identifying and rewarding good performers. The Container Store rewards employee accomplishments in a variety of ways. For example, employees with 20 years of service are given a "dream trip"—one employee went on a seven day Hawaiian cruise.[67] The company is known for its supportive environment and in 2016 celebrated its seventeenth year on *Fortune*'s 100 Best Companies to Work For®.[68]

Involving Employees in Decision Making

Companies have found that involving employees in decisions saves money, makes workers feel better about their jobs, and reduces turnover. Some have found that it pays to take their advice. When General Motors asked workers for ideas on improving manufacturing operations, management was deluged with more than forty-four thousand suggestions during one quarter. Implementing a few of them cut production time on certain vehicles by 15 percent and resulted in sizable savings.[69]

Similarly, in 2001, Edward Jones, a personal investment company, faced a difficult situation during the stock-market downturn. Costs had to be cut, and laying off employees was one option. Instead, however, the company turned to its workforce for solutions. As a group, employees identified cost savings of more than $38 million. At the same time, the company convinced experienced employees to stay with it by assuring them that they'd have a role in managing it.[70]

Why People Quit

As important as such initiatives can be, one bad boss can spoil everything. The way a person is treated by his or her boss may be the primary factor in determining whether an employee stays or goes. People who have quit their jobs cite the following behavior by superiors:

- Making unreasonable work demands
- Refusing to value their opinions
- Failing to be clear about what's expected of subordinates
- Showing favoritism in compensation, rewards, or promotions[71]

Holding managers accountable for excessive turnover can help alleviate the "bad-boss" problem, at least in the long run. In any case, whenever an employee quits, it's a good idea for someone—other than the individual's immediate supervisor—to conduct an exit interview to find out why. Knowing why people are quitting gives an organization the opportunity to correct problems that are causing high turnover rates.

Involuntary Termination

Some companies employ a process called **Forced Ranking** to manage out their under-performers. In this approach, only a certain percentage of employees can receive a particular performance evaluation score, which forces some employees to the bottom of the distribution—sort of the opposite of a curved exam score. The employee pool in question is typically made up of those who do similar kinds of work. Ideally after being given some amount of time to improve, those who remain at the bottom of the performance distribution are then separated from the company. As you can imagine, this practice has caused a fair amount of controversy!

Before we leave this section, we should say a word or two about termination—getting fired. Though turnover—voluntary separations—can create problems for employers, they're not nearly as devastating as the effects of involuntary termination on employees. Losing your job is what psychologists call a "significant life change," and it's high on the list of "stressful life events" regardless of the circumstances. Sometimes, employers lay off workers because revenues are down and they must resort to downsizing—to cutting costs by eliminating jobs. Sometimes a particular job is being phased out, and sometimes an employee has simply failed to meet performance requirements.

Employment at Will

Is it possible for you to get fired even if you're doing a good job and there's no economic justification for your being laid off? In some cases, yes—especially if you're not working under a contract. Without a formal contract, you're considered to be employed at will, which means that both you and your employer have the right to terminate the employment relationship at any time. You can quit whenever you want, but your employer can also fire you whenever they want.

Fortunately for employees, over the past several decades, the courts have made several decisions that created exceptions to the employment-at-will doctrine.[72] Since managers generally prefer to avoid the expense of fighting wrongful discharge claims in court, many no longer fire employees at will. A good practice in managing terminations is to maintain written documentation so that employers can demonstrate just cause when terminating an employee. If it's a case of poor performance, the employee would be warned in advance that his or her current level of performance could result in termination and then be permitted an opportunity to improve performance. When termination is necessary, communication should be handled in a private conversation, with the manager explaining precisely why the action is being taken.

Key Takeaways

1. The process of **humanresource management** consists of actions that an organization takes to attract, develop, and retain quality employees.
2. Human resource managers engage in **strategic human resource planning—**the process of developing a plan for satisfying the organization's human resource needs
3. The HR manager forecasts future hiring needs and begins the **recruiting** process to fill those needs.
4. In recruiting and hiring, managers must comply with antidiscrimination laws enforced by the **Equal Employment Opportunity Commission** (EEOC). They cannot treat people unfairly on the basis of a characteristic unrelated to ability, such as race, color, religion, sex, national origin, age, or disability.
5. HR managers also oversee employee training, from the first **orientation** to continuing **on–** or **off-the-job training**.

6. Attracting a **diverse workforce** goes beyond legal compliance and ethical commitments, because a diverse group of employees can offer perspectives that may be valuable in generating ideas, solving problems, and connecting with an ethnically diverse customer base.
7. Employees are motivated to perform well when they're challenged, respected, treated fairly, and appreciated.
8. Some other factors that contribute to employee satisfaction include **job redesign** to make jobs more interesting and challenging, **job rotation,** which allows employees to rotate from one job to another, **job enlargement,** which enhances a job by adding tasks at similar skill levels, and **job enrichment,** which adds tasks that increase both responsibility and opportunity for growth.
9. Many organizations recognize the need to help employees strike a balance between their work and home lives and offer a variety of work arrangements to accommodate different employee needs, such as **flextime** (flexible scheduling)**, job sharing** (when two people share a job), and **telecommuting** (working from outside the office).
10. Compensation includes pay and benefits. Workers who are paid by the hour earn **wages**, while those who are paid to fulfill the responsibilities of the job earn **salaries**. Some people receive **commissions** based on sales or are paid for output, based on a **piecework** approach.
11. In addition employees can may receive year-end **bonuses**, participate in **profit-sharing plans**, or receive **stock options**.
12. Managers conduct **performanceappraisals** to evaluate work performance.
13. **Turnover** is the permanent separation of an employee from a company and may happen if an employee is unsatisfied with their job, or because the organization is not satisfied with the employee. Sometimes, firms lay off workers, or **downsize**, to cut costs.

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9: Operations Management

Learning Objectives

1. Define operations management and discuss the role of the operations manager in a manufacturing company.
2. Describe the decisions and activities of the operations manager in overseeing the production process in a manufacturing company.
3. Explain how to create and use both PERT and Gantt charts.
4. Explain how manufacturing companies use technology to produce and deliver goods in an efficient, cost-effective manner.
5. Describe the decisions made in planning the product delivery process in a service company.
6. List the characteristics that distinguish service operations from manufacturing operations and identify the activities undertaken to manage operations in a service organization.
7. Explain how manufacturing and service companies alike use total quality management and outsourcing to provide value to customers.

The Challenge: Producing Quality Jetboards

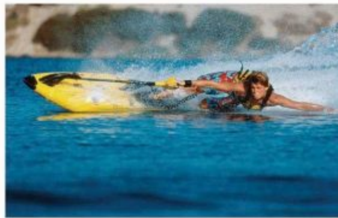


Figure 9.1: The PowerSki Jetboard. To see it in action, visit the company's Web site at www.powerski.com/. Watch the videos that demonstrate what the Jetboard can do.

The product development process can be complex and lengthy. It took sixteen years for Bob Montgomery and others at his company to develop the PowerSki Jetboard, and this involved thousands of design changes. It was worth it, though: the Jetboard was an exciting, engine-propelled personal watercraft – a cross between a high-performance surfboard and a competition water-ski/wakeboard that received extensive media attention and rave reviews. It was showered with honors, including Time magazine's "Best Invention of the Year" award.[1] Stories about the Jetboard appeared in more than fifty magazines around the world, and it was featured in several movies, over twenty-five TV shows, and on YouTube.[2]

Montgomery and his team at PowerSki enjoyed taking their well-deserved bows for the job they did designing the product, but having a product was only the beginning for the company. The next step was developing a system that would produce high-quality Jetboards at reasonable prices. Before putting this system in place, PowerSki managers had to address several questions.

- What kind of production process should they use to make the Jetboards?
- How large should their production facilities be, and where should they be located?
- Where should they buy needed materials?
- What systems will be needed to control the production process and ensure a quality product?

Answering these and other questions helped PowerSki set up a manufacturing system through which it could accomplish the most important task that it had set for itself: efficiently producing quality Jetboards.

Operations Management in Manufacturing

Like PowerSki, every organization—whether it produces goods or provides services— sees Job 1 as furnishing customers with quality products. Thus, to compete with other organizations, a company must convert **resources** (materials, labor, money, information) into **goods or services** as efficiently as possible. The upper-level manager who directs this transformation process is called an **operations manager**. The job of **operations management** (OM) consists of all the activities involved in transforming a product idea into a finished product. In addition, operations managers are involved in planning and controlling the systems that produce goods and services. In other words, operations managers manage the process that transforms inputs into outputs. Figure 10.2 illustrates these traditional functions of operations management.

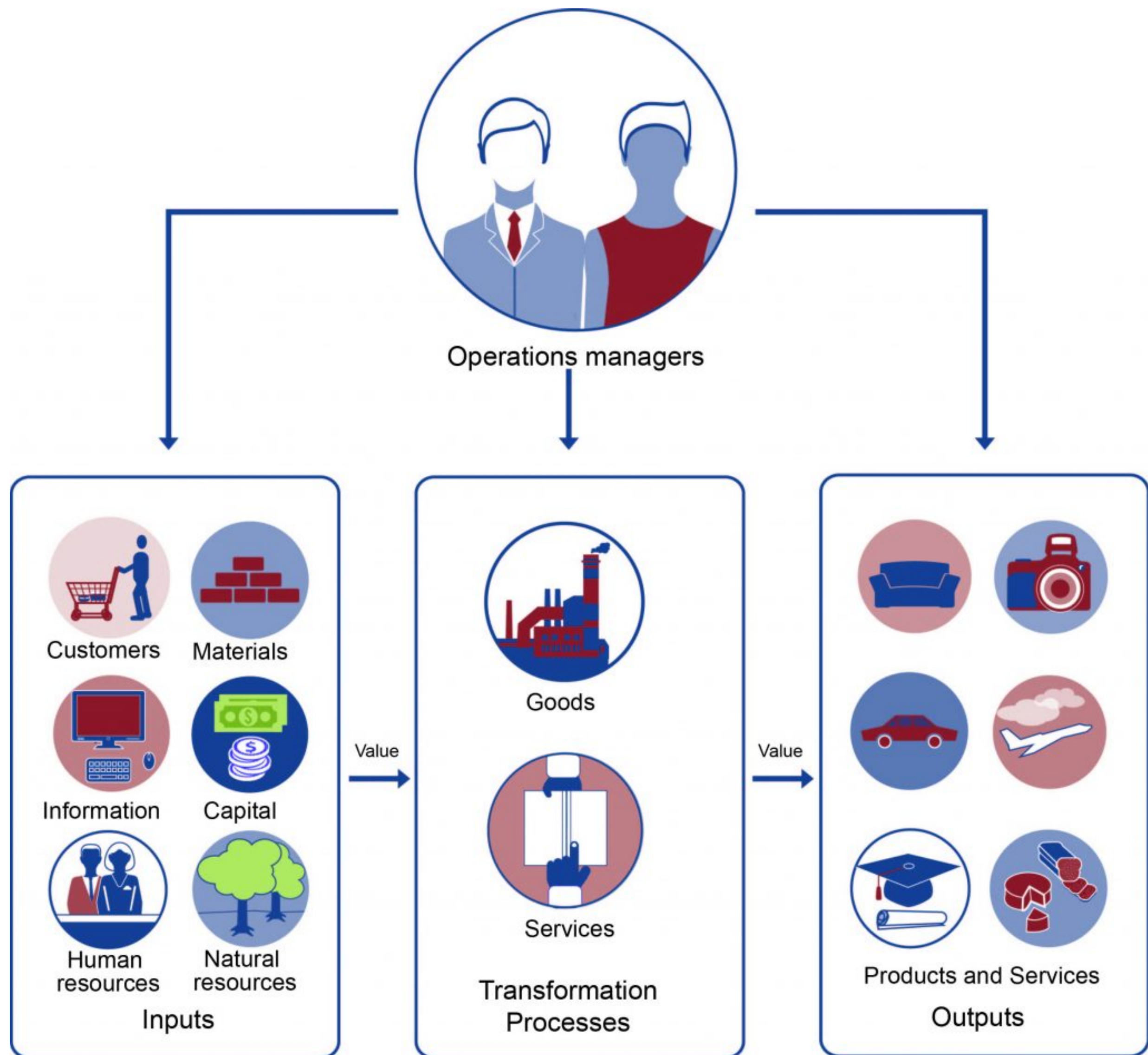


Figure 9.2: The Transformation Process

Like PowerSki, all **manufacturers** set out to perform the same basic function: to transform resources into finished goods. To perform this function in today's business environment, manufacturers must continually strive to improve operational efficiency. They must fine-tune their production processes to focus on quality, to hold down the costs of materials and labor, and to eliminate all costs that add no value to the finished product. Making the decisions involved in the effort to attain these goals is another job of operations managers. Their responsibilities can be grouped as follows:

- **Production planning**. During production planning, managers determine how goods will be produced, where production will take place, and how manufacturing facilities will be laid out.
- **Production control**. Once the production process is under way, managers must continually schedule and monitor the activities that make up that process. They must solicit and respond to feedback and make adjustments where needed. At this stage, they also oversee the purchasing of raw materials and the handling of inventories.
- **Quality control**. The operations manager is directly involved in efforts to ensure that goods are produced according to specifications and that quality standards are maintained.

Let's take a closer look at each of these responsibilities.

Planning the Production Process

The decisions made in the planning stage have long-range implications and are crucial to a firm's success. Before making decisions about the operations process, managers must consider the goals set by marketing managers. Does the company intend to be a low-

cost producer and to compete on the basis of price? Or does it plan to focus on quality and go after the high end of the market? Many decisions involve trade-offs. For example, low cost doesn't normally go hand in hand with high quality. All functions of the company must be aligned with the overall strategy to ensure success.

With these thoughts in mind, let's look at the specific types of decisions that have to be made in the production planning process. We've divided these decisions into those dealing with production methods, site selection, facility layout, and components and materials management.

Production-Method Decisions

The first step in production planning is deciding which type of **productionprocess** is best for making the goods that your company intends to manufacture. In reaching this decision, you should answer such questions as:

- Am I making a one-of-a-kind good based solely on customer specifications, or am I producing high-volume standardized goods to be sold later?
- Do I offer customers the option of "customizing" an otherwise standardized good to meet their specific needs?

One way to appreciate the nature of this decision is by comparing three basic types of processes or methods: make-to-order, mass production, and mass customization. The task of the operations manager is to work with other managers, particularly marketers, to select the process that best serves the needs of the company's customers.

Make-to-Order

At one time, most consumer goods, such as furniture and clothing, were made by individuals practicing various crafts. By their very nature, products were customized to meet the needs of the buyers who ordered them. This process, which is called a **make-to-order** strategy, is still commonly used by such businesses as print or sign shops that produce low-volume, high-variety goods according to customer specifications. This level of customization often results in a longer production and delivery cycle than other approaches.

Mass Production

By the early twentieth century, a new concept of producing goods had been introduced: **mass production** (or make-to-stock strategy), the practice of producing high volumes of identical goods at a cost low enough to price them for large numbers of customers. Goods are made in anticipation of future demand (based on forecasts) and kept in inventory for later sale. This approach is particularly appropriate for standardized goods ranging from processed foods to electronic appliances and generally result in shorter cycle times than a make-to-order process.

Mass Customization

There is at least one big disadvantage to mass production: customers, as one old advertising slogan put it, can't "have it their way." They have to accept standardized products as they come off assembly lines. Increasingly, however, customers are looking for products that are designed to accommodate individual tastes or needs but can still be bought at reasonable prices. To meet the demands of these consumers, many companies have turned to an approach called **mass customization**, which combines the advantages of customized products with those of mass production.

This approach requires that a company interact with the customer to find out exactly what the customer wants and then manufacture the good, using efficient production methods to hold down costs. One efficient method is to mass-produce a product up to a certain cut-off point and then to customize it to satisfy different customers.

One of the best-known mass customizers is Nike, which has achieved success by allowing customers to configure their own athletic shoes, apparel, and equipment through Nike's iD program. The Web has a lot to do with the growth of mass customization. Levi's, for instance, lets customers find a pair of perfect fitting jeans by going through an online fitting process. Oakley offers customized sunglasses, goggles, watches, and backpacks, while Mars, Inc. can make M&M's in any color the customer wants (say, school colors) as well as add text and even pictures to the candy.

Naturally, mass customization doesn't work for all types of goods. Most people don't care about customized detergents or paper products. And while many of us like the idea of customized clothes, footwear, or sunglasses, we often aren't willing to pay the higher prices they command.

Facilities Decisions

After selecting the best production process, operations managers must then decide where the goods will be manufactured, how large the manufacturing facilities will be, and how those facilities will be laid out.

Site Selection

In **site selection** (choosing a location for the business), managers must consider several factors:

- To minimize shipping costs, managers often want to locate plants close to suppliers, customers, or both.
- They generally want to locate in areas with ample numbers of skilled workers.
- They naturally prefer locations where they and their families will enjoy living.
- They want locations where costs for resources and other expenses—land, labor, construction, utilities, and taxes—are low.
- They look for locations with a favorable business climate—one in which, for example, local governments might offer financial incentives (such as tax breaks) to entice them to do business in their locales. For example, an enterprise zone is an area in which incentives are used to attract investments from private companies.

