INTRODUCTION TO BUSINESS



Gifford
HACC Central Pennsylvania's Community College

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Introduction to Business

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This text was compiled on 09/12/2026

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1.1: Prelude - Why Is Apple Successful?

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

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

Figure 2.1: Steve Jobs

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

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

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

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1.2: 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.

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1.3: New Page

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.

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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 1.3.1). 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 1.3.1: Business Stakeholders

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1.4: New Page

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.

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1.6: New Page

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

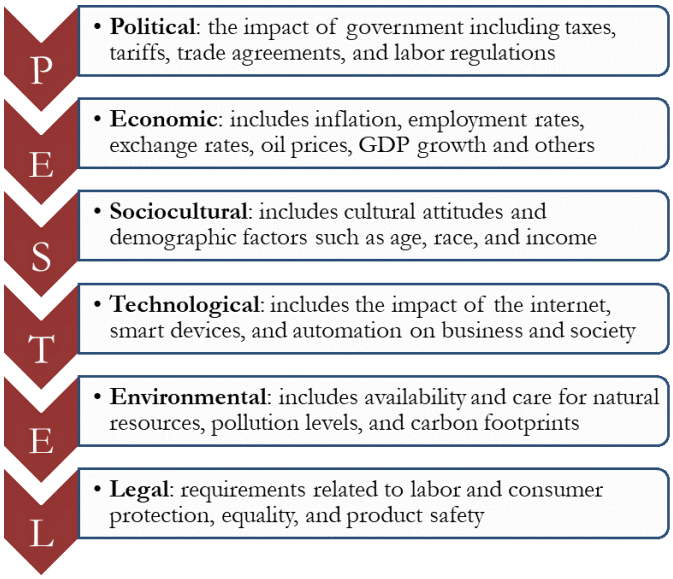


Figure 2.3: Business and its Environment – PESTEL

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

PESTEL Analysis

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

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

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

S indicates the sociocultural environment, which is a category that captures societal attitudes, trends in national

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

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

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

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

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

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

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1.7: New Page

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

After reading this chapter, you should be able to answer these questions:

1. What philosophies and concepts shape personal ethical standards?
2. How can organizations encourage ethical business behavior?
3. What is corporate social responsibility?
4. How do businesses meet their social responsibilities to various stakeholders?
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2.1: Introduction



Exhibit 2.1:

EXPLORING BUSINESS CAREERS

Playing with a Purpose at Hasbro

Hasbro is a global play and entertainment company that takes corporate social responsibility (CSR) very seriously. Founded nearly a century ago in Rhode Island, Hasbro integrates its CSR efforts throughout the organization with the goal of helping to make the world a better place for children of all ages.

In 2017, the company achieved the number one spot in the "100 Best Corporate Citizens" rankings, published annually by *Corporate Responsibility* magazine. Hasbro is no stranger to this achievement; over the past five years, Hasbro has consistently been in the top five spots on this prestigious list—and that is no accident.

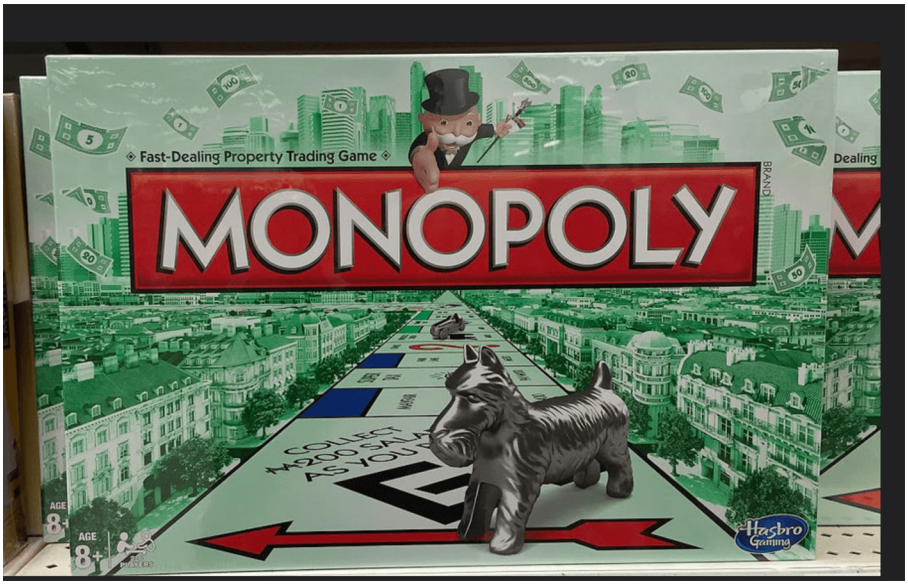


Exhibit 2.2: Hasbro's Monopoly game (Credit: Ben Tsai/ Flickr/ Public Domain)

With more than 5,000 employees, Hasbro relies heavily on its strategic brand blueprint to guide its efforts in CSR, innovation, philanthropy, and product development. With a business portfolio that includes such well-known brands as Nerf, Play-Doh, Transformers, Monopoly, and The Game of Life, the company focuses its CSR efforts on four key areas: product safety, environmental sustainability, human rights and ethical sourcing, and community.

According to the company, product safety is its highest priority. Hasbro uses a five-step quality assurance process that starts with design and then moves to engineering, manufacturing, and packaging. Another key part of product safety at Hasbro is incorporating continuous feedback from both consumers and retailers and insisting that these high standards and quality processes apply to all third-party factories worldwide that manufacture its products.

Hasbro is also committed to finding new ways to reduce its environmental footprint. Over the past several years, the company has reduced energy consumption, cut greenhouse gas emissions, and reduced water consumption and waste production in its production facilities. In addition, Hasbro has totally eliminated the use of wire ties in all of its product packaging, saving more than *34,000* miles of wire ties—more than enough to wrap around the earth's circumference.

Human rights and ethical sourcing remains a key ingredient of Hasbro's CSR success. Treating people fairly is a core company value, as is working diligently to make great strides in diversity and inclusion at all levels of the organization. Company personnel work closely with third-party factories to ensure that the human rights of all workers in the Hasbroglobal supply chain are recognized and upheld.

Philanthropy, corporate giving, and employee volunteering are key components of the Hasbro community. Through its various charitable programs, Hasbro made close to $15 million in financial contributions and product donations in 2016, which reached close to an estimated 4 million children around the globe. Several years ago the company started an annual Global Day of Joy as a way of engaging its employees worldwide in community service. In a recent year, more than 93 percent of Hasbro's employees participated in service projects in more than 40 countries.

Hasbro is in the business of storytelling, and its CSR efforts tell the story of an ethical, responsible organization whose mission is to create the world's best play experiences. Its ability to be accountable for its actions and to help make the world a better place one experience at time continues to make it a highly successful company.

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Every day, managers and business owners make business decisions based on what they believe to be right and wrong. Through their actions, they demonstrate to their employees what is and is not acceptable behavior and shape the moral standard of the organization. As you will see in this module, personal and professional ethics are important cornerstones of an organization and shape its ultimate contributions to society in the form of corporate social responsibility. First, let's consider how individual business ethics are formed.

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2.2: Understanding Business Ethics

What philosophies and concepts shape personal ethical standards?

Ethics is a set of moral standards for judging whether something is right or wrong. The first step in understanding business ethics is learning to recognize an **ethical issue**. An ethical issue is a situation where someone must choose between a set of actions that may be ethical or unethical. For example, Martin Shkreli, former CEO of Turing Pharmaceuticals, raised the price of a drug used for newborns and HIV patients by more than 5000 percent, defending the price increase as a "great business decision."[1] Few people would call that ethical behavior. But consider the actions of the stranded, hungry people in New Orleans who lost everything in the aftermath of Hurricane Katrina. They broke into flooded stores, taking food and bottled water without paying for them. Was this unethical behavior? Or what about the small Texas plastics manufacturer that employed over 100 people and specialized in the Latin American market? The president was distraught because he knew the firm would be bankrupt by the end of the year if it didn't receive more contracts. He knew that he was losing business because he refused to pay bribes. Bribes were part of the culture in his major markets. Closing the firm would put many people out of work. Should he start paying bribes in order to stay in business? Would this be unethical? Let's look at the next section to obtain some guidance on recognizing unethical situations.