Managers rarely find locations that meet all these criteria. As a rule, they identify the most important criteria and aim at satisfying them. In deciding to locate in San Clemente, California, for instance, PowerSki was able to satisfy three important criteria: (1) proximity to the firm's suppliers, (2) availability of skilled engineers and technicians, and (3) favorable living conditions. These factors were more important than operating in a low-cost region or getting financial incentives from local government. Because PowerSki distributes its products throughout the world, proximity to customers was also unimportant.

Capacity Planning

Now that you know where you're going to locate, you have to decide on the quantity of products that you'll produce. You begin by **forecasting** demand for your product, which isn't easy. To estimate the number of units that you're likely to sell over a given period, you have to understand the industry that you're in and estimate your likely share of the market by reviewing industry data and conducting other forms of research.

Once you've forecasted the demand for your product, you can calculate the **capacity requirements** of your production facility—the maximum number of goods that it can produce over a given time under normal working conditions. In turn, having calculated your capacity requirements, you're ready to determine how much investment in plant and equipment you'll have to make, as well as the number of labor hours required for the plant to produce at capacity.

Like forecasting, capacity planning is difficult. Unfortunately, failing to balance capacity and projected demand can be seriously detrimental to your bottom line. If you set capacity too low (and so produce less than you should), you won't be able to meet demand, and you'll lose sales and customers. If you set capacity too high (and turn out more units than you should), you'll waste resources and inflate operating costs.

Managing the Production Process in a Manufacturing Company

Operations managers engage in the daily activities of materials management, which encompasses the activities of purchasing, inventory control, and work scheduling.

Purchasing and Supplier Selection

The process of acquiring the materials and services to be used in production is called **purchasing** (or procurement). For many products, the costs of materials make up about 50 percent of total manufacturing costs. Not surprisingly, materials acquisition gets a good deal of the operations manager's time and attention. As a rule, there's no shortage of vendors willing to supply materials, but the trick is finding the best suppliers. Operations managers must consider questions such as:

- Can the vendor supply the needed quantity of materials at a reasonable price?
- Is the quality good?
- Is the vendor reliable (will materials be delivered on time)?
- Does the vendor have a favorable reputation?
- Is the company easy to work with?

Getting the answers to these questions and making the right choices—a process known as **supplier selection**—is a key responsibility of operations management.

e-Procurement

Technology has changed the way businesses buy things. Through **e-procurement**, companies use the Internet to interact with suppliers. The process is similar to the one you'd use to find a consumer good—say, a high-definition TV—over the Internet. To choose a TV, you might browse the websites of manufacturers like Sony then shop prices and buy at Amazon, the world's largest online retailer.

If you were a purchasing manager using the Internet to buy parts and supplies, you'd follow basically the same process. You'd identify potential suppliers by going directly to private websites maintained by individual suppliers or to public sites that collect information on numerous suppliers. You could do your shopping through online catalogs, or you might participate in an online marketplace by indicating the type and quantity of materials you need and letting suppliers bid. Finally, just as you paid for your TV electronically, you could use a system called electronic data interchange (EDI) to process your transactions and transmit all your purchasing documents.

The Internet provides an additional benefit to purchasing managers by helping them communicate with suppliers and potential suppliers. They can use the Internet to give suppliers specifications for parts and supplies, encourage them to bid on future materials needs, alert them to changes in requirements, and give them instructions on doing business with their employers. Using the Internet for business purchasing cuts the costs of purchased products and saves administrative costs related to transactions. It's also faster for procurement and fosters better communications.

Inventory Control

If a manufacturer runs out of the materials it needs for production, then production stops. In the past, many companies guarded against this possibility by keeping large inventories of materials on hand. It seemed like the thing to do at the time, but it often introduced a new problem—wasting money. Companies were paying for parts and other materials that they wouldn't use for weeks or even months, and in the meantime, they were running up substantial storage and insurance costs. If the company redesigned its products, some parts might become obsolete before ever being used.

Most manufacturers have since learned that to remain competitive, they need to manage inventories more efficiently. This task requires that they strike a balance between two threats to productivity: losing production time because they've run out of materials and wasting money because they're carrying too much inventory. The process of striking this balance is called **inventory control**, and companies now regularly rely on a variety of inventory-control methods.

Just-in-Time Production

One method is called **just-in-time** (JIT) production: the manufacturer arranges for materials to arrive at production facilities just in time to enter the manufacturing process. Parts and materials don't sit unused for long periods, and the costs of "holding" inventory are significantly cut. JIT, however, requires considerable communication and cooperation between the manufacturer and the supplier. The manufacturer has to know what it needs and when. The supplier has to commit to supplying the right materials, of the right quality, at exactly the right time.

Material Requirements Planning

A software tool called **material requirements planning** (MRP), relies on sales forecasts and ordering lead times for materials to calculate the quantity of each component part needed for production and then determine when they should be ordered or made. The detailed sales forecast is turned into a master production schedule (MPS), which MRP then explodes into a forecast for the needed parts based on the bill of materials for each item in the forecast. A bill of materials is simply a list of the various parts that make up the end product. The role of MRP is to determine the anticipated need for each part based on the sales forecast and to place orders so that everything arrives just in time for production.

Graphical Tools: Gantt and PERT Charts

To control the timing of all operations, managers set up schedules: they select jobs to be performed during the production process, assign tasks to work groups, set timetables for the completion of tasks, and make sure that resources will be available when and where they're needed. There are a number of scheduling techniques. We'll focus on two of the most common—Gantt and PERT charts.

Gantt Charts

A **Gantt chart**, named after the designer, Henry Gantt, is an easy-to-use graphical tool that helps operations managers determine the status of projects. Let's say that you're in charge of making the "hiking bear" offered by the Vermont Teddy Bear Company. Figure 10.3 is a Gantt chart for the production of one hundred of these bears. As you can see, it shows that several activities must be completed before the bears are dressed: the fur has to be cut, stuffed, and sewn; and the clothes and accessories must be made. Our Gantt chart tells us that by day six, all accessories and clothing have been made. The sewing and stuffing, however (which must be finished before the bears are dressed), isn't scheduled for completion until the end of day eight. As operations manager, you'll have to pay close attention to the progress of the sewing and stuffing operations to ensure that finished products are ready for shipment by their scheduled date.

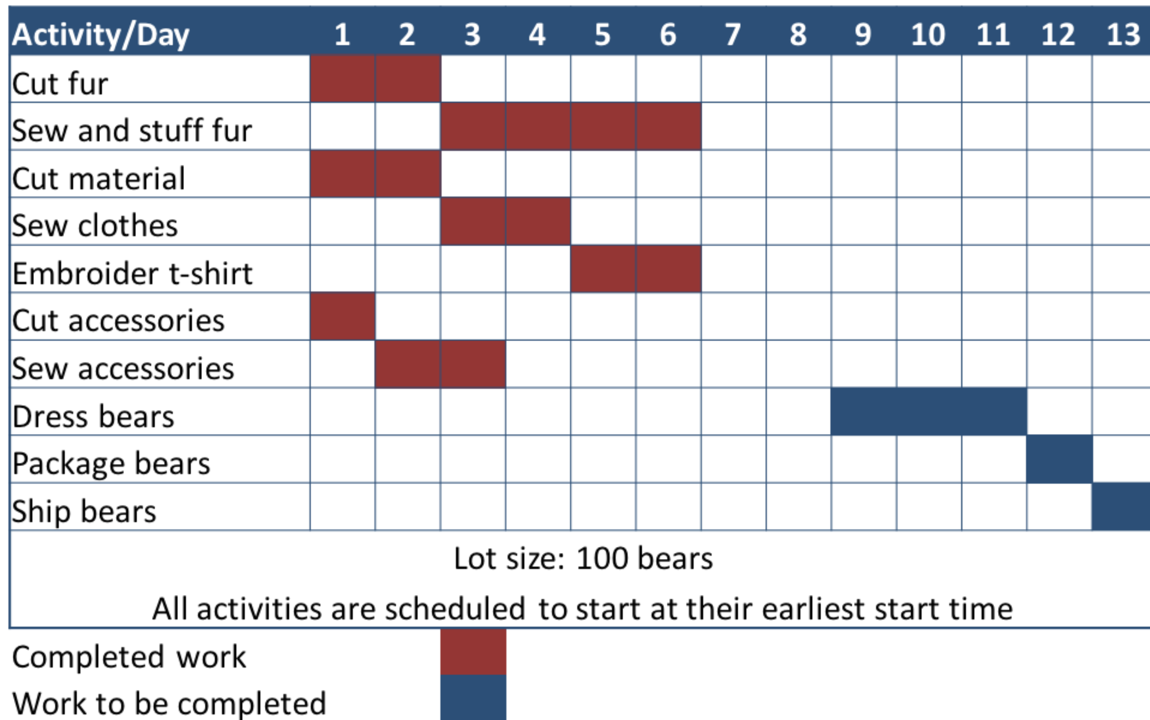


Figure 9.3: A Gantt chart for Vermont Teddy Bears

PERT Charts

Gantt charts are useful when the production process is fairly simple and the activities aren't interrelated. For more complex schedules, operations managers may use **PERT charts**. PERT (which stands for Program Evaluation and Review Technique) is designed to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence. It also identifies a **critical path**: the sequence of activities that will entail the greatest amount of time. Figure 9.4 is a PERT diagram showing the process for producing one "hiker" bear at Vermont Teddy Bear.

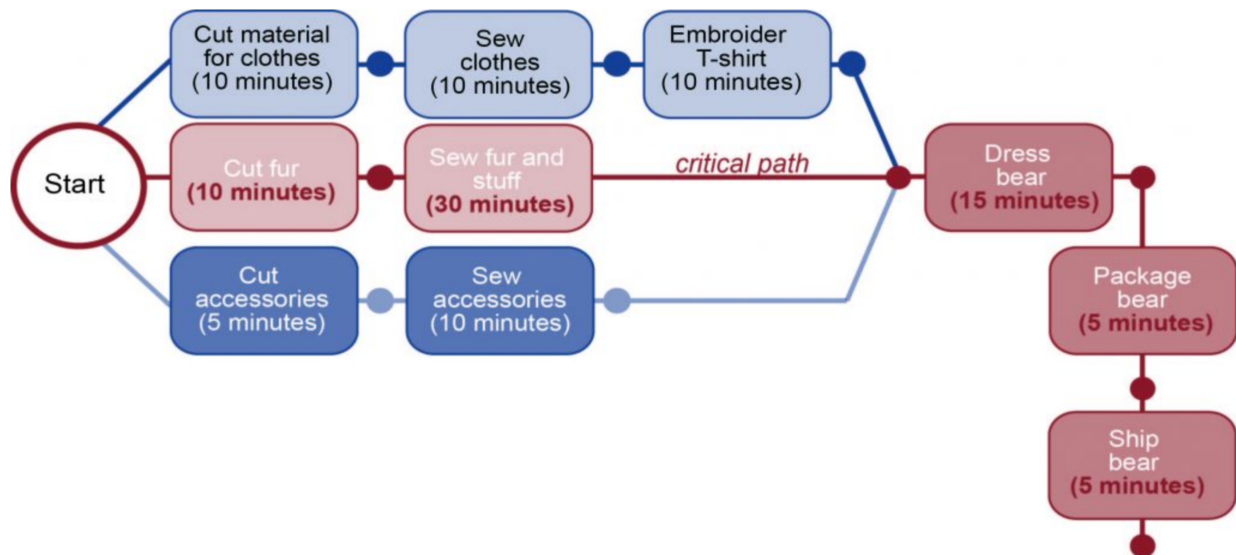


Figure 9.4: A PERT chart for Vermont Teddy Bears

Our PERT chart shows how the activities involved in making a single bear are related. It indicates that the production process begins at the cutting station. Next, the fur that's been cut for this particular bear moves first to the sewing and stuffing stations and then to the dressing station. At the same time that its fur is moving through this sequence of steps, the bear's clothes are being cut and sewn and its T-shirt is being embroidered. Its backpack and tent accessories are also being made at the same time. Note that fur, clothes, and accessories all meet at the dressing station, where the bear is dressed and outfitted with its backpack. Finally, the finished bear is packaged and shipped to the customer's house.

What was the critical path in this process? The path that took the longest amount of time was the sequence that included cutting, stuffing, dressing, packaging, and shipping—a sequence of steps taking sixty-five minutes. If you wanted to produce a bear more quickly, you'd have to save time on this path. Even if you saved the time on any of the other paths, you still wouldn't finish the entire job any sooner: the finished clothes would just have to wait for the fur to be sewn and stuffed and moved to the dressing station. We can gain efficiency only by improving our performance on one or more of the activities along the critical path.

The Technology of Goods Production

PowerSki founder and CEO Bob Montgomery spent sixteen years designing the Jetboard and bringing it to production. At one point, in his efforts to get the design just right, he'd constructed thirty different prototypes. Montgomery thought that he could handle the designing of the engine without the aid of a computer. Before long, however, he realized that it was impossible to keep track of all the changes.

Computer-Aided Design

That's when Montgomery turned to computer technology for help and began using a **computer-aided design** (CAD) software package to design not only the engine but also the board itself and many of its components. The CAD program enabled Montgomery and his team of engineers to test the product digitally and work out design problems before moving to the prototype stage.

The sophisticated CAD software allowed Montgomery and his team to put their design paper in a drawer and to start building both the board and the engine on a computer screen. By rotating the image on the screen, they could even view the design from every angle. Having used their CAD program to make more than four hundred design changes, they were ready to test the Jetboard in the water. During the tests, onboard sensors transmitted data to computers, allowing the team to make adjustments from the shore while the prototype was still in the water. Nowadays, PowerSki uses collaboration software to transmit design changes to the suppliers of the 340 components that make up the Jetboard. In fact, a majority of design work these days is done with the aid of computers, which add speed and precision to the process.

Computer-Aided Manufacturing

For many companies, the next step is to link CAD to the manufacturing process. A **computer-aided manufacturing** (CAM) software system determines the steps needed to produce the component and instructs the machines that do the work. Because CAD

and CAM programs can "talk" with each other, companies can build components that satisfy exactly the requirements set by the computer-generated model. CAD/CAM systems permit companies to design and manufacture goods faster, more efficiently, and at a lower cost, and they're also effective in helping firms monitor and improve quality. CAD/CAM technology is used in many industries, including the auto industry, electronics, and clothing. If you have ever seen how a 3-D printer works, you have a pretty good idea of how CAM works too.

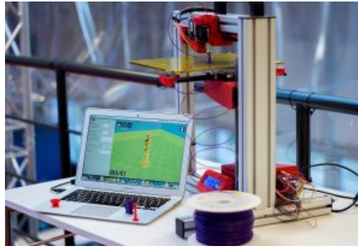


Figure 9.5: A 3-D printer

Computer-Integrated Manufacturing

By automating and integrating all aspects of a company's operations, **computer- integrated manufacturing** (CIM) systems have taken the integration of computer-aided design and manufacturing to a higher level—and are in fact revolutionizing the production process. CIM systems expand the capabilities of CAD/CAM. In addition to design and production applications, they handle such functions as order entry, inventory control, warehousing, and shipping. In the manufacturing plant, the CIM system controls the functions of industrial robots—computer-controlled machines used to perform repetitive tasks that are also hard or dangerous for human workers to perform.

Figure 9.6: Robots at work in a BMW factory in Leipzig, Germany

Operations Management for Service Providers

As the U.S. economy has changed from a goods producer to a service provider over the last sixty years, the dominance of the manufacturing sector has declined substantially. Today, only about 8 percent of U.S. workers are employed in manufacturing,[3] in contrast to 30 percent in 1950.[4] Most of us now hold jobs in the **service sector**, which accounts for 80 percent of U.S. jobs.[5] In 2013, Wal-Mart was America's largest employer, followed by McDonald's, United Parcel Service (UPS), Target and Kroger. Not until we drop down to the ninth-largest employer—Hewlett Packard—do we find a company with a manufacturing component.[6]

Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations. Let's focus on three of them:

- **Intangibility**. Manufacturers produce tangible products—things that can be touched or handled, such as automobiles and appliances. Service companies provide intangible products, such as banking, entertainment, or education.
- **Customization**. Most manufactured goods are standardized. Services, by contrast, are often customized to satisfy the specific needs of a customer. For example, when you go to the hairdresser, you ask for a haircut that looks good on you because of the shape of your face and the texture of your hair.
- **Customer contact**. You could spend your entire working life assembling cars in Detroit and never meet a customer who bought a car that you helped to make. But if you were a restaurant server, you'd interact with customers every day. In fact, their satisfaction with your product would be determined in part by the service that you provided. Unlike manufactured goods, many services are bought and consumed at the same time.

Here is just one of the over twelve thousand Burger King restaurants across the globe. Not surprisingly, operational efficiency is just as important in service industries as it is in manufacturing. To get a better idea of the role of operations management in the service sector, we'll look closely at Burger King (BK), the world's fourth-largest restaurant chain.[7] BK has grown substantially

since selling the first Whopper (for $0.37) almost half a century ago. The instant success of the fire-grilled burger encouraged the Miami founders of the company to expand by selling franchises.

Figure 9.7: Burger King restaurant in Saugus, Massachusetts

Today, there are BK company- and independently-owned franchised restaurants in 100 countries, and they employ over 34,000 people.[8] More than eleven million customers visit BK each day.[9]

Operations Planning

When starting or expanding operations, businesses in the service sector must make a number of decisions quite similar to those made by manufacturers:

- What services (and perhaps what goods) should they offer?
- Where will they locate their business, and what will their facilities look like?
- How will they forecast demand for their services?

Let's see how service firms like BK answer questions such as these.[10]

Operations Processes

Service organizations succeed by providing services that satisfy customers' needs. Companies that provide transportation, such as airlines, have to get customers to their destinations as quickly and safely as possible. Companies that deliver packages, such as FedEx, must pick up, sort, and deliver packages in a timely manner. Companies that provide both services and goods, such as Domino's Pizza, have a dual challenge: they must produce a quality good and deliver it satisfactorily.

Service providers that produce goods can adopt either a **make-to-order** or a **make-to-stock** approach to producing them. BK, which encourages patrons to customize burgers and other menu items, uses a make-to-order approach, building sandwiches one at a time. Meat patties, for example, go from the grill to a steamer for holding until an order comes in. Although many fast food restaurants have adopted the make-to-order model, a few continue to make-to-stock. For example, Dunkin' Donuts does not customize doughnuts, and so they do not have to wait for customer orders before making them.

Figure 9.8: Dunkin' Donuts typical product selection

Like manufacturers, service providers must continuously look for ways to improve **operational efficiency**. Throughout its sixty-year history, BK has introduced a number of innovations that have helped make the company (as well as the fast-food industry itself) more efficient. BK, for example, was the first to offer drive-through service (which now accounts for over 50 percent of its sales[11]).

It was also a BK vice president, David Sell, who came up with the idea of moving the drink station from behind the counter so that customers could take over the time-consuming task of filling cups with ice and beverages. BK was able to cut back one employee per day at every one of its more than eleven thousand restaurants. Material costs also went down because customers usually fill cups with more ice, which is cheaper than a beverage. Moreover, there were savings on supply costs because most customers don't

bother with lids, and many don't use straws. On top of everything else, most customers liked the system (for one thing, it allowed them to customize their own drinks by mixing beverages), and as a result, customer satisfaction went up. Overall, the new process was a major success and quickly became the industry standard.

Facilities

When starting or expanding a service business, owners and managers must invest a lot of time in selecting a location, determining its size and layout, and forecasting demand. A poor location or a badly designed facility can cost customers, and inaccurate estimates of demand for products can result in poor service, excessive costs, or both.

Site Selection

Site selection is also critical in the service industry, but not for the same reasons as in the manufacturing industry. Service businesses need to be accessible to customers. Some service businesses, such as cable-TV providers, package-delivery services, and e-retailers, go to their customers. Many others, however—hotels, restaurants, stores, hospitals, and airports—have to attract customers to their facilities. These businesses must locate where there's a high volume of available customers. In picking a location, BK planners perform a detailed analysis of demographics and traffic patterns; the most important factor is usually traffic count—the number of cars or people that pass by a specific location in the course of a day. In the United States, where we travel almost everywhere by car, so BK looks for busy intersections, interstate interchanges with easy off and on ramps, or such "primary destinations" as shopping malls, tourist attractions, downtown business areas, or movie theaters. In Europe, where public transportation is much more common, planners focus on subway, train, bus, and trolley stops.

Once planners find a site with an acceptable traffic count, they apply other criteria. It must, for example, be easy for vehicles to enter and exit the site, which must also provide enough parking to handle projected dine-in business. Local zoning must permit standard signage, especially along interstate highways. Finally, expected business must be high enough to justify the cost of the land and building.

Size and Layout

In the service sector, most businesses must design their facilities with the customer in mind: they must accommodate the needs of their customers while keeping costs as low as possible. Let's see how BK has met this challenge.

For its first three decades, almost all BK restaurants were pretty much the same. They all sat on one acre of land (located "through the light and to the right"), had about four thousand square feet of space, and held seating for seventy customers. All kitchens were roughly the same size. As long as land was cheap and sites were readily available, this system worked well. By the early 1990s, however, most of the prime sites had been taken, if not by BK itself, then by one of its fast-food competitors or other businesses needing a choice spot, including gas stations and convenience stores. With everyone bidding on the same sites, the cost of a prime acre of land had increased from $100,000 to over $1 million in a few short years.

To continue growing, BK needed to change the way it found and developed its locations. Planners decided that they had to find ways to reduce the size of a typical BK restaurant. For one thing, they could reduce the number of seats, because the business at a typical outlet had shifted over time from 90 percent inside dining to a 50-50 split between drive through and eat-in service.

David Sell (the same executive who had recommended letting customers fill their own drink cups) proposed to save space by wrapping Whoppers in paper instead of serving them in the cardboard boxes that took up more space. So BK switched to a single paper wrapper with the label "Whopper" on one side and "Cheese Whopper" on the other. To show which product was inside, employees just folded the wrapper in the right direction. Ultimately, BK replaced pallets piled high with boxes with just a few boxes of wrappers.

Ideas like these helped BK trim the size of a restaurant from four thousand square feet to as little as one thousand. In turn, smaller facilities enabled the company to enter markets that were once cost prohibitive. Now BK could locate profitably in airports, food courts, strip malls, center-city areas, and even schools.

Capacity Planning

Estimating **capacity** needs for a service business isn't the same thing as estimating those of a manufacturer. Service providers can't store their products for later use: hairdressers can't "inventory" haircuts, and amusement parks can't "inventory" roller-coaster rides. Service firms have to build sufficient capacity to satisfy customers' needs on an "as-demanded" basis. Like manufacturers, service providers must consider many variables when estimating demand and capacity:

- How many customers will I have?

- When will they want my services (which days of the week, which times of the day)?
- How long will it take to serve each customer?
- How will external factors, such as weather or holidays, affect the demand for my services?

Forecasting demand is easier for companies like BK, which has a long history of planning facilities, than for brand-new service businesses. BK can predict sales for a new restaurant by combining its knowledge of customer-service patterns at existing restaurants with information collected about each new location, including the number of cars or people passing the proposed site and the effect of nearby competition.

Managing Operations

Overseeing a service organization puts special demands on managers, especially those running firms, such as hotels, retail stores, and restaurants, who have a high degree of contact with customers. Service firms provide customers with personal attention and must satisfy their needs in a timely manner. This task is complicated by the fact that demand can vary greatly over the course of any given day. Managers, therefore, must pay particular attention to employee work schedules and, in many cases, inventory management.

Managing service operations is about more than efficiency of service. It is about finding a balance between profitability, customer satisfaction and associate satisfaction, sometimes referred to as the **balanced scorecard**.

In his book titled *Moments of Truth*, Jan Carlzon, former Chief Executive Office of SAS Group, refers to those moments when an employee interacts with a customer.[12] Moments can range from calling a help line, checking in at an airline counter, the greeting from a hostess in a restaurant to having a maintenance problem resolved in a hotel guest room. The quality of staff a company hires, how they train their employees, and the focus management places on creating a culture of service will determine how successful the company is in service delivery and maximizing the impact of these moments of truth.

The Ritz-Carlton hotel company maximizes their moments of truth by living their motto, “We are Ladies and Gentleman serving Ladies and Gentleman”. Ritz-Carlton Three Steps of Service are:

1. A warm and sincere greeting. Use the guest’s name.
2. Anticipation and fulfillment of each the needs of each guest.
3. Fond farewell. Give a warm good-bye and use the guest’s name.[13]

Ritz-Carlton reinforces this service culture daily in short meetings with all staff at the beginning of each shift.

Chick-fil-A is recognized as an industry leader in service for the fast food industry. Chick-fil-A uses the term “my pleasure” which founder S. Truett Cathy credits to Ritz-Carlton.[14] The company follows customer-centered leadership. Staff focus on being swift and attentive to customer needs. Chick-fil-A uses this You Tube video as part of their employee orientation and training: “Every life has a story”.

Well-known blogger and marketing consultant Marcus Sheridan explains his view of the success of Chick-Fil-A in this blog post:[15]

> Dang I love it when I see great people and great businesses kicking butt at what they do. Such was the case recently when the fam and I stopped into a local Chick-fil-A restaurant here in Virginia and I was treated to a free course entitled, “This is How To Run a Business that Kicks Butt and Takes Names….”, or at least that something like that …..
>
> As the kids were all eating their food and I was busy being blown away by this perfect company and business model, I decided to ask my 9 year old daughter a simple question:
>
> ***Me*** *: Danielle, what do you notice about this restaura nt that’s different than others?*
>
> ***Danielle*** *(by now used to weird business questions from her father): Well, first of all everyone that works here is happy.*
>
> ***Me*** *: Yes, they are, aren’t they? How’s that make you feel to see them smiling?*
>
> ***Danielle*** *: It makes me feel good inside.*
>
> ***Me*** *: I agree…What else do you notice?*
>
> ***Danielle*** *: There are pictures everywhere. And writings on the walls. And it’s really clean.*
>
> ***Me*** *: Good observations dear. Danielle, you’re looking at the most well run business in America.*

For any of you that have been to Chick-fil-A before, you may already understand and appreciate what I'm talking about. If you haven't gone to one and would like 4 years' worth of business school wrapped up in 45 minutes, then take a stroll on over to one of their restaurants for lunch and just sit, watch, and observe.

But to make what could be a long blog much shorter, allow me to quickly list the 8 reasons why Chick-fil-A has the best business model in America.

Happy Employees/Service: It's unbelievable what type of employees this company has. Heck, while we were eating our meal the other day, an employee with a big smile came over and asked us if we'd like refills on our drinks. For a fast food company, this is utterly unheard of in our society these days. It's obvious that Chick-fil-A doesn't go cheap on their people nor their way of doing things. I'm sure they pay decent wages but they also create an atmosphere that attracts great people. What a wonderful model this is for any business.

They're Clean!: Somewhere along the lines sanitation and cleanliness became a lost art in the fast food industry. Notwithstanding this trend, Chick-fil-A has bucked the system and their restaurants, as well as their bathrooms, are almost always immaculate. I don't know about you, but I'll pay more for clean any day of the week.

They Know What They're GREAT At: Most businesses try to be a jack of all trades, which ends up causing them to be master of none. That's why Chick-fil-A will never have a burger on their menu. Why? Because they don't care. They know they'll never be the best at beef but they sure as heck have created a culture around the chicken sandwich. Wow, what a lesson this is for those businesses out there with no identity, niche, or individual greatness.

They Ain't Cheap: Yep, having high prices is actually a GOOD business model. I don't know about you, but the idea of having to sell a lot to make a little stinks. Chick-fil-A has prices a good bit higher than most of their fast food competitors, notwithstanding they are always full of smiling customers, just waiting to spend the extra green stamps. These higher prices lead to better employees, service, food quality, customers, etc. I'm sure never once has their management even asked, "How can we be the cheapest?" But I'd bet my home they've asked, "How can we be the best, regardless of what it costs?"

Ambiance: The next time you go to Chick-fil-A check out all the little things they do to make their restaurants warm and attractive. They have photos of employees, quotes on the walls, paintings from local children, etc. Everywhere you look in one of their stores you'll find something that makes you smile.

Community Involvement: Wow do they do this better than any fast food company. In fact, this one isn't even close. They are constantly doing promos within the community for youth teams, causes, etc. In fact, it's like they've take social media to another level because for them it's not just about using Facebook and the like, it's about actually being involved and in the trenches. Huge props to Chick-fil-A for this.

Awesome Website: All of you that read this blog know how I feel about the importance of having a great website and web presence in order to be a successful business. If you want to see what a great business website looks like, head on over. Whether it's bios of the employees, social media links, customers stories, etc—this site is spot-on.

The Food is Actually Good: Ahh yes, lest we forget this other forgotten trait of fast food restaurants—great food. Everybody likes Chick-fil-A. Nothing on their menu is poor quality. They're proud of their food and they have every right to be.

So there you have it folks—the 8 qualities of the best business model in America. What's great is that every business can copy the way Chick-fil-A has built their company. The qualities listed above are simply principles that can be applied to any business or any website for that matter. So if you're lacking inspiration for your business, it might be time for a Chicken Sandwich and waffle fries.

***Author's Note: It goes without saying that I have no affiliation with Chick-fil-A, I just happen to write about greatness when I see it.*

Scheduling

In manufacturing, managers focus on scheduling the activities needed to transform raw materials into finished goods. In service organizations, they focus on **scheduling** workers so that they're available to handle fluctuating customer demand. Each week, therefore, every BK store manager schedules employees to cover not only the peak periods of breakfast, lunch, and dinner, but also the slower periods in between. If he or she staffs too many people, labor cost per sales dollar will be too high. If there aren't enough employees, customers have to wait in lines. Some get discouraged, and even leave, and many may never come back.

Scheduling is made easier by information provided by a point-of-sale device built into every BK cash register. The register sends data on every sandwich, beverage, and side order sold by the hour, every hour of the day, every day of the week to a computer system that helps managers set schedules. To determine how many people will be needed for next Thursday's lunch hour, the manager reviews last Thursday's data, using sales revenue and a specific BK formula to determine the appropriate staffing level. Each manager can adjust this forecast to account for other factors, such as current marketing promotions or a local sporting event that will increase customer traffic.

Inventory Control

Businesses that provide both goods and services, such as retail stores and auto-repair shops, have the same **inventory control** problems as manufacturers: keeping levels too high costs money, while running out of inventory costs sales. Technology, such as the point-of-sale registers used at BK, makes the job easier. BK's system tracks everything sold during a given time and lets each store manager know how much of everything should be kept in inventory. It also makes it possible to count the number of burgers and buns, bags and racks of fries, and boxes of beverage mixes at the beginning or end of each shift. Because there are fixed numbers of supplies—say, beef patties or bags of fries—in each box, employees simply count boxes and multiply. In just a few minutes, the manager knows whether the inventory is correct (and should be able to see if any theft has occurred on the shift).

Producing for Quality

What do you do if your brand-new DVD player doesn't work when you get it home? What if you were late for a test because it took you twenty minutes to get a burger and fries at a drive-through window? Like most people, you'd probably be more or less disgruntled. As a customer, you're constantly assured that when products make it to market, they're of the highest possible quality, and you tend to avoid brands that have failed to live up to your expectations or to producers' claims.

But what is **quality**? According to the American Society for Quality, the term quality refers to "the characteristics of a product or service that bear on its ability to satisfy stated or implied needs."[16] When you buy a DVD player, you expect it to play DVDs. When you go to a drive-through window, you expect to be served in a reasonable amount of time. If your expectations are not met, you'll conclude that you're the victim of poor-quality.

Quality Management

Total quality management (TQM), or quality assurance, includes all the steps that a company takes to ensure that its goods or services are of sufficiently high quality to meet customers' needs. Generally speaking, a company adheres to TQM principles by focusing on three tasks:

1. Customer satisfaction
2. Employee involvement
3. Continuous improvement

Let's take a closer look at these three principles.

Customer Satisfaction

Companies that are committed to TQM understand that the purpose of a business is to generate a profit though **customer satisfaction**. Thus, they let their customers define quality by identifying desirable product features and then offering them. They encourage customers to tell them how to offer services that work the right way.

Armed with this knowledge, they take steps to make sure that providing quality is a factor in every facet of their operations—from design, to product planning and control, to sales and service. To get feedback on how well they're doing, many companies routinely use surveys and other methods to monitor customer satisfaction. By tracking the results of feedback over time, they can see where they need to improve.

Employee Involvement

Successful TQM requires that everyone in the organization, not simply upper-level management, commits to satisfying the customer. When customers wait too long at a drive-through window, it's the responsibility of a number of employees, not the manager alone. A defective DVD isn't solely the responsibility of the manufacturer's quality control department; it's the responsibility of every employee involved in its design, production, and even shipping. To get everyone involved in the drive for quality assurance, managers must communicate the importance of quality to subordinates and motivate them to focus on customer satisfaction. Employees have to be properly trained not only to do their jobs but also to detect and correct quality problems.

In many companies, employees who perform similar jobs work as teams, sometimes called **quality circles**, to identify quality, efficiency, and other work-related problems, to propose solutions, and to work with management in implementing their recommendations.

Continuous Improvement

An integral part of TQM is **continuous improvement**: the commitment to making constant improvements in the design, production, and delivery of goods and services.