Recognizing Unethical Business Activities

Researchers from Brigham Young University tell us that all unethical business activities will fall into one of the following categories:

1. *Taking things that don't belong to you.* The unauthorized use of someone else's property or taking property under false pretenses is taking something that does not belong to you. Even the smallest offense, such as using the postage meter at your office for mailing personal letters or exaggerating your travel expenses, belongs in this category of ethical violations.
2. *Saying things you know are not true.* Often, when trying for a promotion and advancement, fellow employees discredit their coworkers. Falsely assigning blame or inaccurately reporting conversations is lying. Although "This is the way the game is played around here" is a common justification, saying things that are untrue is an ethical violation.
3. *Giving or allowing false impressions.* The salesperson who permits a potential customer to believe that cardboard boxes will hold the customer's tomatoes for long-distance shipping when the salesperson knows the boxes are not strong enough has given a false impression. A car dealer who fails to disclose that a car has been in an accident is misleading potential customers.
4. *Buying influence or engaging in a conflict of interest.* A conflict of interest occurs when the official responsibilities of an employee or government official are influenced by the potential for personal gain. Suppose a company awards a construction contract to a firm owned by the father of the state attorney general while the state attorney general's office is investigating that company. If this construction award has the potential to shape the outcome of the investigation, a conflict of interest has occurred.
5. *Hiding or divulging information.* Failing to disclose the results of medical studies that indicate your firm's new drug has significant side effects is the ethical violation of hiding information that the product could be harmful to purchasers. Taking your firm's product development or trade secrets to a new place of employment constitutes the ethical violation of divulging proprietary information.
6. *Taking unfair advantage.* Many current consumer protection laws were passed because so many businesses took unfair advantage of people who were not educated or were unable to discern the nuances of complex contracts. Credit disclosure requirements, truth-in-lending provisions, and new regulations on auto leasing all resulted because businesses misled consumers who could not easily follow the jargon of long, complex agreements.
7. *Committing improper personal behavior.* Although the ethical aspects of an employee's right to privacy are still debated, it has become increasingly clear that personal conduct outside the job can influence performance and company reputation. Thus, a company driver must abstain from substance abuse because of safety issues. Even the traditional company holiday party and summer picnic have come under scrutiny due to the possibility that employees at and following these events might harm others through alcohol-related accidents.
8. *Abusing power and mistreating individuals.* Suppose a manager sexually harasses an employee or subjects employees to humiliating corrections or reprimands in the presence of customers. In some cases, laws protect employees. Many situations, however, are simply interpersonal abuse that constitutes an ethical violation.
9. *Permitting organizational abuse.* Many U.S. firms with operations overseas, such as Apple, Nike, and Levi Strauss, have faced

issues of organizational abuse. The unfair treatment of workers in international operations appears in the form of child labor, demeaning wages, and excessive work hours. Although a business cannot change the culture of another country, it can perpetuate—or stop—abuse through its operations there.

10. *Violating rules.* Many organizations use rules and processes to maintain internal controls or respect the authority of managers. Although these rules may seem burdensome to employees trying to serve customers, a violation may be considered an unethical act.
11. *Condoning unethical actions.* What if you witnessed a fellow employee embezzling company funds by forging her signature on a check? Would you report the violation? A winking tolerance of others' unethical behavior is itself unethical.[2]

After recognizing that a situation is unethical, the next question is what do you do? The action that a person takes is partially based upon his or her ethical philosophy. The environment in which we live and work also plays a role in our behavior. This section describes personal philosophies and legal factors that influence the choices we make when confronting an ethical dilemma.

Justice—The Question of Fairness

Another factor influencing individual business ethics is **justice**, or what is fair according to prevailing standards of society. We all expect life to be reasonably fair. You expect your exams to be fair, the grading to be fair, and your wages to be fair, based on the type of work being done.

Today we take justice to mean an equitable distribution of the burdens and rewards that society has to offer. The distributive process varies from society to society. Those in a democratic society believe in the "equal pay for equal work" doctrine, in which individuals are rewarded based on the value the free market places on their services. Because the market places different values on different occupations, the rewards, such as wages, are not necessarily equal. Nevertheless, many regard the rewards as just. A politician who argued that a supermarket clerk should receive the same pay as a physician, for example, would not receive many votes from the American people. At the other extreme, communist theorists have argued that justice would be served by a society in which burdens and rewards were distributed to individuals according to their abilities and their needs, respectively.

Utilitarianism—Seeking the Best for the Majority

One of the philosophies that may influence choices between right and wrong is **utilitarianism**, which focuses on the consequences of an action taken by a person or organization. The notion that people should act so as to generate the greatest good for the greatest number is derived from utilitarianism. When an action affects the majority adversely, it is morally wrong. One problem with this philosophy is that it is nearly impossible to accurately determine how a decision will affect a large number of people.

Another problem is that utilitarianism always involves both winners and losers. If sales are slowing and a manager decides to fire five people rather than putting everyone on a 30-hour workweek, the 20 people who keep their full-time jobs are winners, but the other five are losers.

A final criticism of utilitarianism is that some "costs," although small relative to the potential good, are so negative that some segments of society find them unacceptable. What if scientists deliberately killed animals by breaking their backs to conduct spinal cord research that someday could lead to a cure for spinal cord injuries? To a number of people, the "costs" of killing these animals are simply too horrible for this type of research to continue.

Following Our Obligations and Duties

The philosophy that says people should meet their obligations and duties when analyzing an ethical dilemma is called **deontology**. This means that a person will follow his or her obligations to another individual or society because upholding one's duty is what is considered ethically correct. For instance, people who follow this philosophy will always keep their promises to a friend and will follow the law. They will produce very consistent decisions, because they will be based on the individual's set duties. Note that this theory is not necessarily concerned with the welfare of others. Say, for example, a technician for Orkin Pest Control has decided that it's his ethical duty (and is very practical) to always be on time to meetings with homeowners. Today he is running late. How is he supposed to drive? Is the technician supposed to speed, breaking his duty to society to uphold the law, or is he supposed to arrive at the client's home late, breaking his duty to be on time? This scenario of conflicting obligations does not lead us to a clear ethically correct resolution, nor does it protect the welfare of others from the technician's decision.

Individual Rights

In our society, individuals and groups have certain rights that exist under certain conditions regardless of any external circumstances. These rights serve as guides when making individual ethical decisions. The term *human rights* implies that certain rights—to life, to freedom, to the pursuit of happiness—are bestowed at birth and cannot be arbitrarily taken away. Denying the rights of an individual or group is considered to be unethical and illegal in most, though not all, parts of the world. Certain rights are guaranteed by the government and its laws, and these are considered *legal rights*. The U.S. Constitution and its amendments, as well as state and federal statutes, define the rights of American citizens. Those rights can be disregarded only in extreme circumstances, such as during wartime. Legal rights include the freedom of religion, speech, and assembly; protection from improper arrest and searches and seizures; and proper access to counsel, confrontation of witnesses, and cross-examination in criminal prosecutions. Also held to be fundamental is the right to privacy in many matters. Legal rights are to be applied without regard to race, color, creed, gender, or ability.

CONCEPT CHECK

1. How are individual business ethics formed?
2. What is utilitarianism?
3. How can you recognize unethical activities?

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2.3: How Organizations Influence Ethical Conduct

How can organizations encourage ethical business behavior?

People choose between right and wrong based on their personal code of ethics. They are also influenced by the ethical environment created by their employers. Consider the following headlines:

- Investment advisor Bernard Madoff was sentenced to 150 years in prison for swindling clients out of more than $65 billion.
- Former United Airlines CEO Jeff Smisek leaves the company after a federal investigation into whether United tried to influence officials at the Port Authority of New York.
- Renaud Laplanche, the founder of Lending Club, loses his job because of faulty practices and conflicts of interest at the online peer-to-peer lender.
- Wells Fargo CEO John Stumpf was fired after company employees opened more than 2 million fake accounts to meet aggressive sales targets.[3]

As these actual stories illustrate, poor business ethics can create a very negative image for a company, can be expensive for the firm and/or the executives involved, and can result in bankruptcy and jail time for the offenders. Organizations can reduce the potential for these types of liability claims by educating their employees about ethical standards, by leading through example, and through various informal and formal programs.

Leading by Example

Employees often follow the examples set by their managers. That is, leaders and managers establish patterns of behavior that determine what's acceptable and what's not within the organization. While Ben Cohen was president of Ben & Jerry'sice cream, he followed a policy that no one could earn a salary more than seven times that of the lowest-paid worker. He wanted all employees to feel that they were equal. At the time he resigned, company sales were $140 million, and the lowest-paid worker earned $19,000 per year. Ben Cohen's salary was $133,000, based on the "seven times" rule. A typical top executive of a $140 million company might have earned 10 times Cohen's salary. Ben Cohen's actions helped shape the ethical values of Ben & Jerry's.

Offering Ethics Training Programs

In addition to providing a system to resolve ethical dilemmas, organizations also provide formal training to develop an awareness of questionable business activities and practice appropriate responses. Many companies have some type of ethics training program. The ones that are most effective, like those created by Levi Strauss, American Express, and Campbell Soup Company, begin with techniques for solving ethical dilemmas such as those discussed earlier. Next, employees are presented with a series of situations and asked to come up with the "best" ethical solution. One of these ethical dilemmas is shown below. According to a recent survey by the Ethics Resource Center, more than 80 percent of U.S. companies provide some sort of ethics training for employees, which may include online activities, videos, and even games.[4]

An Ethical Dilemma Used for Employee Training

Bill Gannon was a middle manager of a large manufacturer of lighting fixtures in Newark, New Jersey. Bill had moved up the company ladder rather quickly and seemed destined for upper management in a few years. Bill's boss, Dana Johnson, had been pressuring him about the semiannual reviews concerning Robert Talbot, one of Bill's employees. Dana, it seemed, would not accept any negative comments on Robert's evaluation forms. Bill had found out that a previous manager who had given Robert a bad evaluation was no longer with the company. As Bill reviewed Robert's performance for the forthcoming evaluation period, he found many areas of subpar performance. Moreover, a major client had called recently complaining that Robert had filled a large order improperly and then had been rude to the client when she called to complain.

Discussion Questions

1. What ethical issues does the situation raise?
2. What courses of action could Bill take? Describe the ethics of each course.
3. Should Bill confront Dana? Dana's boss?
4. What would you do in this situation? What are the ethical implications?

Establishing a Formal Code of Ethics

Most large companies and thousands of smaller ones have created, printed, and distributed codes of ethics. In general, a **code of ethics** provides employees with the knowledge of what their firm expects in terms of their responsibilities and behavior toward fellow employees, customers, and suppliers. Some ethical codes offer a lengthy and detailed set of guidelines for employees. Others are not really codes at all but rather summary statements of goals, policies, and priorities. Some companies have their codes framed and hung on office walls, included as a key component of employee handbooks, and/or posted on their corporate websites.