Improvements can almost always be made to increase efficiency, reduce costs, and improve customer service and satisfaction. Everyone in the organization is constantly on the lookout for ways to do things better.

Statistical Process Control

Companies can use a variety of tools to identify areas for improvement. A common approach in manufacturing is called **statistical process control**. This technique monitors production quality by testing a sample of output to see whether goods in process are being made according to predetermined specifications. An example of a statistical process control method is Six Sigma. A **Six-Sigma** process is one in which 99.99966% of all opportunities to perform an operation are free of defects. This percentage equates to only 3.4 defects per million opportunities.

Assume for a moment that you work for Kellogg's, the maker of Raisin Bran cereal. You know that it's the company's goal to pack two scoops of raisins in every box of cereal.

How can you test to determine whether this goal is being met? You could use a statistical process control method called a sampling distribution. On a periodic basis, you would take a box of cereal off the production line and measure the amount of raisins in the box. Then you'd record that amount on a control chart designed to compare actual quantities of raisins with the desired quantity (two scoops). If your chart shows that several samples in a row are low on raisins, you'd take corrective action.

Outsourcing

PowerSki's Web site states that "PowerSki International has been founded to bring a new watercraft, the PowerSki Jetboard, and the engine technology behind it, to market."[17] That goal was reached in May 2003, when the firm emerged from a lengthy design period. Having already garnered praise for its innovative product, PowerSki was ready to begin mass-producing Jetboards. At this juncture, the management team made a strategic decision; rather than producing Jetboards in-house, they opted for **outsourcing**: having outside vendors manufacture the engines, fiberglass hulls, and associated parts. Assembly of the final product took place in a manufacturing facility owned by All American Power Sports in Moses Lake, Washington. This decision doesn't mean that the company relinquished control over quality; in fact, every component that goes into the PowerSki Jetboard is manufactured to exact specifications set by PowerSki. One advantage of outsourcing its production function is that the management team can thereby devote its attention to refining its product design and designing future products.

Outsourcing in the Manufacturing Sector

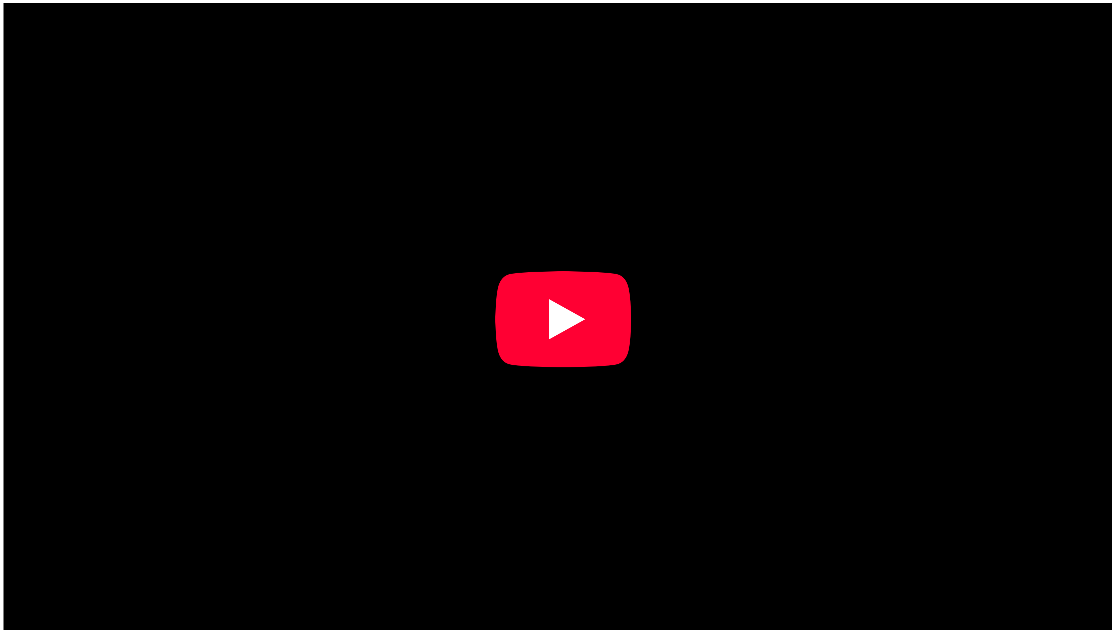
Outsourcing has become an increasingly popular option among manufacturers. For one thing, few companies have either the expertise or the inclination to produce everything needed to make a product. Today, more firms, like PowerSki, want to specialize in the processes that they perform best—and outsource the rest. Like PowerSki, they also want to take advantage of outsourcing by linking up with suppliers located in regions with lower labor costs. Outsourcing can be local, regional, or even international, and companies can outsource everything from parts for their products, like automobile manufacturers do, to complete manufacturing of their products, like Nike and Apple do.

Outsourcing in the Service Sector

Outsourcing is by no means limited to the manufacturing sector. Service providers also outsource many of their non-core functions. Some universities, for instance, outsource functions such as food services, maintenance, bookstore sales, printing, grounds keeping, security, and even residence operations. For example, there are several firms, like RGIS, who offer inventory services. They will send a team to your company to count your inventory for you. As RGIS puts it, "Our teams deliver the hands-on help needed to complete a wide variety of retail projects of all sizes, allowing your team to keep customer service as the number one priority."[18] Some software developers outsource portions of coding as a cost-saving measure. If you've ever had to get phone or chat assistance on your laptop, there's a good chance you spoke with someone in an outsourced call center. The center itself may have even been located offshore. This kind of arrangement can present unique challenges in quality control as differences in accents and the use of slang words can sometimes inhibit understanding. Nevertheless, in this era of globalization, expect the trend towards outsourcing offshore to continue.

Chapter Video

This video presents operations from multiple perspectives including manufacturing, restaurant food preparation, and brewing. Pay attention to the level of automation, which is a key aspect of operational decisions as labor gets more expensive.



Key Takeaways

1. **Operations management** oversees the process of transforming resources into goods and services.

2. During **production planning**, managers determine how goods will be produced, where production will take place, and how manufacturing facilities will be laid out.
3. In selecting the appropriate **production process**, managers consider three basic methods:
   1. **make-to-order**
   2. **mass production**
   3. **mass customization**
4. In **site selection** for a company's manufacturing operations, managers look for locations that minimize shipping costs, have an ample supply of skilled workers, provide a favorable community for workers and their families, offer resources at low cost, and have a favorable business climate.
5. Commonly used inventory control methods include **just-in-time** (JIT) production, by which materials arrive just in time to enter the manufacturing process, and **material requirements planning** (MRP), a software tool to determine material needs.
6. Gantt and PERT charts are two common tools used by operations managers.
   1. A **Gantt chart** helps operations managers determine the status of projects.
   2. **PERT charts** diagram the activities and time required and identify the **critical path**—the sequence of activities that will require the greatest amount of time.
7. S**ervice firms** provide **intangible** products that are often customized to satisfy specific needs. Unlike manufactured goods, many services are bought and consumed at the same time.
8. Estimating **capacity** needs for a service business is more difficult than for a manufacturer because service providers can't store their services for later use.
9. Many companies deliver **quality** goods and services by adhering to principles of **total quality management** (TQM).
10. **Outsourcing** can save companies money by using lower cost, specialized labor, located domestically or abroad.

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10: Marketing - Providing Value to Customers

Learning Objectives

1. Define the terms marketing, marketing concept, and marketing strategy.
2. Outline the tasks involved in selecting a target market.
3. Identify the four Ps of the marketing mix.
4. Explain how to conduct marketing research.
5. Discuss various branding strategies and explain the benefits of packaging and labeling.
6. Describe the elements of the promotion mix
7. Explain how companies manage customer relationships.
8. Identify the advantages and disadvantages of social media marketing.

A Robot with Attitude

Mark Tilden used to build robots for NASA that ended up being destroyed on Mars, but after seven years of watching the results of his work meet violent ends thirty-six million miles from home, he decided to specialize in robots for earthlings. He left the space world for the toy world and teamed up with Wow Wee Toys Ltd. to create “Robosapien,” an intelligent robot with an attitude.[1] The fourteen-inch-tall robot, which is operated by remote control, has great moves. In addition to walking forward, backward, and turning, he dances, raps, and gives karate chops. He can pick up small objects and even fling them across the room, and he does everything while grunting, belching, and emitting other “bodily” sounds.

Figure 10.1: Mark Tilden and his creation, Robosapien

Robosapien gave Wow Wee Toys a good head start in the toy robot market: in the first five months, more than 1.5 million Robosapiens were sold.[2] The company expanded the line to more than a dozen robotics and other interactive toys, including FlyTech Bladestar, a revolutionary indoor flying machine that won a Popular Mechanics magazine Editor’s Choice Award in 2008).[3]

What does Robosapien have to do with marketing? The answer is fairly simple: though Mark Tilden is an accomplished inventor who has created a clever product, Robosapien wouldn’t be going anywhere without the marketing expertise of Wow Wee. In this chapter, we’ll look at the ways in which marketing converts product ideas like Robosapien into commercial successes.

What Is Marketing?

When you consider the functional areas of business—accounting, finance, management, marketing, and operations—marketing is the one you probably know the most about. After all, as a consumer and target of all sorts of advertising messages, you’ve been on the receiving end of marketing initiatives for most of your life. What you probably don’t appreciate, however, is the extent to which marketing focuses on providing value to the customer. According to the American Marketing Association, “Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.”[4]

In other words, marketing isn’t just advertising and selling. It includes everything that organizations do to satisfy customer needs:

- Coming up with a product and defining its features and benefits
- Setting its price

- Identifying its target market
- Making potential customers aware of it
- Getting people to buy it
- Delivering it to people who buy it
- Managing relationships with customers after it has been delivered

Think about a typical business—a local movie theater, for example. It's easy to see how the person who decides what movies to show is involved in marketing: he or she selects the product to be sold. It's even easier to see how the person who puts ads in the newspaper works in marketing: he or she is in charge of advertising—making people aware of the product and getting them to buy it. What about the ticket seller and the person behind the counter who gets the popcorn and soda or the projectionist? Are they marketing the business? Absolutely. The purpose of every job in the theater is satisfying customer needs, and as we've seen, identifying and satisfying customer needs is what marketing is all about. Marketing is a team effort involving everyone in the organization.

If everyone is responsible for marketing, can the average organization do without an official marketing department? Not necessarily: most organizations have marketing departments in which individuals are actively involved in some marketing-related activity—product design and development, pricing, promotion, sales, and distribution. As specialists in identifying and satisfying customer needs, members of the **marketing department** manage—plan, organize, lead, and control—the organization's overall marketing efforts.

The Marketing Concept

Figure 10.2 is designed to remind you that to achieve company profitability goals, you need to start with three things:

1. Find out what customers or potential customers need.
2. Develop products to meet those needs.
3. Engage the entire organization in efforts to satisfy customers.

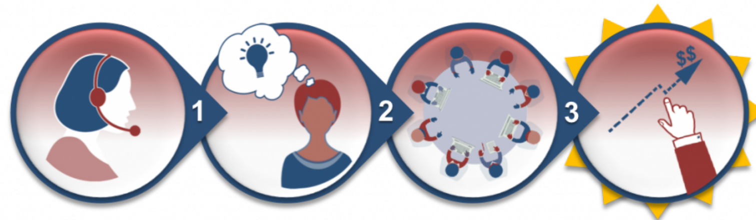


Figure 10.2: The marketing concept leads to company profit

At the same time, you need to achieve organizational goals, such as profitability and growth. This basic philosophy—satisfying customer needs while meeting organizational goals—is called the **marketing concept**, and when it's effectively applied, it guides all of an organization's marketing activities.

The marketing concept puts the customer first: as your most important goal, satisfying the customer must be the goal of everyone in the organization. But this doesn't mean that you ignore the bottom line; if you want to survive and grow, you need to make some profit. What you're looking for is the proper balance between the commitments to customer satisfaction and company survival. Consider the case of Medtronic, a manufacturer of medical devices, such as pacemakers and defibrillators. The company boasts more than 50 percent of the market in cardiac devices and is considered the industry standard setter.[5] Everyone in the organization understands that defects are intolerable in products that are designed to keep people alive. Thus, committing employees to the goal of zero defects is vital to both Medtronic's customer base and its bottom line. "A single quality issue," explains CEO Arthur D. Collins Jr., "can deep-six a business."[6]

Selecting a Target Market

Businesses earn profits by selling goods or providing services. It would be nice if everybody in the marketplace was interested in your product, but if you tried to sell it to everybody, you'd probably spread your resources too thin. You need to identify a specific group of consumers who should be particularly interested in your product, who would have access to it, and who have the means to buy it. This group represents your **target market**, and you need to aim your marketing efforts at its members.

Identifying Your Market

How do marketers identify target markets? First, they usually identify the overall market for their product—the individuals or organizations that need a product and are able to buy it. This market can include either or both of two groups:

1. A **consumer market**—buyers who want the product for personal use
2. An **industrial market**—buyers who want the product for use in making other products

You might focus on only one market or both. A farmer, for example, might sell blueberries to individuals on the consumer market and, on the industrial market, to bakeries that will use them to make muffins and pies.

Segmenting the Market

The next step in identifying a target market is to divide the entire market into smaller portions, or **market segments**—groups of potential customers with common characteristics that influence their buying decisions. An especially narrow market segment is known as a **niche market**, for example, extreme luxury goods that less than 1% of people can afford. Let's look at some of the most useful categories in detail.

Demographic Segmentation

Demographic segmentation divides the market into groups based on such variables as age, marital status, gender, ethnic background, income, occupation, and education.

Age, for example, will be of interest to marketers who develop products for children, retailers who cater to teenagers, colleges that recruit students, and assisted-living facilities that promote services among the elderly. Lifetime Television for Women targets female viewers, while Telemundo networks targets Hispanics. When Hyundai offers recent college graduates a $400 bonus towards leasing or buying a new Hyundai, the company's marketers are segmenting the market according to education level.[7]

Geographic Segmentation

Geographic segmentation—dividing a market according to such variables as climate, region, and population density (urban, suburban, small-town, or rural)—is also quite common. Climate is crucial for many products: snow shovels would not sell in Hawaii. Consumer tastes also vary by region. That's why McDonald's caters to regional preferences, offering a breakfast of Spam and rice in Hawaii, [8] tacos in Arizona, and lobster rolls in Massachusetts.[9] Outside the United States, menus diverge even more widely (you can get seaweed burgers or, if you prefer, seasoned seaweed fries in Japan).[10]

Figure 10.3: A McDonald's Ebi (prawn) burger meal in Singapore

Likewise, differences between urban and suburban life can influence product selection. For example, it's a hassle to parallel park on crowded city streets. Thus, Toyota engineers have developed a product especially for city dwellers. The Japanese version of the Prius, Toyota's hybrid gas-electric car, can automatically parallel park itself. Using computer software and a rear-mounted camera, the parking system measures the spot, turns the steering wheel, and swings the car into the space (making the driver—who just sits there—look like a master of parking skills).[11] After its success in the Japanese market, the self-parking feature was brought to the United States.

Behavioral Segmentation

Dividing consumers by such variables as attitude toward the product, user status, or usage rate is called **behavioral segmentation**. Companies selling technology-based products might segment the market according to different levels of receptiveness to technology. They could rely on a segmentation scale developed by Forrester Research that divides consumers into two camps: technology optimists, who embrace new technology, and technology pessimists, who are indifferent, anxious, or downright hostile when it comes to technology.[12]

Some companies segment consumers according to user status, distinguishing among nonusers, potential users, first-time users, and regular users of a product. Depending on the product, they can then target specific groups, such as first-time users. Credit-card companies use this approach when they offer membership points to potential customers in order to induce them to get their card.

Psychographic Segmentation

Psychographic segmentation classifies consumers on the basis of individual lifestyles as they're reflected in people's interests, activities, attitudes, and values. Do you live an active life and love the outdoors? If so, you may be a potential buyer of hiking or camping equipment or apparel. If you're a risk taker, you might catch the attention of a gambling casino. The possibilities are limited only by the imagination.

Clustering Segments

Typically, marketers determine target markets by combining, or "**clustering**," segmenting criteria. What characteristics does Starbucks look for in marketing its products? Three demographic variables come to mind: age, geography, and income. Buyers are likely to be males and females ranging in age from about twenty-five to forty (although college students, aged eighteen to twenty-four, are moving up in importance). Geography is a factor as customers tend to live or work in cities or upscale suburban areas. Those with relatively high incomes are willing to pay a premium for Starbucks specialty coffee and so income—a socioeconomic factor—is also important.

The Marketing Mix

After identifying a target market, your next step is developing and implementing a marketing program designed to reach it. As Figure 14.4 shows, this program involves a combination of tools called the **marketing mix**, often referred to as the "**four P's**" of marketing:

1. Developing a **product** that meets the needs of the target market
2. Setting a **price** for the product
3. Distributing the product—getting it to a **place** where customers can buy it
4. **Promoting** the product—informing potential buyers about it

Pricing will be covered in more detail in its own dedicated chapter.