Examples of company codes of ethics:

- Costco phx.corporate-ir.net/phoenix....-govhighlights
- Starbucks www.starbucks.com/about-us/c...and-compliance
- AT&T www.att.com/gen/investor-relations?pid=5595

Do codes of ethics make employees behave in a more ethical manner? Some people believe that they do. Others think that they are little more than public relations gimmicks. If senior management abides by the code of ethics and regularly emphasizes the code to employees, then it will likely have a positive influence on behavior.

The "100 Best Corporate Citizens" as ranked by *Corporate Responsibility* magazine are selected based on seven categories, including employee relations, human rights, corporate governance (including code of ethics), philanthropy and community support, financial performance, environment, and climate change.[5] The top corporate citizens in 2017 were:

1. Hasbro, Inc.
2. Intel Corp.
3. Microsoft Corp.
4. Altria Group, Inc.
5. Campbell Soup Company
6. Cisco Systems, Inc.
7. Accenture
8. Hormel Foods Corp.
9. Lockheed Martin Corp.
10. Ecolab, Inc.

CUSTOMER SATISFACTION AND QUALITY

Campbell's Adds CSR to Its Recipe

The Campbell Soup Company is no longer just about traditional cans of processed soup. Under the guidance of its management team, particularly its former CEO Denise Morrison (Morrison retired from Campbell's in July of 2018), Campbell's has undergone a transformation that includes a strong emphasis on organics and fresh food—and a large serving of corporate citizenship.

Named one of the Best Corporate Citizens by *Corporate Responsibility*magazine in 2017, Campbell's is working to make sustainability and transparency part of its business DNA, and this culture shift has had an important influence on the company's business strategies.

Morrison, who took over as CEO in 2011, is a firm believer in the company's central vision: real food that matters for life's moments. "We can make a profit and make a difference, and we are doing both through our business . . . in a way that's authentic, that's transparent, and that truly matters," she explains.

Under Morrison's watch, the company recently acquired several fresh food and organic companies, including Bolthouse Farms, one of the largest suppliers of fresh carrots in the United States, and Garden Fresh Gourmet, which produces a top line of fresh salsa and hummus. Tracking the strong change in consumer preference for healthier food, Campbell's also recently acquired Plum Organics, a line of organic baby food products, which should help solidify the company's reputation for fresh ingredients with millennials and their families.

The company's transformation from a processed food giant to a major competitor in the fresh food business has also had a positive influence on the company's bottom line. Campbell's shareholders have to be pleased with the 20 percent increase in the company's stock price over the past two years, as the markets, competitors, and consumers take notice of the company's strong commitment to sustainability.

Inherent in the company's reinvention is the strong emphasis on corporate citizenship—doing good and giving back seem to be top priorities for Campbell's. In addition to acquiring sustainable and fresh food companies, Campbell's has also made a conscious decision to support the communities where their employees live and work. For example, the company launched a healthy communities initiative in Camden, New Jersey, where Campbell's is headquartered—an urban city that has seen its share of economic and social challenges in the past. In partnership with several local organizations, this initiative has helped fund community gardens, food pantries, nutrition education, and cooking classes that help build healthy communities. The Camden experience has been so successful that the company has expanded the program to other cities where it operates, including Detroit, Michigan, and Norwalk, Connecticut.

The company's ongoing commitment to fresh food, community involvement, and corporate social responsibility has helped change the narrative when it comes to being a sustainable and ethical organization.

Questions for Discussion

1. How does Campbell Soup Company's recent business acquisitions help support its CSR strategies?
2. Provide examples of how the company's transformation from a processed food giant to a purveyor of fresh ingredients can help attract a new group of customers.

Sources: "Corporate Responsibility and Sustainability Are Good for Business," https://www.campbellsoupcompany.com, accessed June 27, 2017; "Campbell Soup Wants to Make You a Personal Eating Plan (video)," *Fortune,* http://fortune.com, May 2, 2017; Don Seiffert, "Campbell Soup CEO Makes 3 Predictions about the Future of Food," *Boston Business Journal,* http://www.bizjournals.com, April 13, 2017; Aaron Hurst, "How Denise Morrison Took Processed Food Icon Campbell's on a Fresh Food Buying Spree," *Fast Company,* https://www.fastcompany.com, March 2, 2017; Abigail Stevenson, "Campbell Soup CEO: Stunning Disruption in the Ecosystem of Food," *CNBC,* http://www.cnbc.com, July 21, 2016.

Making the Right Decision

In many situations, there may be no simple right or wrong answers. Yet there are several questions you can ask yourself, and a couple of self-tests you can do, to help you make the right ethical decision. First, ask yourself, "Are there any legal restrictions or violations that will result from the action?" If so, take a different course of action. If not, ask yourself, "Does it violate my company's code of ethics?" If so, again find a different path to follow. Third, ask, "Does this meet the guidelines of my own ethical philosophy?" If the answer is "yes," then your decision must still pass two important tests.

The Feelings Test

You must now ask, "How does it make me feel?" This enables you to examine your comfort level with a particular decision. Many people find that, after reaching a decision on an issue, they still experience discomfort that may manifest itself in a loss of sleep or appetite. Those feelings of conscience can serve as a future guide in resolving ethical dilemmas.

The Newspaper or Social Media Test

The final test involves the front page of the newspaper or social media posts. The question to be asked is how an objective reporter would describe your decision in a front-page newspaper story, an online media site, or a social media platform such as Twitter or Facebook. Some managers rephrase the test for their employees: How will the headline read if I make this decision, or what will be the reaction of my social media followers? This test is helpful in spotting and resolving potential conflicts of interest.

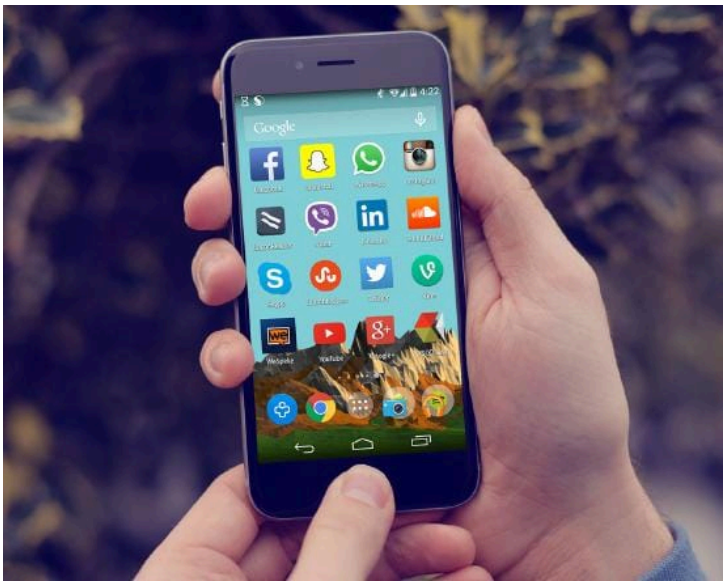


Exhibit 2.3: Making an ethical decision might come down to how you feel about the decision or to the newspaper or social media post test. The question to ask yourself is how the decision would make you feel if an objective reporter described the decision on the front page of a newspaper or via a social media post on Twitter or Facebook—all of which would be viewed by many, many people. Speaking of social media, it plays a pivotal role in ethical decision-making today, when people use the medium to share critical comments about friends as well as employers, business colleagues, and competitors. *Should companies view employees' social media pages on a regular basis, or is that information off-limits to employers?* (Credit: Mike MacKenzie/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

CONCEPT CHECK

1. What is the role of top management in organizational ethics?
2. What is a code of ethics?

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2.4: Managing a Socially Responsible Business

What is corporate social responsibility?

Acting in an ethical manner is one of the four components of the pyramid of **corporate social responsibility (CSR),** which is the concern of businesses for the welfare of society as a whole. It consists of obligations beyond those required by law or union contract. This definition makes two important points. First, CSR is voluntary. Beneficial action required by law, such as cleaning up factories that are polluting air and water, is not voluntary. Second, the obligations of corporate social responsibility are broad. They extend beyond investors in the company to include workers, suppliers, consumers, communities, and society at large.

Exhibit 2.4 portrays economic responsibility as the foundation for the other three responsibilities. At the same time that a business pursues profits (economic responsibility), however, it is expected to obey the law (legal responsibility); to do what is right, just, and fair (ethical responsibility); and to be a good corporate citizen (philanthropic responsibility). These four components are distinct but together constitute the whole. Still, if the company doesn't make a profit, then the other three responsibilities won't matter.

Many companies continue to work hard to make the world a better place to live. Recent data suggests that Fortune 500 companies spend more than $15 billion annually on CSR activities. Consider the following examples:

- Starbucks has donated more than one million meals to local communities via its FoodShare program and alliance with Feeding America, giving 100 percent of leftover food from their seven thousand U.S. company-owned stores.
- Salesforce encourages its employees to volunteer in community activities and pays them for doing so, up to 56 paid hours every year. For employees who participate in seven days of volunteerism in one year, Salesforce also gives them a $1,000 grant to donate to the employee's nonprofit of choice.
- Employees who work for Deloitte, a global audit, consulting, and financial services organization, can get paid for up to 48 hours of volunteer work each year. In a recent year, more than 27,000 Deloitte professionals contributed more than 353,000 volunteer hours to their communities around the world.[6]

Understanding Social Responsibility

Peter Drucker, the late globally respected management expert, said that we should look first at what an organization does *to* society and second at what it can do *for*society. This idea suggests that social responsibility has two basic dimensions: legality and responsibility.