Figure 10.4: The Marketing Mix

Developing a Product

The development of Robosapien was a bit unusual for a company that was already active in its market.[13] Generally, product ideas come from people within the company who understand its customers' needs. Internal engineers are then challenged to design the product. In the case of Robosapien, the creator, Mark Tilden, had conceived and designed the product before joining Wow Wee Toys. The company gave him the opportunity to develop the product for commercial purposes, and Tilden was brought on board to oversee the development of Robosapien into a product that satisfied Wow Wee's commercial needs.

Robosapien is not a "kid's toy," though kids certainly love its playful personality. It's a home-entertainment product that appeals to a broad audience—children, young adults, older adults, and even the elderly. It's a big gift item, and it has developed a following of techies and hackers who take it apart, tinker with it, and even retrofit it with such features as cameras and ice skates.

Conducting Marketing Research

Before settling on a strategy for Robosapien, the marketers at Wow Wee did some homework. First, to zero in on their target market, they had to find out what various people thought of the product. More precisely, they needed answers to questions like the following:

- Who are our potential customers?
- What do they like about Robosapien? What would they change?
- How much are they willing to pay for it?
- Where will they expect to buy it?
- How can we distinguish it from competing products?
- Will enough people buy Robosapien to return a reasonable profit for the company?

The last question would be left up to Wow Wee management, but, given the size of the investment needed to bring Robosapien to market, Wow Wee couldn't afford to make the wrong decision. Ultimately, the company was able to make an informed decision because its marketing team provided answers to key questions through **marketing research**—the process of collecting and analyzing the data that are relevant to a specific marketing situation. This data had to be collected in a systematic way. Market research seeks two types of data:

1. Marketers generally begin by looking at **secondary data**—information already collected, whether by the company or by others, that pertains to the target market.

2. With secondary data in hand, they're prepared to collect **primary data**—newly collected information that addresses specific questions.

Secondary data can come from inside or outside the organization. Internally available data includes sales reports and other information on customers. External data can come from a number of sources. The U.S. Census Bureau, for example, posts demographic information on American households (such as age, income, education, and number of members), both for the country as a whole and for specific geographic areas.

Population data helped Wow Wee estimate the size of its potential U.S. target market. Other secondary data helped the firm assess the size of foreign markets in regions around the world, such as Europe, the Middle East, Latin America, Asia, and the Pacific Rim. This data helped position the company to sell Robosapien in eighty-five countries, including Canada, England, France, Germany, South Africa, Australia, New Zealand, Hong Kong, and Japan.

Using secondary data that is already available (and free) is a lot easier than collecting your own information. Unfortunately, however, secondary data didn't answer all the questions that Wow Wee was asking in this particular situation. To get these answers, the marketing team had to conduct primary research, working directly with members of their target market. First they had to decide exactly what they needed to know, then determine who to ask and what methods would be most effective in gathering the information.

We know what they wanted to know—we've already listed example questions. As for whom to talk to, they randomly selected representatives from their target market. There is a variety of tools for collecting information from these people, each of which has its advantages and disadvantages. To understand the marketing-research process fully, we need to describe the most common of these tools:

- **Surveys**. Sometimes marketers mail questionnaires to members of the target market. The process is time consuming and the response rate generally low. Online surveys are easier to answer and so get better response rates than other approaches.
- **Personal interviews**. Though time consuming, personal interviews not only let you talk with real people but also let you demonstrate the product. You can also clarify answers and ask open-ended questions.
- **Focus groups**. With a focus group, you can bring together a group of individuals (perhaps six to ten) and ask them questions. A trained moderator can explain the purpose of the group and lead the discussion. If sessions are run effectively, you can come away with valuable information about customer responses to both your product and your marketing strategy.

Wow Wee used focus groups and personal interviews because both approaches had the advantage of allowing people to interact with Robosapien. In particular, focus-group sessions provided valuable opinions about the product, proposed pricing, distribution methods, and promotion strategies.

Researching your target market is necessary before you launch a new product, but the benefits of marketing research don't extend merely to brand-new products. Companies also use it when they're deciding whether or not to refine an existing product or develop a new marketing strategy for an existing product. Kellogg's, for example, conducted online surveys to get responses to a variation on its Pop-Tarts brand—namely, Pop-Tarts filled with a mixture of traditional fruit filling and yogurt. Marketers had picked out four possible names for the product and wanted to know which one kids and mothers liked best. They also wanted to know what they thought of the product and its packaging. Both mothers and kids liked the new Pop-Tarts (though for different reasons) and its packaging, and the winning name for the product launched in the spring of 2011 was "Pop-Tarts Yogurt Blasts." The online survey of 175 mothers and their children was conducted in one weekend by an outside marketing research group.[14]

Branding

Armed with positive feedback from their research efforts, the Wow Wee team was ready for the next step: informing buyers—both consumers and retailers—about their product. They needed a **brand**—some word, letter, sound, or symbol that would differentiate their product from similar products on the market. They chose the brand name Robosapien, hoping that people would get the connection between homo sapiens (the human species) and Robosapien (the company's coinage for its new robot "species"). To prevent other companies from coming out with their own "Robosapiens," they took out a **trademark**: a symbol, word, or words legally registered or established by use as representing a company or product. Trademarking requires registering the name with the U.S. Patent and Trademark Office. Though this approach—giving a unique brand name to a particular product—is a bit unusual, it isn't unprecedented. Mattel, for example, established a separate brand for Barbie, and Anheuser-Busch sells beer under the brand

name Budweiser. Note, however, that the more common approach, which is taken by such companies as Microsoft, Dell, and Apple, calls for marketing all the products made by a company under the company's brand name.

Branding Strategies

Companies can adopt one of three major strategies for branding a product:

1. With **private branding** (or private labeling), a company makes a product and sells it to a retailer who in turn resells it under its own name. A soft-drink maker, for example, might make cola for Wal-Mart to sell as its Sam's Choice Cola.
2. With **generic branding**, the maker attaches no branding information to a product except a description of its contents. Customers are often given a choice between a brand-name prescription drug or a cheaper generic drug with the same formula.
3. With **manufacturer branding**, a company sells one or more products under its own brand names. Adopting a **multiproduct-branding** approach, it sells many products under one brand name. Food-maker ConAgra sells soups, frozen treats, and complete meals under its *Healthy Choice* label. Using a **multibranding** approach, the company assigns different brand names to products covering different segments of the market. Automakers often use multibranding. The Volkwagen group of brands also includes Audi and Lamborghini.

Branding is used in hotels to allow chains (Marriott, Hyatt, Hilton) to offer hotel brands that meet various customers' travel needs while still maintaining their loyalty to the chain. The same customer who would choose an Extended Stay hotel with a full kitchen when on a long term assignment might stay at a convention hotel when attending a trade show and then stay in a resort property when traveling with their family. By segmenting different types of hotel locations, amenities, room sizes and décor, hotel chains can meet the needs of a wide variety of travelers. In the past decade "soft" branding has become common to allow unique hotels to take advantage of being part of a chain reservation system and loyalty program. For example, Marriott has over 100 affiliated independent hotels in its Autograph Collection.[15]

Figure 10.5: Major hotel chains and their brands

Type of Hotel	Mariott	Hilton	Hyatt
Luxury	Ritz Carlton JW Marriott	Waldorf Astoria Conrad	Park Hyatt Andaz
Independent	Autograph Collection	Curio Collection	Unbound Collection
Full Service	Marriott Renaissance Gaylord	Hilton Canopy Doubletree	Hyatt
Select Service	Courtyard by Marriott AC Hotels	Hilton Garden Inn Hampton Inn	Hyatt Place
Extended Stay	Residence Inn	Homewood Suites	Hyatt House

Loyalty programs are heavily used in the hospitality industry, especially airlines and hotels, as part of their Customer Relationship Management programs. Loyalty programs are often targeted to high value business travelers with less price sensitivity. They achieve loyalty status and perks while traveling as well as earning points to use for personal travel rewards. Once a loyalty program member obtains elite status with significant associated perks such as guaranteed room availability, airport club lounge access, etc., the customer is much less likely to use other brands.

Building Brand Equity

Wow Wee went with the multibranding approach, deciding to market Robosapien under the robot's own brand name. Was this a good choice? The answer would depend, at least in part, on how well the product sells. Another consideration is the impact on Wow Wee's other brands. If Robosapien fared poorly, its failure would not reflect badly on Wow Wee's other products. On the other hand, if customers liked Robosapien, they would have no reason to associate it with other Wow Wee products. In this case,

Wow Wee wouldn't gain much from its **brand equity**—any added value generated by favorable consumer experiences with Robosapien. To get a better idea of how valuable brand equity is, think for a moment about the effect of the name Dell on a product. When you have a positive experience with a Dell product—say, a laptop or a printer—you come away with a positive opinion of the entire Dell product line and will probably buy more Dell products. Over time, you may even develop brand loyalty: you may prefer—or even insist on—Dell products. Not surprisingly, brand loyalty can be extremely valuable to a company. Because of customer loyalty, Apple's brand tops Interbrand's *Best Global Brands* ranking with a value of over $170 billion. Google's brand is valued at $120 billion, the Coca-Cola brand is estimated at more than $78 billion, and Microsoft and IBM round out the top five, with brands valued at over $65 billion each.[16]

Packaging and Labeling

Packaging can influence a consumer's decision to buy a product or pass it up. Packaging gives customers a glimpse of the product, and it should be designed to attract their attention, with consideration given to color choice, style of lettering, and many other details. Labeling not only identifies the product but also provides information on the package contents: who made it and where or what risks are associated with it (such as being unsuitable for small children).

How has Wow Wee handled the packaging and labeling of Robosapien? The robot is fourteen inches tall, and is also fairly heavy (about seven pounds), and because it's made out of plastic and has movable parts, it's breakable. The easiest, and least expensive, way of packaging it would be to put it in a square box of heavy cardboard and pad it with Styrofoam. This arrangement would not only protect the product from damage during shipping but also make the package easy to store. However, it would also eliminate any customer contact with the product inside the box (such as seeing what it looks like). Wow Wee, therefore, packages Robosapien in a container that is curved to his shape and has a clear plastic front that allows people to see the whole robot. Why did Wow Wee go to this much trouble and expense? Like so many makers of so many products, it has to market the product while it's still in the box.

Figure 10.6: Robosapien in its package

Meanwhile, the labeling on the package details some of the robot's attributes. The name is highlighted in big letters above the descriptive tagline "A fusion of technology and personality." On the sides and back of the package are pictures of the robot in action with such captions as "Dynamic Robotics with Attitude" and "Awesome Sounds, Robo-Speech & Lights." These colorful descriptions are conceived to entice the consumer to make a purchase because its product features will satisfy some need or want.

Packaging can serve many purposes. The Robosapien package attracts attention to the product's features. For other products, packaging serves a more functional purpose. Nabisco packages some of its snacks— Oreos, Chips Ahoy, and Lorna Doone's—in "100 Calorie Packs." The packaging makes life simpler for people who are keeping track of calories.

Place

A great deal is involved in getting a product to the place in which it is ultimately sold. If you're a fast food retailer, for example, you'll want your restaurants to be in high-traffic areas to maximize your potential business. If your business is selling beer, you'll want it to be offered in bars, restaurants, grocery stores, convenience stores, and even stadiums. Placing a product in each of these locations requires substantial negotiations with the owners of the space, and often the payment of slotting fees, an allowance paid by the manufacturer to secure space on store shelves.

Retailers are marketing intermediaries that sell products to the eventual consumer. Without retailers, companies would have a much more difficult time selling directly to individual consumers, no doubt at a substantially higher cost. The most common types

of retailers are summarized in Figure 10.7 below. You will likely recognize many of the examples provided. It is important to note that many retailers do not fit neatly into only one category. For example, WalMart, which began as a discount store, has added groceries to many of its outlets, also placing it in competition with supermarkets.

Figure 10.7: The Most Common Types of Retailers, with examples

Type of Retailer	Description	Examples
Category Killer	Sells a wide variety of products of a particular type, selling at a low price due to their large scale	Dick's Sporting Goods
Convenience Store	Offers food, beverages, and other products, typically in individual servings, at a higher price, and geared to fast service	7-Eleven
Department Store	Offers a wide assortment of products grouped into different departments (e.g., jewelry, apparel, perfume)	Nordstrom, Macy's
Discount Store	Organized into departments, but offer a range of merchandise generally seen as lower quality and at a much lower price	Target, Wal Mart
Specialty Store	Offers goods typically confined to a narrow category; high level of personal service and higher prices than other retailers	Local running shops or jewelry stores
Supermarket	Offers mostly consumer staples such as food and other household items	Kroger, Food Lion
Warehouse Club Stores	Offers a wide variety of products in a warehouse-style setting; sells many products in bulk; usually requires membership fee	Costco, Sam's Club

Of course, in an age where e-commerce is taking an increasing share of the retail spending dollar, “place” is not always a physical location that the customer visits. Products ordered online ship from manufacturers to distribution centers and then directly on to the end customer without passing through a traditional retail outlet. An emerging trend in retailing is **showrooming** in which a customer visits a traditional retailer, gets familiar with particular items available, and then orders the item online, often from an unrelated online retailer. The term comes from the fact that the traditional retail outlet has served only as a showroom – a place to view the product, as opposed to a place where the sale is made. As shopping habits change, retailers have been challenged to keep their space relevant and attractive to the ultimate consumer.

Promoting a Product

Your **promotion mix**—the means by which you communicate with customers—may include advertising, personal selling, sales promotion, and publicity. These are all tools for telling people about your product and persuading potential customers to buy it. Before deciding on an appropriate promotional strategy, you should consider a few questions:

- What's the main purpose of the promotion?
- What is my target market?
- Which product features should I emphasize?

- How much can I afford to invest in a promotion campaign?
- How do my competitors promote their products?

To promote a product, you need to imprint a clear image of it in the minds of your target audience. What do you think of, for instance, when you hear “Ritz-Carlton”? What about “Motel 6”? They’re both hotel chains, that have been quite successful in the hospitality industry, but they project very different images to appeal to different clienteles. The differences are evident in their promotions. The Ritz-Carlton web site describes “luxury hotels” and promises that the chain provides “the finest personal service and facilities throughout the world.”[17] Motel 6, by contrast, characterizes its facilities as “discount hotels” and assures you that you’ll pay “the lowest price of any national chain.”[18]

Promotional Tools

We’ll now examine each of the elements that can go into the promotion mix— advertising, personal selling, sales promotion, and publicity. Then we’ll see how Wow Wee incorporated them into a promotion mix to create a demand for Robosapien.

Advertising

Advertising is paid, non-personal communication designed to create an awareness of a product or company. Ads are everywhere—in print media (such as newspapers, magazines, the Yellow Pages), on billboards, in broadcast media (radio and TV), and on the Internet. It’s hard to escape the constant barrage of advertising messages; it’s estimated that the average consumer is confronted by about 5,000 ad messages each day (compared with about 500 ads a day in the 1970s).[19] For this very reason, ironically, ads aren’t as effective as they used to be. Because we’ve learned to tune them out, companies now have to come up with innovative ways to get through to potential customers. A New York Times article[20] claims that “anywhere the eye can see, it’s likely to see an ad.” Subway turnstiles are plastered with ads for GEICO auto insurance, Chinese food containers are decorated with ads for Continental Airways, and parking meters display ads for Campbell’s Soup[21] Advertising is still the most prevalent form of promotion.

Figure 10.8: A digital advertising screen in the New York subway

The choice of **advertising media** depends on your product, target audience, and budget. A travel agency selling spring-break getaways to college students might post flyers on campus bulletin boards or run ads in campus newspapers. The cofounders of Nantucket Nectars found radio ads particularly effective. Rather than pay professionals, they produced their own ads themselves.[22] As unprofessional as this might sound, the ads worked, and the business grew.

Personal Selling

Personal selling refers to one-on-one communication with customers or potential customers. This type of interaction is necessary in selling large-ticket items, such as homes, and it’s also effective in situations in which personal attention helps to close a sale, such as sales of cars and insurance policies.

Figure 10.9: Personal selling at Best Buy

Many retail stores depend on the expertise and enthusiasm of their salespeople to persuade customers to buy. Home Depot has grown into a home-goods giant in large part because it fosters one-on-one interactions between salespeople and customers. The real difference between Home Depot and everyone else isn't the merchandise; it's the friendly, easy-to-understand advice that sales people give to novice homeowners, according to one of its cofounders.[23] Best Buy's knowledgeable sales associates make them "uniquely positioned to help consumers navigate the increasing complexity of today's technological landscape" according to CEO Hubert Joly.[24]

Sales Promotion

It's likely that at some point, you have purchased an item with a coupon or because it was advertised as a buy-one-get-one special. If so, you have responded to a **sales promotion** – one of the many ways that sellers provide incentives for customers to buy. Sales promotion activities include not only those mentioned above but also other forms of discounting, sampling, trade shows, in-store displays, and even sweepstakes. Some promotional activities are targeted directly to consumers and are designed to motivate them to purchase now. You've probably heard advertisers make statements like "limited time only" or "while supplies last". If so, you've encountered a sales promotion directed at consumers. Other forms of sales promotion are directed at dealers and intermediaries. Trade shows are one example of a dealer-focused promotion. Mammoth centers such as McCormick Place in Chicago host enormous events in which manufacturers can display their new products to retailers and other interested parties. At food shows, for example, potential buyers can sample products that manufacturers hope to launch to the market. Feedback from prospective buyers can even result in changes to new product formulations or decisions not to launch.

Figure 10.10: Sales promotion at Wal-Mart

Publicity and Public Relations

Free **publicity**—say, getting your company or your product mentioned or pictured in a newspaper or on TV—can often generate more customer interest than a costly ad. When Dr. Dre and Jimmy Iovine were finalizing the development of their Beats headphones, they sent a pair to LeBron James. He liked them so much he asked for 15 more pairs, and they "turned up on the ears of every member of the 2008 U.S. Olympic basketball team when they arrived in Shanghai. 'Now that's marketing,' says Iovine."[25] It wasn't long before the pricey headphones became a must-have fashion accessory for everyone from celebrities to high school students.

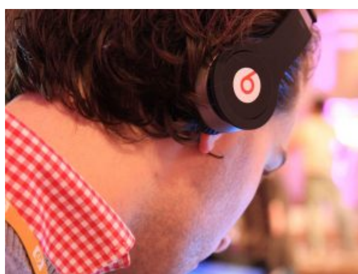


Figure 10.11: Beats headphones by Dr. Dre

Consumer perception of a company is often important to a company's success. Many companies, therefore, manage their public relations in an effort to garner favorable publicity for themselves and their products. When the company does something noteworthy, such as sponsoring a fund-raising event, the public relations department may issue a press release to promote the event. When the company does something negative, such as selling a prescription drug that has unexpected side effects, the public relations department will work to control the damage to the company. Each year the Hay Group and Korn Ferry survey more than a

thousand company top executives, directors, and industry leaders in twenty countries to identify companies that have exhibited exceptional integrity or commitment to corporate social responsibility. The rankings are publishes annually as Fortune magazine's "World's Most Admired Companies.®"[26] Topping the list in 2016 are Apple, Alphabet (Google), Amazon, Berkshire Hathaway, and Walt Disney.[27]

Marketing Robosapien

Now let's look more closely at the strategy that Wow Wee pursued in marketing Robosapien in the United States. The company's goal was ambitious: to promote the robot as a must-have item for kids of all ages. As we know, Wow Wee intended to position Robosapien as a home-entertainment product, not as a toy. The company rolled out the product at Best Buy, which sells consumer electronics, computers, entertainment software, and appliances. As marketers had hoped, the robot caught the attention of consumers shopping for TV sets, DVD players, home and car audio equipment, music, movies, and games. Its $99 price tag was a little lower than the prices of other merchandise, and that fact was an important asset: shoppers were willing to treat Robosapien as an impulse item—something extra to pick up as a gift or as a special present for children, as long as the price wasn't too high.

Figure 10.12: Robosapien

Meanwhile, Robosapien was also getting lots of free publicity. Stories appeared in newspapers and magazines around the world, including the New York Times, the Times of London, Time magazine, and National Parenting magazine. Commentators on The Today Show, The Early Show, CNN, ABC News, and FOX News all covered it. The product received numerous awards, and experts predicted that it would be a hot item for the holidays.

At Wow Wee, Marketing Director Amy Weltman (who had already had a big hit with the Rubik's Cube) developed a gala New York event to showcase the product. From mid- to late August, actors dressed in six-foot robot costumes roamed the streets of Manhattan, while the fourteen-inch version of Robosapien performed in venues ranging from Grand Central Station to city bars. Everything was recorded, and film clips were sent to TV stations.

The stage was set for expansion into other stores. Macy's ran special promotions, floating a twenty-four-foot cold-air robot balloon from its rooftop and lining its windows with armies of Robosapien's. Wow Wee trained salespeople to operate the product so that they could help customers during in-store demonstrations. Other retailers, including The Sharper Image, Spencer's, and Toys "R" Us, carried Robosapien, as did e-retailers such as Amazon.com. The product was also rolled out (with the same marketing flair) in Europe and Asia.

When national advertising hit in September, all the pieces of the marketing campaign came together—publicity, sales promotion, personal selling, and advertising. Wow Wee ramped up production to meet anticipated fourth-quarter demand and waited to see whether Robosapien would live up to commercial expectations.

Interacting with Customers

Customer-Relationship Management

Customers are the most important asset that any business has. Without enough good customers, no company can survive. Firms must not only attract new customers but also retain current customers. In fact, repeat customers are more profitable. It's estimated that it costs as much as five times more to attract and sell to a new customer than to an existing one.[28] Repeat customers also tend to spend more, and they're much more likely to recommend you to other people.

Retaining customers is the purpose of **customer-relationship management**—a marketing strategy that focuses on using information about current customers to nurture and maintain strong relationships with them. The underlying theory is fairly basic:

to keep customers happy, you treat them well, give them what they want, listen to them, reward them with discounts and other loyalty incentives, and deal effectively with their complaints.

Take Caesars Entertainment Corporation, which operates more than fifty casinos under several brands, including Caesars, Harrah's, Bally's, and Horseshoe. Each year, it sponsors the World Series of Poker with a top prize in the millions. Caesars gains some brand recognition when the twenty-two-hour event is televised on ESPN, but the real benefit derives from the information cards filled out by the seven thousand entrants who put up $10,000 each. Data from these cards is fed into Caesars database, and almost immediately every entrant starts getting special attention, including party invitations, free entertainment tickets, and room discounts. The program is all part of Harrah's strategy for targeting serious gamers and recognizing them as its best customers.[29]

Sheraton Hotels uses a softer approach to entice return customers. Sensing that its resorts needed both a new look and a new strategy for attracting repeat customers, Sheraton launched its "Year of the Bed" campaign; in addition to replacing all its old beds with luxurious new mattresses and coverings, it issued a "service promise guarantee"—a policy that any guest who's dissatisfied with his or her Sheraton stay will be compensated. The program also calls for a customer-satisfaction survey and discount offers, both designed to keep the hotel chain in touch with its customers.[30]

Another advantage of keeping in touch with customers is the opportunity to offer them additional products. Amazon.com is a master at this strategy. When you make your first purchase at Amazon.com, you're also making a lifelong "friend"—one who will suggest (based on what you've bought before) other things that you might like to buy. Because Amazon.com continually updates its data on your preferences, the company gets better at making suggestions.

Social Media Marketing

In the last several years, the popularity of **social media marketing** has exploded. You already know what social media is — Facebook, Twitter, LinkedIn, YouTube, and any number of other online sites that allow you to network, share your opinions, ideas, photos, etc. Social media marketing is the practice of including social media as part of a company's marketing program.

Why do businesses use social media marketing? Before responding, ask yourself these questions: how much time do I spend watching TV? When I watch TV, do I sit through the ads? Do I read newspapers or magazines and flip right past the ads? Now, put yourself in the place of Annie Young-Scrivner, global chief marketing officer of Starbucks. Does it make sense for her to spend millions of dollars to place an ad for Starbucks on TV or in a newspaper or magazine? Or should she instead spend the money on social media marketing initiatives that have a high probability of connecting to Starbucks's market?

For companies like Starbucks, the answer is clear. The days of trying to reach customers through ads on TV, in newspapers, or in magazines are over. Most television watchers skip over commercials, and few Starbucks's customers read newspapers or magazines, and even if they do, they don't focus on the ads. Social media marketing provides a number of advantages to companies, including enabling them to:[31]

- create brand awareness;
- connect with customers and potential customers by engaging them in two-way communication;
- build brand loyalty by providing opportunities for a targeted audience to participate in company-sponsored activities, such as contests;
- offer and publicize incentives, such as special discounts or coupons;
- gather feedback and ideas on how to improve products and marketing initiatives;
- allow customers to interact with each other and spread the word about a company's products or marketing initiatives; and
- take advantage of low-cost marketing opportunities by being active on free social sites, such as Facebook.

To get an idea of the power of social media marketing, think of the ALS Ice Bucket Challenge. According to the ALS Association: "the ALS Ice Bucket Challenge started in the summer of 2014 and became the world's largest global social media phenomenon. More than 17 million people uploaded their challenge videos to Facebook; these videos were watched by 440 million people a total of 10 billion times."[32] The ALS Association raised $115 million in six weeks (their usual annual budget was only $20 million).[33] To see how companies try to harness this power, let's look at social media campaigns of two leaders in this field: PepsiCo (Mountain Dew) and Starbucks.

Figure 10.13: The ALS Ice Bucket Challenge in action

Mountain Dew (PepsiCo)

When PepsiCo announced it wouldn't show a television commercial during the 2010 Super Bowl game, it came as a surprise (probably a pleasant one to its competitor, Coca-Cola, who had already signed on to show several Super Bowl commercials). What PepsiCo planned to do instead was invest $20 million into social media marketing campaigns. One of PepsiCo's most successful social media initiatives has been the DEWmocracy campaign, which two years earlier, resulted in the launch of product—Voltage—created by Mountain Dew fans.[34] Now called DEWcision, the 2016 campaign asks fans to vote between two rival flavors of Mountain Dew. The campaign engages a number of social media outlets with challenges for fans to earn votes for their favorite flavor, including Twitter, Instagram, and Facebook.[35] The example in Figure 10.14 is for a challenge to dye your hair the color of your favorite flavor, then Tweet the picture with the hashtag #DewDye. According to Mountain Dew's director of marketing, "PepsiCo looks at social media as the best way to get direct dialog with their fans and for the company to hear from those fans without filters. 'It's been great for us to have this really unique dialogue that we normally wouldn't have,' he said. 'It really has opened our eyes up.'"[36]

Figure 10.14: Two friends who disagree on which Mountain Dew Flavor to vote for

Starbucks

One of most enthusiastic users of social media marketing is Starbucks. Let's look at a few of their promotions: a discount for "Foursquare" mayors and free coffee on Tax Day via Twitter's promoted tweets and a free pastry day promoted through Twitter and Facebook.[37]

Discount for "Foursquare" Mayors of Starbucks

This promotion was a joint effort of Foursquare and Starbucks. Foursquare is a mobile social network, and in addition to the handy "friend finder" feature, you can use it to find new and interesting places around your neighborhood to do whatever you and your friends like to do. It even rewards you for doing business with sponsor companies, such as Starbucks. The individual with the most "check in's" at a particular Starbucks holds the title of mayor. For a period of time, the mayor of each store got $1 off a Frappuccino. Those who used Foursquare were particularly excited about Starbucks's nationwide mayor rewards program because it brought attention to the marketing possibilities of the location-sharing app.[38]

Figure 10.15: Starbucks and Foursquare promotion

Free Coffee on Tax Day (via Twitter's Promoted Tweets)

Starbucks was not the only company to give away freebies on Tax Day, April 15, 2010. Lots of others did.[39] But it was the only company to spread the message of their giveaway on the then-new Twitter's Promoted Tweets platform (which went into operation on April 13, 2010). Promoted Tweets are Twitter's means of making money by selling sponsored links to companies.[40] Keeping with Twitter's 140 characters per tweet rule, Starbucks's Promoted Tweet read, "On 4/15 bring a reusable tumbler and we'll fill it with brewed coffee for free. Let's all switch from paper cups." The tweet also linked to a page that detailed Starbucks's environmental initiatives.[41]

Free Pastry Day (Promoted through Twitter and Facebook)

Starbucks's "free pastry day" was promoted on Facebook and Twitter.[42] As the word spread from person to person in digital form, the wave of social media activity drove more than a million people to Starbucks's stores around the country in search of free food.[43]

As word of the freebie offering spread, Starbucks became the star of Twitter, with about 1 percent of total tweets commenting on the brand. That's almost ten times the number of mentions on an average day. It performed equally well on Facebook's event page where almost 600,000 people joined their friends and signed up as "attendees."[44] This is not surprising given that Starbucks is the most popular brand on Facebook and has over 36 million "likes" in 2016.[45]

How did Starbucks achieve this notoriety on Facebook? According to social media marketing experts, Starbucks earned this notoriety by making social media a central part of its marketing mix, distributing special offers, discounts, and coupons to Facebook users and placing ads on Facebook to drive traffic to its page. As explained by the CEO of Buddy Media, which oversees the brand's social media efforts, "Starbucks has provided Facebook users a reason to become a fan."[46]

Social Media Marketing Challenges

The main challenge of social media marketing is that it can be very time consuming. It takes determination and resources to succeed. Small companies often lack the staff to initiate and manage social media marketing campaigns.[47] Even large companies can find the management of media marketing initiates overwhelming. A recent study of 1,700 chief marketing officers indicates that many are overwhelmed by the sheer volume of customer data available on social sites, such as Facebook and Twitter.[48] This is not surprising given that in 2016, Facebook had more than 1.6 billion active users,[49] and five hundred million tweets are sent each day.[50] The marketing officers recognize the potential value of this data but are not always capable of using it. A chief marketing officer in the survey described the situation as follows: "The perfect solution is to serve each consumer individually. The problem? There are 7 billion of them."[51] In spite of these limitations, 82 percent of those surveyed plan to increase their use of social media marketing over the next 3 to 5 years. To understand what real-time information is telling them, companies will use analytics software, which is capable of analyzing unstructured data. This software is being developed by technology companies, such as IBM, and advertising agencies.

The bottom line: what is clear is that marketing, and particularly advertising, has changed forever. As Simon Pestridge, Nike's global director of marketing for Greater China, said about Nike's marketing strategy, "We don't do advertising any more. Advertising is all about achieving awareness, and we no longer need awareness. We need to become part of people's lives, and digital allows us to do that."[52]

A New Marketing Model

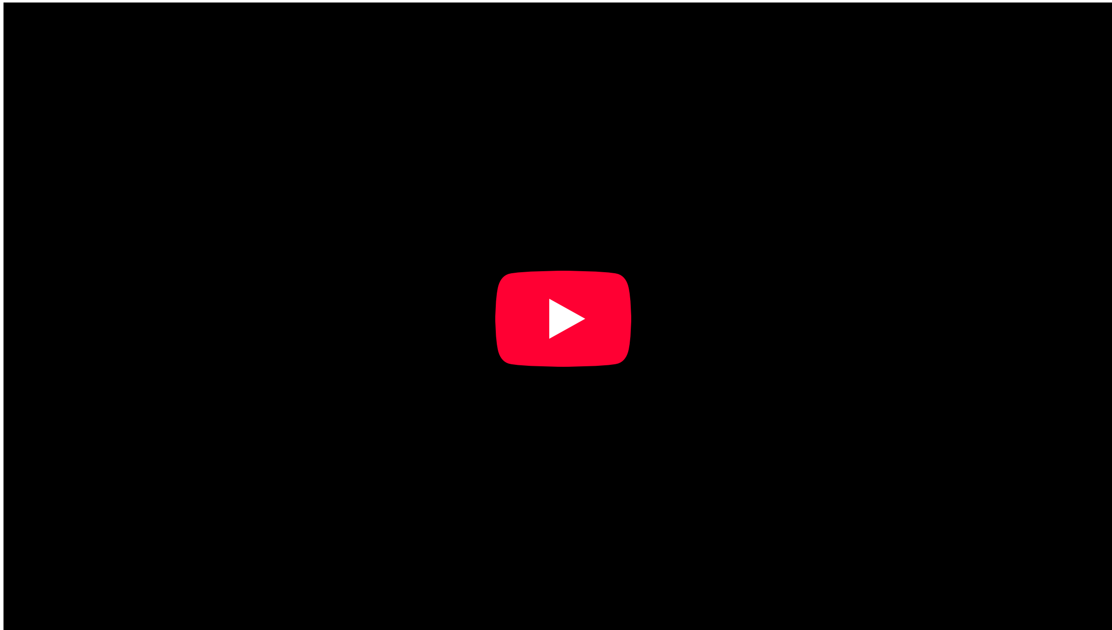
The 4 P's have served marketers well for generations, but new innovations can disrupt even the most established concepts. A new framework is taking hold in marketing – the **4 C's**. In this model, each of the C words replaces one of the P's, flipping the model from the perspective of the marketer to that of the customer. In the new model:

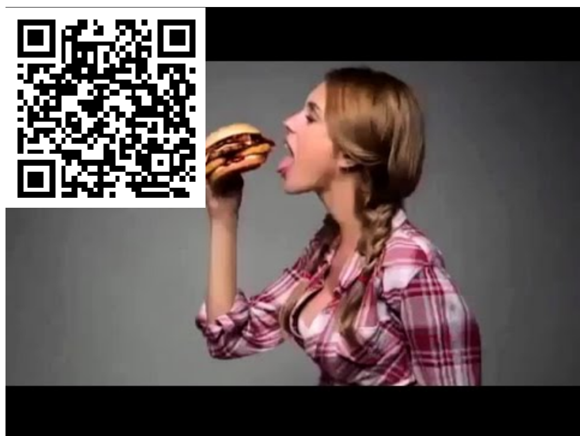
1. **Consumer** replaces Product: Products solve a need for a customer; by focusing on the consumer in the 4 C's model, the point of view changes to a customer-based perspective and also allows for the inclusion of services, which are purchased about as often as physical products.
2. **Convenience** rather than Place: Both words speak to the same point – where can my customers obtain my product or service? But in an age where so many products and services are sourced online, the word "convenience" incorporates more than just a physical location, as was implied by the word "place".
3. **Cost** takes the place of Price: From the standpoint of the buyer, the price charged by the seller becomes their cost. Moving to the word "cost" results in seeing things from the perspective of the customer, consistent with other aspects of the model.
4. **Communication** replaces Promotion: In its most basic form, promotion is about informing potential customers so that they will recognize the value in a product or service and part with the funds necessary to obtain it. However, the word "promotion" also has taken on the context of a deal or discount. By moving to the word "communication", the new model incorporates all forms of reaching customers, whether through advertising, coupons, social media campaigns, and many others.