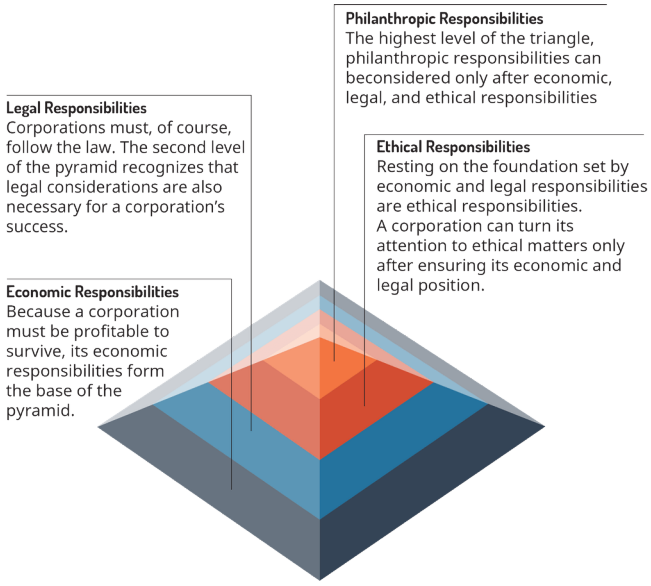


Exhibit 2.4: The Pyramid of Corporate Social Responsibility (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Illegal and Irresponsible Behavior

The idea of corporate social responsibility is so widespread today that it is hard to conceive of a company continually acting in illegal and irresponsible ways. Nevertheless, such actions do sometimes occur, which can create financial ruin for organizations, extreme financial hardships for many former employees, and general struggles for the communities in which they operate. Unfortunately, top executives still walk away with millions. Some, however, will ultimately pay large fines and spend time in prison for their actions. Federal, state, and local laws determine whether an activity is legal or not. The laws that regulate business are discussed later in this module.

Irresponsible but Legal Behavior

Sometimes companies act irresponsibly, yet their actions are legal. For example, the Minnesota-based company that makes MyPillow was recently fined $1 million by the state of California for making unsubstantiated claims that the "most comfortable pillow you'll ever own" could help alleviate medical conditions such as snoring, fibromyalgia, migraines, and other disorders. The company's CEO countered that the claims were actually made by customers; these testimonials were posted on the company's website but later removed. In addition to the fine, the company faced several class-action lawsuits, and the Better Business Bureau has revoked MyPillow's accreditation.[7]

CATCHING THE ENTREPRENEURIAL SPIRIT

Badger Company Founder Walks the Walk

As a carpenter, Bill Whyte was always looking for a solution to his dry, cracked hands, especially in the harsh New Hampshire winters. After trying many commercial lotions that didn't really work, Whyte experimented with olive oil and beeswax to come up with a soothing balm to help heal rough hands. Mixing up the concoction at home, Whyte came up with a product that seemed to work and was made from natural ingredients.

Originally called Bear Paw, the lotion became known as Badger Balm after a friend found a competing product already named Bear Paw. Whyte set up a production line at home to fill the tins. Soon he was pounding the pavement in the town of Gilsum, trying to sell the new product to hardware stores, lumber yards, and health food stores.

Fast-forward a little more than 20 years from his early days of experimentation, and Whyte (affectionately known as the "head badger") runs W.S. Badger Company with the same goals and passions he started with back in the mid-1990s. The company uses only organic plant extracts, exotic oils, beeswax, and minerals to make the most effective products to soothe, heal, and protect the body. And the natural ingredients come from all over the world—for example, organic extra virgin olive oil from Spain, organic rose essential oil from Bulgaria, and bergamot oil from southern Italy.

Badger's homey culture is no accident. In fact, in the early days, Whyte made soup every Friday for the small staff. Today, Whyte and family members, including his wife Kathy, chief operating officer; daughter Rebecca, head of sustainability and innovation; and daughter Emily, head of sales and marketing, all embrace the ethical and social principles of this family business that have made the company a success.

To reinforce the commitment of being socially responsible and demonstrating transparency, W.S. Badger Company became a Certified Benefit Corporation, or B Corp for short. This certification requires companies to meet rigorous standards for transparency, accountability, and social and environmental performance. (Benefit Corporations are discussed in more detail later in this module.)

Becoming a B Corp. has helped the company organize how it operates. For example, pay for the highest-paid full-time employee is capped at five times that of the lowest paid, which is now $15 an hour (more than double New Hampshire's minimum wage); a portion of company profits flows to employees via profit sharing, and all employees participate in a bonus plan; and new parents are encouraged to bring their babies to work, a program that has helped foster a new style of teamwork for the entire organization, as well as increase employee morale. In addition, Badger donates 10 percent of its pre-tax profits annually to nonprofit organizations that focus on the health and welfare of children, matches employee contributions to charitable causes (up to $100 per employee), and donates an additional $50 to a nonprofit chosen by each employee on their birthday.

Badger staff, which now number more than 100, enjoy a living wage, great benefits, and a socially responsible work environment

thanks to a visionary who found an eco-friendly way to soothe his rough hands and created an ethical business as part of his journey.

Questions for Discussion

1. How does Badger's approach to social responsibility help attract and retain employees?
2. Does the company's certification as a Benefit Corporation provide Badger with a competitive advantage? Explain your reasoning.

Sources: "Badger's History & Legend," "Babies at Work Policy," and "2016 Annual Impact Report," www.badgerbalm.com, accessed June 27, 2017; "About Badger," https://www.bcorporation.net, accessed June 27, 2017; "Badger 'Still In' on Climate Action, Asks New Hampshire Businesses, State Officials, and Local Leaders to Join Forces in Honoring Paris Agreement," http://www.prweb.com, June 22, 2017; Amy Feldman, "Badger Balm Creator Once Dismissed Being a B Corp as 'Just Marketing.' Now He's a True Believer," *Forbes,* http://www.forbes.com, May 9, 2017.

Legal and Responsible Behavior

The vast majority of business activities fall into the category of behavior that is both legal and responsible. Most companies act legally, and most try to be socially responsible. Research shows that consumers, especially those under 30, are likely to buy brands that have excellent ethical track records and community involvement. Outdoor specialty retailer REI, for example, recently announced that it gave back nearly 70 percent of its profits to the outdoor community. A member cooperative, the company invested a record $9.3 million in its nonprofit partners in 2016.[8]

CONCEPT CHECK

1. What are the four components of social responsibility?
2. Give an example of legal but irresponsible behavior.

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2.5: Responsibilities to Stakeholders

How do businesses meet their social responsibilities to various stakeholders?

What makes a company be admired or perceived as socially responsible? Such a company meets its obligations to its stakeholders. **Stakeholders** are the individuals or groups to whom a business has a responsibility. The stakeholders of a business are its employees, its customers, the general public, and its investors.

Responsibility to Employees

An organization's first responsibility is to provide a job to employees. Keeping people employed and letting them have time to enjoy the fruits of their labor is the finest thing business can do for society. Beyond this fundamental responsibility, employers must provide a clean, safe working environment that is free from all forms of discrimination. Companies should also strive to provide job security whenever possible.

Enlightened firms are also empowering employees to make decisions on their own and suggest solutions to company problems. Empowerment contributes to an employee's self-worth, which, in turn, increases productivity and reduces absenteeism.

Each year, in collaboration with Great Place to Work®, *Fortune* conducts an extensive employee survey of the best places to work in the United States. For 2017, the top companies included Google, Wegmans Food Markets, Edward Jones, Genentech, Salesforce, Acuity, and Quicken Loans. Some companies offer unusual benefits to their employees. For example, biotech company Genentech offers employee compensation for taking alternative methods of transportation to work at its South San Francisco campus. Employees can earn $12 per day for walking or biking to work, and those who drive a carpool or vanpool can earn $8 and $16, respectively. In addition, the company offers free commuter bus service for all employees via 27 routes around the Bay Area.[9]

Responsibility to Customers

To be successful in today's business environment, a company must satisfy its customers. A firm must deliver what it promises, as well as be honest and forthright in everyday interactions with customers, suppliers, and others. Recent research suggests that many consumers, particularly millennials, prefer to do business with companies and brands that communicate socially responsible messages, utilize sustainable manufacturing processes, and practice ethical business standards.[10]

Responsibility to Society

A business must also be responsible to society. A business provides a community with jobs, goods, and services. It also pays taxes that go to support schools, hospitals, and better roads. Some companies have taken an additional step to demonstrate their commitment to stakeholders and society as a whole by becoming Certified Benefit Corporations, or B Corps for short. Verified by B Lab, a global nonprofit organization, B Corps meet the highest standards of social and environmental performance, public transparency, and legal accountability and strive to use the power of business to solve social and environmental problems via an impact assessment that rates each company on a possible score of 200 points. To become certified as a Benefit Corporation, companies need to reach a score of at least 80 and must be recertified every two years. There are more than 2,000 companies worldwide that have been certified as B Corps, including Method, W.S. Badger Company, Fishpeople Seafood, LEAP Organics, New Belgium Brewing Company, Ben & Jerry's, Cabot Creamery Co-op, Comet Skateboards, Etsy, Patagonia, Plum Organics, and Warby Parker.[11]

Environmental Protection

Business is also responsible for protecting and improving the world's fragile environment. The world's forests are being destroyed

fast. Every second, an area the size of a football field is laid bare. Plant and animal species are becoming extinct at the rate of 17 per hour. A continent-size hole is opening up in the earth's protective ozone shield. Each year we throw out 80 percent more refuse than we did in 1960; as a result, more than half of the nation's landfills are filled to capacity.

To slow the erosion of the world's natural resources, many companies have become more environmentally responsible. For example, Toyota now uses renewable energy sources such as solar, wind, geothermal, and water power for electricity to run its facilities. When its new $1 billion North American headquarters opened in Plano, Texas, in May 2017, Toyota said the 2.1 million square-foot campus would eventually be powered by 100% clean energy, helping the auto giant move closer to its goal of eliminating carbon emissions in all of its operations.[12]

ETHICS IN PRACTICE

This Fish Story Has a Tasting Ending

Duncan Berry has always been an environmentalist at heart. Brought up on the Oregon coast, he was a sea captain at an early age, spending nearly two decades on the ocean before going on to become a successful entrepreneur in the organic cotton industry. After selling the textile business at the age of 50, he retired back to the Oregon coast to work on a state initiative to preserve marine habitats.

He quickly discovered that the state's commercial fishing industry had gone into major disrepair since his seafaring adventure years earlier. Berry learned the majority of seafood consumed in the United States was being imported from other countries and more than 90 percent of U.S. seafood was being exported. In addition, great harm was being done to the ocean because it was being overfished.

Although several groups were already working to improve the commercial fishing industry, he observed that one key group was not part of the discussion: consumers. Berry decided a key component of change had to be involving consumers in the process. He spent more than a year meeting with everyone involved in the Oregon fishing industry—from fishermen to processors, distributors, truck drivers, chefs, and consumers—to gain perspective on why the industry was failing. His "aha" moment occurred when he realized the majority of fish is consumed in restaurants because consumers think preparing fish at home is too difficult and time-consuming. That's when he co-founded Fishpeople Seafood.

Started in 2012, Fishpeople has a mission of changing the way people think about seafood by being transparent about where the seafood comes from, how it is processed, and how it is handled. Berry believes the company's transparency helps consumers understand how the process translates into sustainable food that tastes good and is good for you. The company makes shelf-stable, ready-to-eat restaurant-quality seafood in the form of soups, meal kits, and fresh and frozen filets, complete with farm-to-table ingredients. On every package there is a code consumers can enter at the company's website that will tell them everything about the seafood's origin, down to the fisherman who caught it. Fishpeople also operates a processing plant in Toledo, Oregon, where workers are paid a livable wage and receive health insurance—benefits typically unheard of in the fishing industry.

Fishpeople's products are available in more than 5,000 stores nationwide, including Walmart, Whole Foods, Costco, Kroger, and other grocery stores and markets. Recently the company announced a merger with Ilwaco Landing Fishermen, which will help further the two groups' shared vision of supporting local fishermen and providing sustainable seafood to consumers.

Questions for Discussion

1. How does Fishpeople's transparency contribute to the company's success?
2. What responsibility, if any, does Fishpeople have to the local fishing industry?

Sources: Company website, https://fishpeopleseafood.com, accessed June 27, 2017; J. David Santen, Jr., "Adding Value to Oregon Seafood," *Built Oregon,* http://builtoregon.com, accessed June 27, 2017; Elizabeth Crawford, "Fishpeople Wants to Fix the 'Fundamentally Broken' Seafood Industry with Increased Transparency," *Food Navigator,*http://www.foodnavigator-usa.com, May 25, 2017; Fishpeople Seafood Announces Merger with Ilwaco Landing Fishermen," *Tillamook County Pioneer*, https://www.tillamookcountypioneer.net, May 22, 2017; Leigh Buchanan, "Why This Entrepreneur Ditched Fashion for the 'Hunting and Gathering' Business," *Inc.,* https://www.inc.com, April 2017 issue; Kate Harrison, "This Former Green Textile Maven Is Making Microwaved Seafood Sustainable," *Forbes,* http://www.forbes.com, August 25, 2015.

Corporate Philanthropy

Companies also display their social responsibility through corporate philanthropy. **Corporate philanthropy** includes cash contributions, donations of equipment and products, and support for the volunteer efforts of company employees. Recent statistics suggest U.S. corporate philanthropy exceeds more than $19 billion annually.[13] American Express is a major supporter of the American Red Cross. The organization relies almost entirely on charitable gifts to carry out its programs and services, which include disaster relief, armed-forces emergency relief, blood and tissue services, and health and safety services. The funds provided by American Express have enabled the Red Cross to deliver humanitarian relief to victims of numerous disasters around the world.[14] When Hurricane Katrina hit the Gulf Coast, Bayer sent 45,000 diabetes blood glucose monitors to the relief effort. Within weeks of the disaster, Abbott, Alcoa, Dell, Disney, Intel, UPS, Walgreens, Walmart, and others contributed more than $550 million for disaster relief.[15]



Exhibit 2.5: Hybrid cars and all-electric vehicles such as Tesla models are turning heads and changing the way the world drives. Electric vehicles are more eco-friendly, but they are also more expensive to own. Analysts project that after charging, insurance, and maintenance costs, electric cars cost thousands of dollars more than conventional vehicles. *Do the environmental benefits associated with electric cars justify the higher cost of ownership?* (Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Responsibilities to Investors

Companies' relationships with investors also entail social responsibility. Although a company's economic responsibility to make a profit might seem to be its main obligation to its shareholders, some investors increasingly are putting more emphasis on other aspects of social responsibility.

Some investors are limiting their investments to securities (e.g., stocks and bonds) that coincide with their beliefs about ethical and social responsibility. This is called **social investing**. For example, a social investment fund might eliminate from consideration the securities of all companies that make tobacco products or liquor, manufacture weapons, or have a history of being environmentally irresponsible. Not all social investment strategies are alike. Some ethical mutual funds will not invest in government securities because they help to fund the military; others freely buy government securities, with managers noting that federal funds also support the arts and pay for AIDS research. Today, assets invested using socially responsible strategies total more than $7 trillion.[16]

Perhaps partly as the result of the global recession of 2007–2009, over the last several years companies have tried to meet responsibilities to their investors as well as to their other stakeholders. Recent research suggests that now more than ever, CEOs are being held to higher standards by boards of directors, investors, governments, media, and even employees when it comes to corporate accountability and ethical behavior. A recent global study by PwC reveals that over the last several years, there has been a large increase in the number of CEOs being forced out due to some sort of ethical lapse in their organizations. Strategies to prevent such missteps should include establishing a culture of integrity to prevent anyone from breaking the rules, making sure company goals and metrics do not create undue pressure on employees to cut corners, and implementing effective processes

and controls to minimize the opportunity for unethical behavior.[17]

CONCEPT CHECK

1. How do businesses carry out their social responsibilities to consumers?
2. What is corporate philanthropy?
3. Is a company's only responsibility to its investors to make a profit? Why or why not?

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2.6: Trends in Ethics and Corporate Social Responsibility

What are the trends in ethics and corporate social responsibility?

Three important trends related to ethics and corporate social responsibility are strategic changes in corporate philanthropy, a new social contract between employers and employees, and the growth of global ethics and corporate social responsibility.

Changes in Corporate Philanthropy

Historically, corporate philanthropy has typically involved companies seeking out charitable groups and giving them money or donating company products or services. Today, the focus has shifted to **strategic giving**, which ties philanthropy and corporate social responsibility efforts closely to a company's mission or goals and targets donations to the communities where a company does business. Some of the top businesses recognized for their efforts in giving back to the communities in which they operate include technology giant Salesforce, San Antonio's NuStar Energy, insurance and financial services firm Veterans United, and software leader Intuit.[18]

A Social Contract between Employer and Employee

Another trend in social responsibility is the effort by organizations to redefine their relationship with their employees. Many people have viewed social responsibility as a one-way street that focuses on the obligations of business to society, employees, and others. Now, companies recognize that the social contract between employer and employee is an important aspect of the workplace and that both groups have to be committed to working together in order for the organization to prosper. The social contract can be defined in terms of four important aspects: compensation, management, culture, and learning and development.[19]

When it comes to compensation, companies today must recognize that most employees do not stay with one organization for decades. Thus, companies need to change their compensation structure to acknowledge the importance of short-term performance and to update their methods for determining compensation, including benefits and other nontraditional perks such as increased paid leave and telecommuting options.

In the current workplace environment, where employees are likely to jump to new jobs every couple years, managers need to take a more active and engaged approach to supervising employees and perhaps change the way they think about loyalty, which may be difficult for managers used to supervising the same group of employees for a long period of time. Engaging employees on a regular basis, setting realistic expectations, and identifying specific development paths may help retain key employees.

Thanks to today's tight labor market, some employees feel empowered to demand more from their employer and its overall culture via strategies such as increased flexibility, transparency, and fairness. This increased importance of the employee's role in the company's culture helps workers stay engaged in the mission of the organization and perhaps makes them less likely to look elsewhere for employment.

Finally, rapidly changing technology used in today's workplace continues to shift the learning and development component of the employer-employee contract, causing immense challenges to both companies and workers. It may be more difficult to identify the employee skills that will be critical over the next several years, causing employers either to increase training of current workers or to look outside the organization for other individuals who already possess the technical skills needed to get the job done.