The 4 C's framework appears to be gaining traction, and it may eventually replace the 4 P's altogether. If so, we will no doubt find ourselves rewriting this entire chapter!

Chapter Video

Marketing is unfortunately not always truthful or entirely accurate. This video features some examples of misleading advertising which persists in business because it often works.





Key Takeaways

1. **Marketing** is a set of processes for creating, communicating, and delivering value to customers and for improving customer relationships.
2. A **target market** is a specific group of consumers who are particularly interested in a product, would have access to it, and are able to buy it.
3. Target markets are identified through **market segmentation**—finding specific subsets of the overall market that have common characteristics that influence buying decisions.
4. Markets can be segmented on a number of variables including **Demographics**, **Geographics**, **Behavior**, and **Psychographics** (or lifestyle variables).
5. Developing and implementing a marketing program involves a combination of tools called the **marketingmix**: **product**, **price**, **place**, and **promotion**.
6. Before settling on a marketing strategy, marketers often do **marketingresearch** to collect and analyze relevant data.
7. Methods for collecting primary data include **surveys**, **personalinterviews**, and **focusgroups**.
8. To protect a **brand** name, companies register trademarks with the U.S. Patent and Trademark Office.
9. There are three major **brandingstrategies**:
    1. With **private branding**, the maker sells a product to a retailer who resells it under its own name.
    2. Under **generic branding**, a no-brand product contains no identification except for a description of the contents.
    3. Using **manufacturerbranding**, a company sells products under its own brand names.
10. When consumers have a favorable experience with a product, it builds **brand equity**.
    1. If consumers are loyal to it over time, it enjoys **brand loyalty**.
11. **Retailers** are intermediaries that sell to the end consumer. Types of retailers include **category killers, convenience stores, department stores, discount stores, specialty stores, supermarkets, and warehouse club stores**.
12. The **promotion mix** includes all the tools for telling people about a product and persuading potential customers to buy it. It can include **advertising**, **personal selling**, **sales promotion**, and **publicity**.

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11: Accounting and Financial Information

Learning Objectives

1. Define accounting and explain the differences between managerial accounting and financial accounting.
2. Identify some of the users of accounting information and explain how they use it.
3. Explain the function of the income statement.
4. Explain the function of the balance sheet.
5. Calculate a break-even point given the necessary information.
6. Evaluate a company's performance using financial statements and ratio analysis.

Figure 11.1: Apple Headquarters in Cupertino, California

Apple Inc. is the most valuable company in the world. This statement is based on market value, which in June 2016 was roughly $500 billion. Although markets can fluctuate, sometimes wildly, if you are reading this chapter for a course later in 2016 or in 2017, it is not unlikely that Apple will have retained its leadership position. Its value as of June 2016 was more than $40 billion greater than that of the next largest company, Alphabet, the parent company of Google. Apple has briefly ceded the leadership position to Alphabet on a couple of occasions, but for the most part, it has been the leader for quite some time.[1]

You may wonder what kind of information is used to make these determinations. How does the market know that Apple should be valued more than $100 billion higher than Exxon-Mobil, for example?[2] Do investors just make their decisions on instinct? Well, some do, but it's not a formula for sustained success. In most cases, in deciding how much to pay for a company, investors rely on published accounting and financial information released by publicly-traded companies. This chapter will introduce you to the subject of accounting and financial information so you can begin to get an understanding for how the valuation process works.

The Role of Accounting

Accounting is often called "the language of business" because it communicates so much of the information that owners, managers, and investors need to evaluate a company's financial performance. These people are stakeholders in the business—they're interested in its activities because they're affected by them. The financial futures of owners and other investors may depend heavily on strong financial performance from the business, and when performance is poor, managers may be replaced or laid off in a downsizing. In fact, a key purpose of accounting is to help stakeholders make better business decisions by providing them with financial information. You shouldn't try to run an organization or make investment decisions without accurate and timely financial information, and it is the accountant who prepares this information. More importantly, accountants make sure that stakeholders understand the meaning of financial information, and they work with both individuals and organizations to help them use financial information to deal with business problems. Actually, collecting all the numbers is the easy part. The hard part is analyzing, interpreting, and communicating the information. Of course, you also have to present everything clearly while effectively interacting with people from every business discipline. In any case, we're now ready to define **accounting** as the process of measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other decision makers.

Fields of Accounting

Accountants typically work in one of two major fields. **Management accountants** provide information and analysis to decision makers inside the organization in order to help them run it. **Financial accountants** furnish information to individuals and groups both inside and outside the organization in order to help them assess its financial performance. Their primary focus, however, is on external parties. In other words, management accounting helps you keep your business running while financial accounting tells the outside world how well you're running it.

Management Accounting

Management accounting, also known as managerial accounting, plays a key role in helping managers carry out their responsibilities. Because the information that it provides is intended for use by people who perform a wide variety of jobs, the format for reporting information is flexible. Reports are tailored to the needs of individual managers, and the purpose of such reports is to supply relevant, accurate, timely information that will aid managers in making decisions. In preparing, analyzing, and communicating such information, accountants work with individuals from all the functional areas of the organization—human resources, operations, marketing, etc.

Figure 11.2: The role of Managerial accounting

Financial Accounting

Financial accounting is responsible for preparing the organization's **financial statements**—including the **income statement**, the **statement of owner's equity**, the **balance sheet**, and the **statement of cash flows**—that summarize a company's past performance and evaluate its current financial condition. If a company is traded publicly on a stock market such as the NASDAQ, these financial statements must be made public, which is not true of the internal reports produced by management accountants. In preparing financial statements, financial accountants adhere to a uniform set of rules called **generally accepted accounting principles** (GAAP)—the basic principles for financial reporting issued by an independent agency called the **Financial Accounting Standards Board** (FASB). Users want to be sure that financial statements have been prepared according to GAAP because they want to be sure that the information reported in them is accurate. They also know that when financial statements have been prepared by the same rules, they can be compared from one company to another.

While companies headquartered in the United States follow U.S.-based GAAP, many companies located outside the United States follow a different set of accounting principles called **International Financial Reporting Standards** (IFRS). These multinational standards, which are issued by the International Accounting Standards Board (IASB), differ from U.S. GAAP in a number of important ways, but we're not at the point yet of exploring these sometimes fine distinctions. Bear in mind, however, that, according to most experts, a single set of worldwide standards will eventually emerge to govern the accounting practices of both U.S. and non-U.S. companies.

Who Uses Financial Accounting Information?

The users of managerial accounting information are pretty easy to identify—basically, they're a firm's managers. We need to look a little more closely, however, at the users of financial accounting information, and we also need to know a little more about what

they do with the information that accountants provide them.

Owners and Managers

In summarizing the outcomes of a company's financial activities over a specified period of time, financial statements are, in effect, report cards for owners and managers. They show, for example, whether the company did or didn't make a profit and furnish other information about the firm's financial condition. They also provide some information that managers and owners can use in order to take corrective action, though reports produced by management accountants offer a much greater level of depth.

Investors and Creditors

Investors and **creditors** furnish the money that a company needs to operate, and not surprisingly, they want to know how that business is performing. Because they know that it's impossible to make smart investment and loan decisions without accurate reports on an organization's financial health, they study financial statements to assess a company's performance and to make decisions about continued investment.

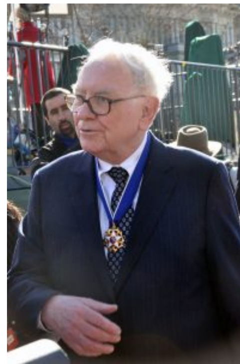

Figure 11.3: Warren Buffet, Presidential Medal of Freedom recipient in 2011

According to the world's most successful investor, Warren Buffett, the best way to prepare yourself to be an investor is to learn all the accounting you can. Buffett, chairman and CEO of Berkshire Hathaway, a company that invests in other companies, turned an original investment of $10,000 into a net worth of $66 billion[3] in four decades, and he did it, in large part, by paying close attention to financial accounting reports.

Figure 11.4: The role of Financial accounting

Government Agencies

Businesses are required to furnish financial information to a number of government agencies. Publicly-owned companies, for example—the ones whose shares are traded on a stock exchange—must provide annual financial reports to the **Securities and Exchange Commission** (SEC), a federal agency that regulates stock trades and which is charged with ensuring that companies tell the truth with respect to their financial positions. Companies must also provide financial information to local, state, and federal taxing agencies, including the Internal Revenue Service (IRS).

Other Users

A number of other external users have an interest in a company's financial statements. Suppliers, for example, need to know if the company to which they sell their goods is having trouble paying its bills or may even be at risk of going under. Employees and labor unions are interested because salaries and other forms of compensation are dependent on an employer's performance.

Figures 17.2 and 17.4 illustrate the main users of management and financial accounting and the types of information produced by accountants in the two areas. In the rest of this chapter, we'll learn how to prepare a set of financial statements and how to interpret them. We'll also discuss issues of ethics in the accounting communities and career opportunities in the accounting profession.

Understanding Financial Statements

We hope that, so far, at least one thing is clear: If you're in business, you need to understand financial statements. The law no longer allows high-ranking executives to plead ignorance or fall back on delegation of authority when it comes to responsibility for a firm's financial reporting. In a business environment tainted by episodes of fraudulent financial reporting and other corporate misdeeds, top managers are now being held responsible for the financial statements issued by the people who report to them. Top managers need to know how well the company is performing. Financial information helps managers identify signs of impending trouble before it is too late.

The Function of Financial Statements

Put yourself in the place of Connie in Figure 17.5 on the next page, who runs Connie's Confections out of her home. She loves what she does, and she feels that she's doing pretty well. In fact, she has an opportunity to take over a nearby store at very reasonable rent, and she can expand by getting a modest bank loan and investing some more of her own money. So it's decision time for Connie: She knows that the survival rate for start-ups isn't very good, and before taking the next step, she'd like to get a better idea of whether she's actually doing well enough to justify the risk. The basic financial statements will give her some answers.

Since this book is for an introductory course, we will focus our attention on the income statement and balance sheet only, even though we mentioned other financial statements earlier in the chapter.

Toying with a Business Idea

To bring this concept closer to home, let's assume that you need to earn money while you're in college and that you've decided to start a small business. Your business will involve selling stuff to other college students, and to keep things simple, we'll assume that you're going to operate on a "cash" basis: you'll pay for everything with cash, and everyone who buys something from you will pay in cash.

You may have at least a little cash on you right now—some currency, or paper money, and coins. In accounting, however, the term **cash** refers to more than just paper money and coins. It also refers to the money that you have in checking and savings accounts and includes items that you can deposit in these accounts, such as money orders and different types of checks.

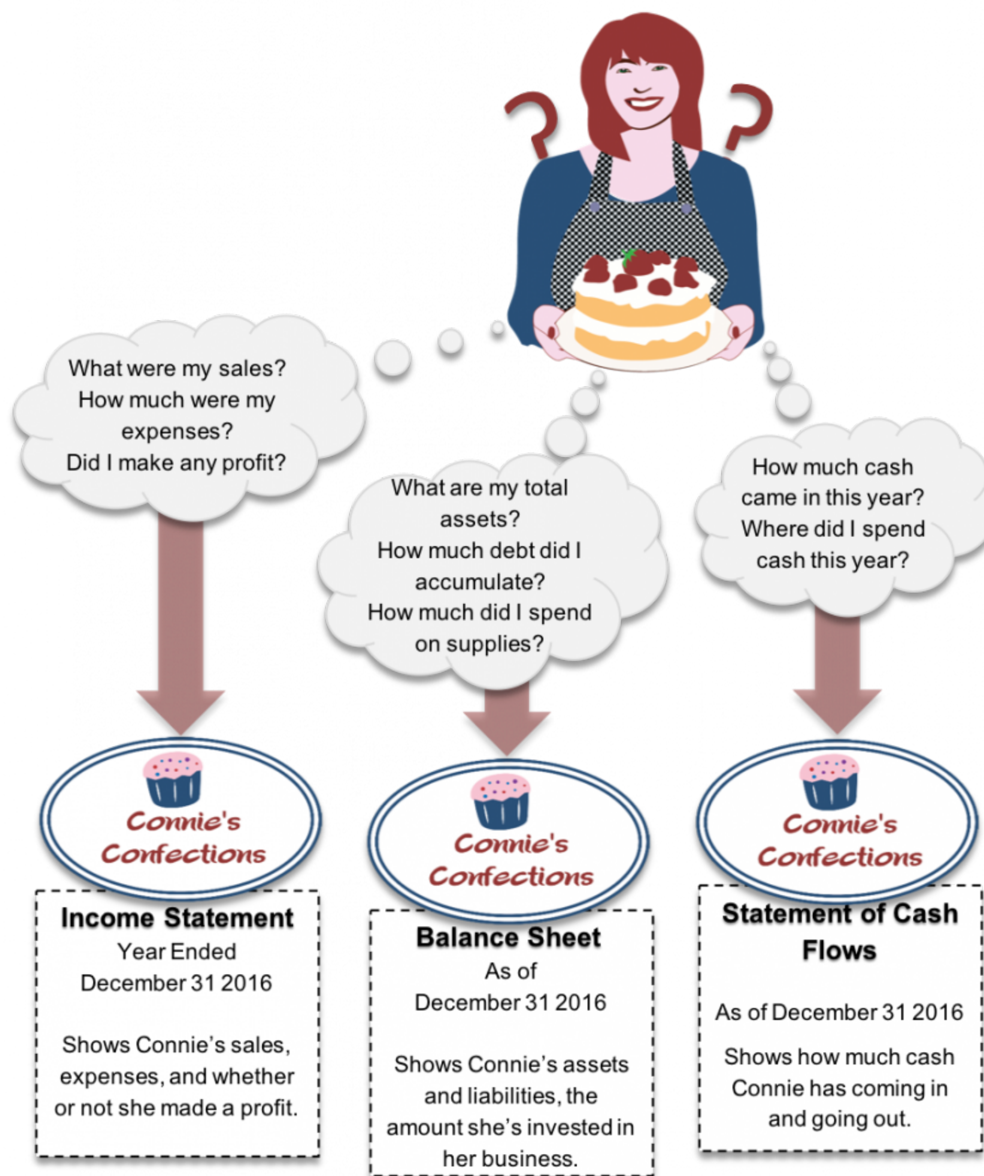

Figure 11.5: Connie has questions about her questions about her business that financial statements can help her answer

Your first task is to decide exactly what you're going to sell. You've noticed that with homework, exams, social commitments, and the hectic lifestyle of the average college student, you and most of the people you know always seem to be under a lot of stress. Sometimes you wish you could just lie back between meals and bounce a ball off the wall. And that's when the idea hits you: Maybe you could make some money by selling a product called the "Stress-Buster Play Pack." Here's what you have in mind: you'll buy small toys and other fun stuff—instant stress relievers—at a local dollar store and pack them in a rainbow-colored plastic treasure chest labeled "Stress-Buster."

The Accounting Equation

To begin keeping track of your company financially, you'll first need to understand the fundamental accounting equation:

Assets = Liabilities + Owner's Equity

Think of assets as things *owned* by your business – cash in the bank, product inventory, etc. And think of liabilities as the amounts *owed* – perhaps you've had a job where your pay check came a couple of weeks after you did the work; during that unpaid window, the amount due to you was a liability to your employer. *Owner's equity* represents the value of the firm according to your financial statements; obviously it is good to own more than you owe.

This simple but important equation highlights the fact that a company's **assets** came from somewhere: either from investments made by the owners (**owner's equity**) or from loans (**liabilities**). This means that the asset section of the balance sheet on the one hand and the liability and owner's-equity section on the other must be equal, or **balance**.