Global Ethics and Social Responsibility

When U.S. businesses expand into global markets, they must take their codes of ethics and policies on corporate social responsibility with them. As a citizen of several countries, a multinational corporation has several responsibilities. These include respecting local practices and customs, ensuring that there is harmony between the organization's staff and the host population, providing management leadership, and developing a solid group of local managers who will be a credit to their community. When a multinational firm makes an investment in a foreign country, it should commit to a long-term relationship. That means involving all stakeholders in the host country in decision-making. Finally, a responsible multinational will implement ethical guidelines

within the organization in the host country. By fulfilling these responsibilities, the company will foster respect for both local and international laws.

Multinational corporations often must balance conflicting interests of stakeholders when making decisions regarding social responsibilities, especially in the area of human rights. Questions involving child labor, forced labor, minimum wages, and workplace safety can be particularly difficult. Recently Gap, Inc. decided to publish the list of its global factories in an effort to provide transparency about its suppliers and the efforts the company continues to make to improve working conditions around the world. The company has partnered with Verité, a nongovernmental organization focused on ensuring that people work under safe, fair, and legal conditions. By soliciting feedback from factory workers making its products, Gap is hoping to improve working conditions and help these factories become leaders in their local communities.[20]

CONCEPT CHECK

1. Describe strategic giving.
2. What role do employees have in improving their job security?
3. How do multinational corporations demonstrate social responsibility in a foreign country?

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3: ECONOMICS

3.1: Understanding the Business Environment
3.2: How Business and Economics Work
3.3: Macroeconomics- The Big Picture
3.4: Achieving Macroeconomic Goals
3.5: Microeconomics- Zeroing in on Businesses and Consumers
3.6: Competing in a Free Market
3.7: Trends in the Business Environment and Competition

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3.1: Understanding the Business Environment

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

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

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

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

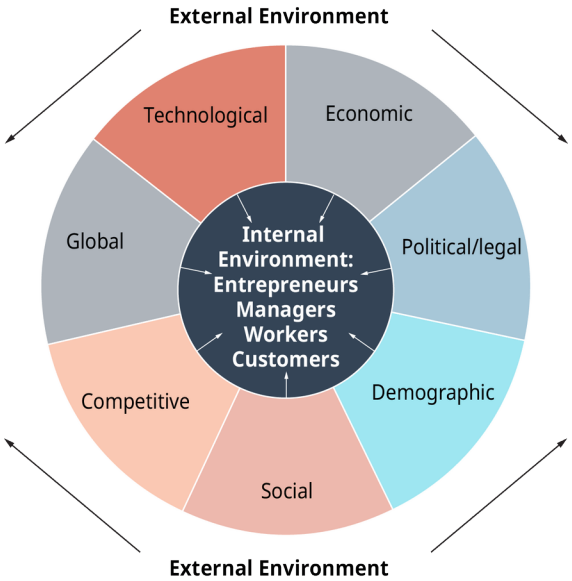


Exhibit 1.4: The Dynamic Business Environment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

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

influences.

Economic Influences

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

Political and Legal Influences

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

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

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

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

Demographic Factors

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

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

In addition, minorities represent more than 38 percent of the total population, with immigration bringing millions of new residents

to the country over the past several decades. By 2060 the U.S. Census Bureau projects the minority population to increase to 56 percent of the total U.S. population.[14] Companies recognize the value of hiring a diverse workforce that reflects our society. Minorities' buying power has increased significantly as well, and companies are developing products and marketing campaigns that target different ethnic groups.

Social Factors

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

MANAGING CHANGE

Balancing Comes Easy at H&R Block

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

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

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

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

Questions for Discussion

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

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

Technology

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

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

CONCEPT CHECK

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

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3.2: How Business and Economics Work

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

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

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

Global Economic Systems

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

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

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

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

Table 1.1: The Basic Economic Systems of the World

	Capitalism	Communism	Socialism	Mixed Economy
Ownership of Business	Businesses are privately owned with minimal government ownership or interference.	Government owns all or most enterprises.	Basic industries such as railroads and utilities are owned by government. Very high taxation as government redistributes income from successful private businesses and entrepreneurs.	Private ownership of land and businesses but government control of some enterprises. The private sector is typically large
Control of Markets	Complete freedom of trade. No or little government control.	Complete government control of markets.	Some markets are controlled, and some are free. Significant central-government planning. State enterprises are managed by bureaucrats. These enterprises are rarely profitable.	Some markets, such as nuclear energy and the post office, are controlled or highly regulated.

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

Capitalism

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

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

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



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

Communism

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

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

Socialism

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

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

Mixed Economic Systems

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

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

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

Macroeconomics and Microeconomics

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

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

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

Economics as a Circular Flow

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

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

the flow.

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

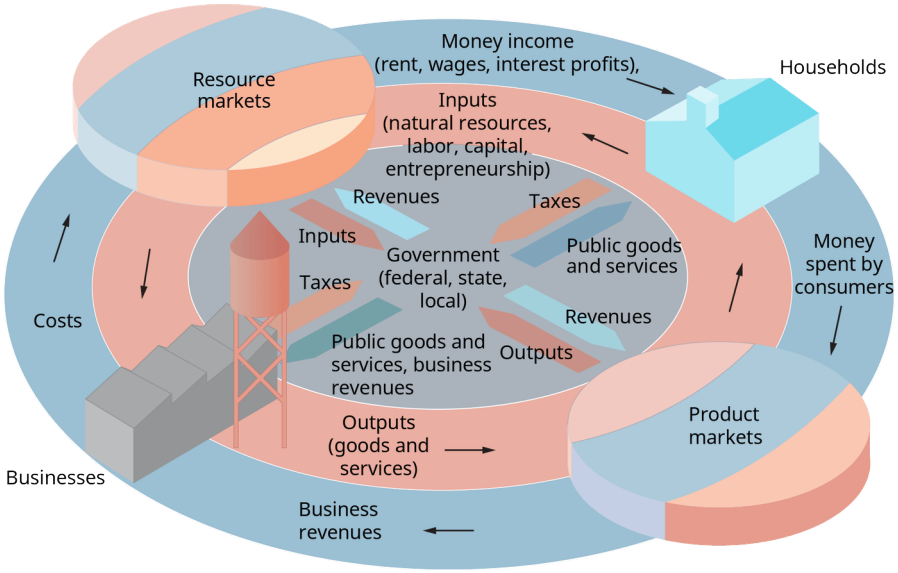


Exhibit 1.6: **Economics as a Circular Flow** (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK

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

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3.3: Macroeconomics- The Big Picture

How do economic growth, full employment, price stability, and inflation indicate a nation's economic health?

Have you ever looked at CNN's *Headline News* on a mobile device or turned on the radio and heard something like, "Today the Labor Department reported that for the second straight month unemployment declined"? Statements like this are macroeconomic news. Understanding the national economy and how changes in government policies affect households and businesses is a good place to begin our study of economics.

Let's look first at macroeconomic goals and how they can be met. The United States and most other countries have three main macroeconomic goals: economic growth, full employment, and price stability. A nation's economic well-being depends on carefully defining these goals and choosing the best economic policies for achieving them.

Striving for Economic Growth

Perhaps the most important way to judge a nation's economic health is to look at its production of goods and services. The more the nation produces, the higher its standard of living. An increase in a nation's output of goods and services is **economic growth**.

The most basic measure of economic growth is the **gross domestic product (GDP)**. GDP is the total market value of all final goods and services produced within a nation's borders each year. The Bureau of Labor Statistics publishes quarterly GDP figures that can be used to compare trends in national output. When GDP rises, the economy is growing.

The rate of growth in real GDP (GDP adjusted for inflation) is also important. Recently, the U.S. economy has been growing at a slow but steady rate of between 3 and 4 percent annually. This growth rate has meant a steady increase in the output of goods and services and relatively low unemployment. When the growth rate slides toward zero, the economy begins to stagnate and decline.

One country that continues to grow more rapidly than most is China, whose GDP has been growing at 6 to 7 percent per year. Today few things in the global marketplace are not or cannot be made in China. The primary contributor to China's rapid growth has been technology. For example, most tablets and laptops are manufactured in China.

The level of economic activity is constantly changing. These upward and downward changes are called **business cycles**. Business cycles vary in length, in how high or low the economy moves, and in how much the economy is affected. Changes in GDP trace the patterns as economic activity expands and contracts. An increase in business activity results in rising output, income, employment, and prices. Eventually, these all peak, and output, income, and employment decline. A decline in GDP that lasts for two consecutive quarters (each a three-month period) is called a **recession**. It is followed by a recovery period when economic activity once again increases. The most recent recession began in December 2007 and ended in June 2009.

Businesses must monitor and react to the changing phases of business cycles. When the economy is growing, companies often have a difficult time hiring good employees and finding scarce supplies and raw materials. When a recession hits, many firms find they have more capacity than the demand for their goods and services requires. During the most recent recession, many businesses operated at substantially lower than capacity. When plants use only part of their capacity, they operate inefficiently and have higher costs per unit produced. Let's say that Mars Corp. has a huge plant that can produce one million Milky Way candy bars a day, but because of a recession Mars can sell only half a million candy bars a day. The plant uses large, expensive machines. Producing Milky Ways at 50 percent capacity does not efficiently utilize Mars's investment in its plant and equipment.

Keeping People on the Job

Another macroeconomic goal is **full employment**, or having jobs for all who want to and can work. Full employment doesn't actually mean 100 percent employment. Some people choose not to work for personal reasons (attending school, raising children) or are temporarily unemployed while they wait to start a new job. Thus, the government defines full employment as the situation when about 94 to 96 percent of those available to work actually have jobs. During the 2007–2009 recession in the United States,

the unemployment rate peaked at 10 percent in October 2009. Today, that rate hovers at about 4 percent.[19]

Maintaining low unemployment levels is of concern not just to the United States but also to countries around the world. For example, high youth unemployment rates (for workers 25 years of age and younger) in Spain, Italy, and Greece continue to cause protests in these European countries as elected officials struggle with how to turn around their respective economies and put more people, particularly young people, back to work. The UK's impending exit from the European Union may also have an effect on unemployment rates, as global companies move jobs out of Britain to central European countries such as Poland.[20]

Measuring Unemployment

To determine how close we are to full employment, the government measures the **unemployment rate**. This rate indicates the percentage of the total labor force that is not working but is actively looking for work. It excludes "discouraged workers," those not seeking jobs because they think no one will hire them. Each month the U.S. Department of Labor releases statistics on employment. These figures help us understand how well the economy is doing.

Types of Unemployment

Economists classify unemployment into four types: frictional, structural, cyclical, and seasonal. The categories are of small consolation to someone who is unemployed, but they help economists understand the problem of unemployment in our economy.

- **Frictional unemployment** is short-term unemployment that is not related to the business cycle. It includes people who are unemployed while waiting to start a better job, those who are reentering the job market, and those entering for the first time, such as new college graduates. This type of unemployment is always present and has little impact on the economy.
- **Structural unemployment** is also unrelated to the business cycle but is involuntary. It is caused by a mismatch between available jobs and the skills of available workers in an industry or a region. For example, if the birthrate declines, fewer teachers will be needed. Or the available workers in an area may lack the skills that employers want. Retraining and skill-building programs are often required to reduce structural unemployment.
- **Cyclical unemployment**, as the name implies, occurs when a downturn in the business cycle reduces the demand for labor throughout the economy. In a long recession, cyclical unemployment is widespread, and even people with good job skills can't find jobs. The government can partly counteract cyclical unemployment with programs that boost the economy.

In the past, cyclical unemployment affected mainly less-skilled workers and those in heavy manufacturing. Typically, they would be rehired when economic growth increased. Since the 1990s, however, competition has forced many American companies to downsize so they can survive in the global marketplace. These job reductions affected workers in all categories, including middle management and other salaried positions. Firms continue to reevaluate workforce requirements and downsize to stay competitive to compete with Asian, European, and other U.S. firms. After a strong rebound from the global recession of 2007–2009, when the auto industry slashed more than 200,000 hourly and salaried workers from their payrolls, the automakers are now taking another close look at the size of their global workforces. For example, as sales steadily rose after the recession, Ford Motor Company's workforce in North America increased by 25 percent over the past five years. As car sales plateaued in 2017, the company recently announced it would cut approximately 10 percent of its global workforce in an effort to reduce costs, boost profits, and increase its stock value for shareholders.[21]

The last type is **seasonal unemployment**, which occurs during specific times of the year in certain industries. Employees subject to seasonal unemployment include retail workers hired for the holiday shopping season, lettuce pickers in California, and restaurant employees in ski country during the summer.

Keeping Prices Steady

The third macroeconomic goal is to keep overall prices for goods and services fairly steady. The situation in which the average of all prices of goods and services is rising is called **inflation**. Inflation's higher prices reduce **purchasing power**, the value of what money can buy. Purchasing power is a function of two things: inflation and income. If incomes rise at the same rate as inflation, there is no change in purchasing power. If prices go up but income doesn't rise or rises at a slower rate, a given amount of income buys less, and purchasing power falls. For example, if the price of a basket of groceries rises from $30 to $40 but your salary remains the same, you can buy only 75 percent as many groceries ($30 ÷ $40) for $30. Your purchasing power declines by 25 percent ($10 ÷ $40). If incomes rise at a rate faster than inflation, then purchasing power increases. So you can, in fact,

have rising purchasing power even if inflation is increasing. Typically, however, inflation rises faster than incomes, leading to a decrease in purchasing power.

Inflation affects both personal and business decisions. When prices are rising, people tend to spend more—before their purchasing power declines further. Businesses that expect inflation often increase their supplies, and people often speed up planned purchases of cars and major appliances.

From the early 2000s to April 2017, inflation in the United States was very low, in the 0.1 to 3.8 percent range; for 2016 it was 1.3 percent. For comparison, in the 1980s, the United States had periods of inflation in the 12 to 13 percent range.[22] Some nations have had high double- and even triple-digit inflation in recent years. As of early 2017, the monthly inflation rate in Venezuela was an astounding 741 percent, followed by the African country of South Sudan at 273 percent.[23]



Exhibit 1.7: Nespresso. Buyers of Nespresso coffee, KitKat chocolate bars, and Purina pet food are paying more for these items as global food giant Nestlé raises prices. Increasing input costs, such as costs of raw materials, have been hard on food businesses, raising the price of production, packaging, and transportation. *How might fluctuations in the producer price index (PPI) affect the consumer price index (CPI) and why?* (Credit: Kārlis Dambrāns/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Types of Inflation

There are two types of inflation. **Demand-pull inflation** occurs when the demand for goods and services is greater than the supply. Would-be buyers have more money to spend than the amount needed to buy available goods and services. Their demand, which exceeds the supply, tends to pull prices up. This situation is sometimes described as “too much money chasing too few goods.” The higher prices lead to greater supply, eventually creating a balance between demand and supply.

Cost-push inflation is triggered by increases in production costs, such as expenses for materials and wages. These increases push up the prices of final goods and services. Wage increases are a major cause of cost-push inflation, creating a “wage-price spiral.” For example, assume the United Auto Workers union negotiates a three-year labor agreement that raises wages 3 percent per year and increases overtime pay. Carmakers will then raise car prices to cover their higher labor costs. Also, the higher wages will give autoworkers more money to buy goods and services, and this increased demand may pull up other prices. Workers in other industries will demand higher wages to keep up with the increased prices, and the cycle will push prices even higher.

How Inflation Is Measured

The rate of inflation is most commonly measured by looking at changes in the **consumer price index (CPI)**, an index of the prices of a “market basket” of goods and services purchased by typical urban consumers. It is published monthly by the Department of Labor. Major components of the CPI, which are weighted by importance, are food and beverages, clothing, transportation, housing, medical care, recreation, and education. There are special indexes for food and energy. The Department of Labor collects about 80,000 retail price quotes and 5,000 housing rent figures to calculate the CPI.

The CPI sets prices in a base period at 100. The base period, which now is 1982–1984, is chosen for its price stability. Current prices are then expressed as a percentage of prices in the base period. A rise in the CPI means prices are increasing. For example, the CPI was 244.5 in April 2017, meaning that prices more than doubled since the 1982–1984 base period.

Changes in wholesale prices are another important indicator of inflation. The **producer price index (PPI)** measures the prices paid by producers and wholesalers for various commodities, such as raw materials, partially finished goods, and finished products. The PPI, which uses 1982 as its base year, is actually a family of indexes for many different product categories, including crude goods (raw materials), intermediate goods (which become part of finished goods), and finished goods. For example, the PPI for finished goods was 197.7 in April 2017, a 3.9-point increase, and for chemicals was 196.5, up 3.8 points since April 2016. Examples of other PPI indexes include processed foods, lumber, containers, fuels and lubricants, metals, and construction. Because the PPI measures prices paid by producers for raw materials, energy, and other commodities, it may foreshadow subsequent price changes for businesses and consumers.

The Impact of Inflation

Inflation has several negative effects on people and businesses. For one thing, inflation penalizes people who live on fixed incomes. Let's say that a couple receives $2,000 a month retirement income beginning in 2018. If inflation is 10 percent in 2019, then the couple can buy only about 91 percent (100 ÷ 110) of what they could purchase in 2018. Similarly, inflation hurts savers. As prices rise, the real value, or purchasing power, of a nest egg of savings deteriorates.

CONCEPT CHECK

1. What is a business cycle? How do businesses adapt to periods of contraction and expansion?
2. Why is full employment usually defined as a target percentage below 100 percent?
3. What is the difference between demand-pull and cost-push inflation?

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3.4: Achieving Macroeconomic Goals

How does the government use monetary policy and fiscal policy to achieve its macroeconomic goals?

To reach macroeconomic goals, countries must often choose among conflicting alternatives. Sometimes political needs override economic needs. For example, bringing inflation under control may call for a politically difficult period of high unemployment and low growth. Or, in an election year, politicians may resist raising taxes to curb inflation. Still, the government must try to guide the economy to a sound balance of growth, employment, and price stability. The two main tools it uses are monetary policy and fiscal policy.

Monetary Policy

Monetary policy refers to a government's programs for controlling the amount of money circulating in the economy and interest rates. Changes in the money supply affect both the level of economic activity and the rate of inflation. **The Federal Reserve System (the Fed)**, the central banking system of the United States, projects the likely demand for new currency, and places an order with the Department of the Treasury's Bureau of Engraving and Printing for U.S. Currency (paper money), and the U.S. Mint makes U.S. Coins and charges the Fed for the cost of production. The money supply is also controlled by the Fed's regulation of certain bank activities.

When the Fed increases or decreases the amount of money in circulation, it affects interest rates (the cost of borrowing money and the reward for lending it). The Fed can change the interest rate on money it lends to banks to signal the banking system and financial markets that it has changed its monetary policy. These changes have a ripple effect. Banks, in turn, may pass along this change to consumers and businesses that receive loans from the banks. If the cost of borrowing increases, the economy slows because interest rates affect consumer and business decisions to spend or invest. The housing industry, business, and investments react most to changes in interest rates.