Let's say you have $200 in cash and borrow $400 from your parents and plan to buy a month's worth of plastic treasure chests and toys. After that, you'll use the cash generated from sales of Stress-Buster Play Packs to replenish your supply. You open a bank account for your new business and create your opening financial statement – the **balance sheet.**

The Balance Sheet

A **balance sheet** reports the following information:

- **Assets**: the resources from which it expects to gain some future benefit
- **Liabilities**: the debts that it owes to outside individuals or organizations
- **Owner's equity**: the investment in the business

At the time you open the account, your balance sheet would look like this:

Figure 11.6: Stress-Buster's balance sheet as of September 1, 2019

Stress-Buster Company Balance Sheet As of September 1, 2019	
Assets	
Cash	**$600**
Liabilities and Owner's Equity	
Liabilities	400
Owner's Equity	200
Total Liabilities and Owner's Equity	**$600**

The amount you owe your parents is a liability to you, and your own investment of $200 in the business is represented by your owner's equity.

Now it is time to start buying toys, repackaging them, and selling your Stress-Busters. Each plastic chest will cost $1.00, and you'll fill each one with a variety of five simple toys, all of which you can buy for $1.00 each.

You plan to sell each Stress-Buster Play Pack for $10 from a rented table stationed outside a major dining hall. Renting the table will cost you $20 a month. In order to make sure you can complete your school work, you decide to hire fellow students to staff the table at peak traffic periods. They'll be on duty from noon until 2:00 p.m. each weekday except Fridays, and you'll pay them a generous $7.50 an hour. Wages, therefore, will cost you $240 a month (2 hours × 4 days × 4 weeks = 32 hours × $7.50). Finally, you'll run ads in the college newspaper at a monthly cost of $40. Thus your total monthly costs will amount to $300 ($20 + $240 + $40).

The Income Statement

Let's say that during your first month, you sell one hundred play packs. Not bad, you say to yourself, but did I make a profit? To find out, you prepare an income statement showing **revenues**, or sales, and **expenses**—the costs of doing business. You divide your expenses into two categories:

- **Cost of goods sold**: the total cost of the goods that you've sold
- **Operating expenses**: the costs of operating your business except for the costs of things that you've sold.

Now you need to do some subtracting:

- The difference between sales revenue and cost of goods sold is your **gross profit**, also known as **gross margin**.
- The difference between gross profit and operating expenses is your **net income** or **profit**, which is the proverbial "bottom line." Note we've assumed you're making money, but businesses can also have a net loss.

Figure 11.7 is your income statement for the first month. (Remember that we've made things simpler by handling everything in cash.)

Figure 11.7: Stress-Buster's income statement for September 2019

Stress-Buster Company Income Statement Month Ended September 30, 2019		
Sales (100x$10.00)		$1,000
Less cost of goods sold (100x$6)		600
Gross profit (100x ($10 -$6))		400
Less operating expenses		
Salaries	240	
Advertising	40	
Table rental	20	
	300	
Net income (Profit) ($400-$300)		**$100**

Did You Make Any Money?

What does your income statement tell you? It has provided you with four pieces of valuable information:

You sold 100 units at $10 each, bringing in **revenues** or **sales** of $1,000.

Each unit that you sold cost you $6—$1 for the treasure chest plus 5 toys costing $1 each. So your **costofgoodssold** is $600 (100 units × $6 per unit).

Your **gross profit**—the amount left after subtracting cost of goods sold from sales—is $400 (100 units × $4 each).

After subtracting **operatingexpenses** of $300—the costs of doing business other than the cost of products sold—you generated a positive **netincome** or **profit** of $100.

Whereas your **balance sheet** tells you what you have *at a specific point in time*, your **income statement** tells you how much income you earned *over some period of time*, in this case, the month of September.

Companies prepare financial statements on at least a twelve-month basis—that is, for a **fiscal year** which ends on December 31 or some other logical date, such as June 30 or September 30. Fiscal years can vary because companies generally pick a fiscal-year end date that coincides with the end of a peak selling period; thus a crabmeat processor might end its fiscal year in October, when the crab supply has dwindled. Most companies also produce financial statements on a quarterly or monthly basis. For Stress-Buster, you'll want to prepare them monthly to stay on top of how your new business is doing. Let's prepare a new balance sheet to how things have changed by the end of the month.

Recall that Stress- Buster earned $100 during the month of September and that you decided to leave these earnings in the business. This $100 profit increases two items on your balance sheet: the assets of the company (its cash) and your investment in it (its owner's equity). Figure 11.8 shows what your balance sheet will look like on September 30. You now have $700 in cash: $400 that

you borrowed plus $300 that you've invested in the business (your original $200 investment plus the $100 profit from the first month of operations, which you've kept in the business).

Figure 11.8: Stress-Buster's balance sheet at the end of September 2019

Stress-Buster Company Balance Sheet As of September 30, 2019	
Assets	
Cash (original $600 plus $100 earned)	**$700**
Liabilities and Owner's Equity	
Liabilities	400
Owner's Equity ($200 invested by owner plus $100 profits retained)	300
Total Liabilities and Owner's Equity	**$700**

A Quick Word About Credit

Because the money you borrowed came from your trusting parents, they loaned it to you on the basis of you signing a simple note promising to pay it back. Such a loan is considered *unsecured credit.* But what if you had borrowed the money from a bank? The banker would probably have required *collateral*, which is property or some other asset that would become the property of the lender if you failed to pay. If you know someone who had a car loan, you probably know that if the loan went unpaid, the bank could repossess the car. This type of loan is called *secured credit*, because the bank makes it with the security that if the borrower cannot or will not pay, they can take possession of the collateral, sell it, and recover their money that way.

Breakeven Analysis

Let's take a short detour to see how Stress Buster's financial information might be put to use. As you look at your first financial statements, you might ask yourself: is there some way to figure out the level of sales you need to avoid losing money—to "break even"? This can be done using **breakeven analysis**. To break even (have no profit or loss), your total sales revenue must exactly equal all your expenses (both variable and fixed). **Variable costs** depend on the quantity produced and sold; for example, each Stress-Buster includes the treasure chest and the toys inside. **Fixed costs** don't change as the quantity sold changes; for example, you'll pay for your advertising whether you sell Stress-Busters or not. The balance between revenue and expenses will occur when gross profit equals all other (fixed) costs. To determine the level of sales at which this will occur, you need to do the following (using data from the previous example):

1. Determine your total fixed costs:
   - Fixed costs = $240 salaries + $40 advertising + $20 table = $300
2. Identify your variable costs on a per-unit basis:
   - Variable cost per unit = $6 ($1 for the treasure chest and $5 for the toys)
3. Determine your **contribution margin** per unit: selling price per unit – variable cost per unit:
   - Contribution margin = $10 selling price – $6 variable cost per unit = $4
4. Calculate your breakeven point in units: fixed costs / contribution margin per unit:
   - Breakeven in units = $300 fixed costs / $4 contribution margin per unit = 75 units

Your calculation means that if you sell 75 units, you'll end up with zero profit (or loss) and will exactly break even. To test your calculation, you can prepare a what-if income statement for

75 units in sales (your breakeven number). The resulting statement is shown in Figure 11.9.

Of course you want to do better than just break even, so you could modify this analysis to a targeted level of profit by adding that amount to your fixed costs and repeating the calculation. Breakeven analysis is rather handy. It enables you to determine the level of sales that you must reach to avoid losing money and the level of sales that you have to reach to earn a certain profit. Such information will be vital to planning your business.

Figure 11.9: Stress-Buster's breakeven income statement

Stress-Buster Company Income Statement Month Ended September 30, 2019 (at breakeven level of sales=75 units)		
Sales (75x$10.00)		$750
Less cost of goods sold (75x$6)		450
Gross profit ($75x ($10 -$6))		300
Less operating expenses		
Salaries	240	
Advertising	40	
Table rental	20	
	300	
Net income (Profit) ($300-$300)		**$0**

Financial Statement Analysis

Now that you know a bit about financial statements, we'll spend a little time talking about they're used to help owners, managers, investors, and creditors assess a firm's performance and financial strength. You can glean a wealth of information from financial statements, but first you need to learn a few basic principles for "unlocking" it.

Types of Financing Used by Companies

Before we go any further, let's outline two basic forms of financing – i.e., how do companies get the money they need in order to operate? One way is to borrow the money, which is known as *debt financing*. A business might take a loan from a commercial bank, or it might issue bonds which pay a particular rate of interest over a set period of time. At the end of the life of the bond, the borrower would repay the *principal*, i.e., the amount borrowed, to the holders of those bonds. Another form of financing would be to sell an ownership stake in the company, which is known as *equity financing*. Many business owners are reluctant to part with an ownership stake in the company because they then have to share the profits with those who have purchased a share of the company. However, lenders will only provide so much financing before they begin to get concerned about the borrower's ability to repay, so in practice, most businesses use some combination of debt and equity financing to fund the operations of the company.

Trend Analysis from the Income Statement

Now let's look at some of the things we can learn from analyzing financial statements. Figure 11.10 is an abbreviated financial statement for Apple for 2014 taken directly from their website. You will note that instead of showing only the current year's results, the company has shown data for the prior two years as well.

From this relatively simple exhibit, considerable information about Apple's performance can be obtained. For example:

- Apple sales grew at 6.95% from 2013 to 2014, not bad for a company with such a large base of sales already, but certainly not the rapid-growth company it once was.

- Net income as a percent of sales (a ratio also known as return on sales) was 21.6% – or in other words, for every $5 in sales, Apple turned more than $1 of it into profit. That is substantial!

Many other calculations are possible from Apple's data, and we will look at a few more as we explore ratio analysis.

Apple Inc. – Consolidated Statement of Operations (Income Statement)

(In millions, except number of shares which are reflected in thousands and per share amounts)

Figure 11.10: Apple statement of operations, 2014

Years ended	September 27, 2014	September 28, 2013	September 29, 2012
Net sales	$182,795	$170,910	$156,508
Cost of sales	$112,258	$106,606	$87,846
Gross margin	$70,537	$64,304	$68,662
Operating expenses:			
Research and development	$6,041	$4,475	$3,381
Selling, general and administrative	$11,993	$10,830	$10,040
Total operating expenses	$18,034	$15,305	$13,421
Operating income	$52,503	$48,999	$55,241
Other income/(expense), net	$980	$1,156	$522
Income before provision for income:			
Taxes	$53,483	$50,155	$55,763
Provision for income taxes	$13,973	$13,118	$14,030
Net income	$39,510	$37,037	$41,733
Earnings per share:			
Basic	$6.49	$5.72	$6.38
Diluted	$6.45	$5.68	$6.31
Shares used in computing earnings per share:			
Basic	$6,085,572	$6,477,320	$6,543,726
Diluted	$6,122,663	$6,521,634	$6,617,483

Cash dividends declared per common share:	$1.82	$1.64	$0.38

Ratio Analysis

How do you compare Apple's financial results with those of other companies in your industry or with the other companies whose stock is available to investors? And what about your balance sheet? Are there relationships on this statement that also warrant investigation? These issues can be explored by using **ratio analysis**, a technique for evaluating a company's financial performance.

Remember that a ratio is just one number divided by another, with the result expressing the relationship between the two numbers. It's hard to learn much from just one ratio, or even a number of ratios covering the same period. Rather, the deeper value in ratio analysis lies in looking at the trend of ratios over time and in comparing the ratios for several time periods with those of other companies. There are a number of different ways to categorize financial ratios.

Here's one set of categories:

- **Profitability ratios** tell you how much profit is made relative to the amount invested (return on investment) or the amount sold (return on sales).
- **Liquidity ratios** tell you how well positioned a company is to pay its bills in the near term. Liquidity refers to how quickly an asset can be turned into cash. For example, share of stock is substantially more liquid than a building or a machine.
- **Debt ratios** look at how much borrowing a company has done in order to finance the operations of the business. The more borrowing, the more risk a company has taken on, and so the less likely it would be for new lenders to approve loan applications.
- **Efficiency ratios** tell you how well your assets are being managed.

We could employ many different ratios, but we'll focus on a few key examples.

Profitability Ratios

Earlier we looked at the **return on sales** for Apple. Another profitability ratio on which the financial markets focus is **earnings per share**, also known as EPS. This ratio divides net income by the number of shares of stock outstanding. According to the earlier exhibit, Apple increased its EPS from $5.72 in 2013 to $6.49 in 2014, which indicates growth of about 13% — excellent for a company that is already among the world's largest. Well-paid analysts will spend hours to understand how these results were achieved every time Apple issues new financial statements.

Liquidity Ratios

Liquidity ratios are one element of measuring the financial strength of a company. They assess its ability to pay its current bills. A key liquidity ratio is called the **current ratio**. It simply examines the relationship between a company's **current assets** and its **current liabilities**. On September 27, 2014 (remember that balance sheets reflect a point in time), Apple had $68.5 billion in current assets and $63.4 billion in current liabilities. Simply, what this means is that Apple has more money on hand than they need to pay their bills. When a company has a current ratio greater than 1, they are in good shape to pay their bills; companies selling to Apple on credit would not need to worry that it is likely to run out of money.

Apple, Inc. – Consolidated Balance Sheets

(In millions, except number of shares which are reflected in thousands and par value)

Figure 11.11: Apple balance sheet, 2014

	September 27, 2014	September 28, 2013
Assets:		
Current Assets:		
Cash and cash equivalents	$13,844	$14,259
Short-term marketable securities	$11,233	$26,287

Accounts receivable, net of allowances	$17,460	$13,102
Inventories	$2,111	$1,764
Other current assets	$23,883	$17,874
Total current assets	**$68,531**	**$73,286**
Long-term marketable securities	$130,162	$106,215
Property, plant and equipment, net	$20,624	$16,597
Goodwill and acquired intangible assets, net	$8,758	$5,756
Other assets	$3,764	$5,146
Total assets	**$231,839**	**$207,000**
Liabilities and Shareholders' Equity:		
Current Liabilities:		
Accounts payable	$30,196	$22,367
Accrued expenses	$18,453	$13,856
Other current liabilities	$14,799	$7,435
Total current liabilities	**$63,448**	**$43,658**
Long-term debt	$28,987	$16,960
Other non-current liabilities	$27,857	$22,833
Total liabilities	**$120,292**	**$83,451**
Shareholders' equity:		
Common stock and additional paid-in capital	$23,313	$19,764
Retained earnings	$87,152	$104,256
Accumulated other comprehensive income/(loss)	$1,082	-$471
Total shareholders' equity	**$111,547**	**$123,549**
Total liabilities and shareholders' equity	**$231,839**	**$207,000**

[latexpage]

Apple's current ratio:

$$\frac{\$68.5 Billion}{\$63.4 Billion} = 1.08 > 1 \tag{11.1}$$

Now, let's look quickly at something that is not part of the ratio; look down one line on the balance sheet to long-term marketable securities and see that Apple owns $130.2 billion. While they are long term and so not part of the current ratio, these securities are still easily convertible to cash. So Apple has far more cushion than the current ratio reflects, even though it reflected a healthy financial position already.

Debt Ratios

Apple's debt to equity ratio:

$$\frac{\$120.3 Billion}{\$111.5 Billion} = 1.08 \tag{11.2}$$

A key debt ratio, which tells us how the company is financed, is the **debt-to-equity ratio**, which calculates the relationship between funds acquired from creditors (**debt**) and funds invested by owners (**equity**). For this ratio calculation, we use Apple's *total liabilities*, not just the line on the balance sheet that says long-term debt, because in effect, Apple is borrowing from those who it owes but has not yet paid. Apple's total liabilities at the end of its 2014 fiscal year were $120.3 billion versus owner's equity of $111.5 billion, a ratio of 1.08, which means Apple has borrowed more than it has invested in the business.

To some investors, that high level of debt might seem alarming. But remember that Apple has $130.2 billion invested in marketable securities. If it wished to do so, Apple could sell some of those securities and pay down its debts, thus improving its ratio. It's likely that anyone thinking about lending money to Apple and seeing these figures would be confident that Apple has the ability to pay back what they borrow.

Efficiency and Effectiveness Ratios

There are many more ratios which we could apply to Apple to more completely understand its performance. Yet going deeper into ratios would be beyond the scope of an introductory business course. If you continue your study of business, you will get ample exposure to these ratios in your accounting and finance courses. So we'll leave the rest for another day.

Key Takeaways

1. **Accounting** is the process of measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other decision makers
2. **Managerial accounting** deals with information produced for internal users, while **financial accounting** deals with external reporting.
3. The **income statement** captures sales and expenses over a period of time and shows how much a firm made or lost in that period.
4. The **balance sheet** reflects the financial position of a firm at a given point in time, including its assets, liabilities, and owner's equity. It is based on the following equation: assets – liabilities = owner's equity.
5. **Breakeven analysis** is a technique used to determine the level of sales needed to break even—to operate at a sales level at which you have neither profit nor loss.
6. **Ratio analysis** is used to assess a company's performance and financial condition over time and to compare one company to similar companies or to an overall industry.
7. Categories of ratios include: **profitability ratios**, **liquidity ratios**, **debt ratios**, and **efficiency and effectiveness ratios**.

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