As a result of the 2007–2009 recession and the global financial crisis that ensued, the Fed dropped the federal funds rate—the interest rate charged on overnight loans between banks—to 0 percent in December 2008 and kept the rate at zero until December 2015, when it raised the rate to 0.25 percent. This decision marked the first increase in the federal-funds rate since June 2006, when the federal funds rate was 5.25 percent. As the U.S. economy continues to show a slow but steady expansion, the Fed subsequently increased the federal funds rate to a range of 0.75 to 1 percent in March 2017. As expected, this change has a ripple effect: the regional Federal Reserve Banks increase the discount rate they charge commercial banks for short-term loans, many commercial banks raise the interest rates they charge their customers, and credit card companies increase the annual percentage rate (APR) they charge consumers on their credit card balances.[24]

As you can see, the Fed can use monetary policy to contract or expand the economy. With **contractionary policy**, the Fed restricts, or tightens, the money supply by selling government securities or raising interest rates. The result is slower economic growth and higher unemployment. Thus, contractionary policy reduces spending and, ultimately, lowers inflation. With **expansionary policy**, the Fed increases, or loosens, growth in the money supply. An expansionary policy stimulates the economy. Interest rates decline, so business and consumer spending go up. Unemployment rates drop as businesses expand. But increasing the money supply also has a negative side: more spending pushes prices up, increasing the inflation rate.



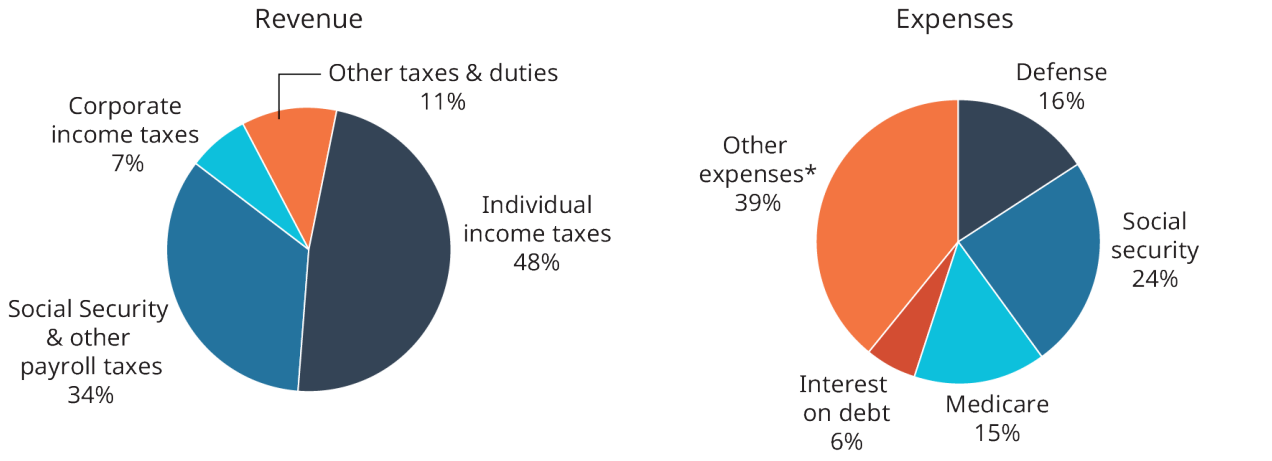
Exhibit 1.8: Powell. As chair of the Board of Governors of the Federal Reserve System, Jerome (Jay) Powell is considered the face of U.S. monetary policy. Powell took over the chair in February 2018 from Janet Yellen, the first woman ever to be appointed Fed chair. *What are the responsibilities of the chair of the Board of Governors of the Federal Reserve System?*(Credit: Federalreserve/ flickr/ US Government Works)

Fiscal Policy

The other economic tool used by the government is **fiscal policy**, its program of taxation and spending. By cutting taxes or by increasing spending, the government can stimulate the economy. Look again at **Exhibit 1.6**. The more government buys from businesses, the greater the business revenues and output. Likewise, if consumers or businesses have to pay less in taxes, they will have more income to spend for goods and services. Tax policies in the United States therefore affect business decisions. High corporate taxes can make it harder for U.S. firms to compete with companies in countries with lower taxes. As a result, companies may choose to locate facilities overseas to reduce their tax burden.

Nobody likes to pay taxes, although we grudgingly accept that we have to. Although most U.S. citizens complain that they are overtaxed, we pay lower taxes per capita (per person) than citizens in many countries similar to ours. In addition, our taxes represent a lower percentage of gross income and GDP compared to most countries.

Taxes are, of course, the major source of revenue for our government. Every year, the president prepares a budget for the coming year based upon estimated revenues and expenditures. Congress receives the president's report and recommendations and then, typically, debates and analyzes the proposed budget for several months. The president's original proposal is always modified in numerous ways. **Exhibit 1.9** shows the sources of revenue and expenses for the U.S. budget.



*This category includes both mandatory spending, such as expenditures for veterans' benefits and administration of justice, and discretionary spending, such as expenditures for education, community development, agriculture, science, and commerce.

Exhibit 1.9: **Revenues and Expenses for the Federal Budget** Source: U.S. Treasury, "Final Monthly Treasury Statement of Receipts and Outlays of the United States Government for Fiscal Year 2016," https://www.fiscal.treasury.gov, accessed May 23, 2017.

Whereas fiscal policy has a major impact on business and consumers, continual increases in government spending raises another important issue. When government takes more money from business and consumers (the private sector), a phenomenon known as **crowding out** occurs. Here are three examples of crowding out:

1. The government spends more on public libraries, and individuals buy fewer books at bookstores.
2. The government spends more on public education, and individuals spend less on private education.
3. The government spends more on public transportation, and individuals spend less on private transportation.

In other words, government spending is crowding out private spending.

If the government spends more for programs (social services, education, defense) than it collects in taxes, the result is a **federal budget deficit**. To balance the budget, the government can cut its spending, increase taxes, or do some combination of the two. When it cannot balance the budget, the government must make up any shortfalls by borrowing (just like any business or household).

In 1998, for the first time in a generation, there was a federal budget surplus (revenue exceeding spending) of about $71 billion. That budget surplus was short lived, however. By 2005, the deficit was more than $318 billion. In the fiscal year of 2009, the federal deficit was at an all-time high of more than $1.413 trillion. Six years later, at the end of the 2015 fiscal year, the deficit decreased to $438 billion.[25] The U.S. government has run budget deficits for many years. The accumulated total of these past deficits is the **national debt**, which now amounts to about $19.8 trillion, or about $61,072 for every man, woman, and child in the United States. Total interest on the debt is more than $2.5 trillion a year.[26] To cover the deficit, the U.S. government borrows money from people and businesses in the form of Treasury bills, Treasury notes, and Treasury bonds. These are federal IOUs that pay interest to their owners.

The national debt is an emotional issue debated not only in the halls of Congress, but by the public as well. Some believe that deficits contribute to economic growth, high employment, and price stability. Others have the following reservations about such a high national debt:

- *Not Everyone Holds the Debt:* The government is very conscious of who actually bears the burden of the national debt and keeps track of who holds what bonds. If only the rich were bondholders, then they alone would receive the interest payments and could end up receiving more in interest than they paid in taxes. In the meantime, poorer people, who held no bonds, would end up paying taxes that would be transferred to the rich as interest, making the debt an unfair burden to them. At times, therefore, the government has instructed commercial banks to reduce their total debt by divesting some of their bond holdings. That's also why the Treasury created **savings bonds**. Because these bonds are issued in relatively small denominations, they allow more people to buy and hold government debt.
- *It Crowds Out Private Investment:* The national debt also affects private investment. If the government raises the interest rate on bonds to be able to sell them, it forces private businesses, whose corporate bonds (long-term debt obligations issued

by a company) compete with government bonds for investor dollars, to raise rates on their bonds to stay competitive. In other words, selling government debt to finance government spending makes it more costly for private industry to finance its own investment. As a result, government debt may end up crowding out private investment and slowing economic growth in the private sector.

CONCEPT CHECK

1. What are the two kinds of monetary policy?
2. What fiscal policy tools can the government use to achieve its macroeconomic goals?
3. What problems can a large national debt present?

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3.5: Microeconomics- Zeroing in on Businesses and Consumers

What are the basic microeconomic concepts of demand and supply, and how do they establish prices?

Now let's shift our focus from the whole economy to *microeconomics,* the study of households, businesses, and industries. This field of economics is concerned with how prices and quantities of goods and services behave in a free market. It stands to reason that people, firms, and governments try to get the most from their limited resources. Consumers want to buy the best quality at the lowest price. Businesses want to keep costs down and revenues high to earn larger profits. Governments also want to use their revenues to provide the most effective public goods and services possible. These groups choose among alternatives by focusing on the prices of goods and services.

As consumers in a free market, we influence what is produced. If Mexican food is popular, the high demand attracts entrepreneurs who open more Mexican restaurants. They want to compete for our dollars by supplying Mexican food at a lower price, of better quality, or with different features, such as Santa Fe Mexican food rather than Tex-Mex. This section explains how business and consumer choices influence the price and availability of goods and services.



Exhibit 1.10: Galaxy Note 7. Samsung's strategy to take on Apple's iPhone domination hit a terrible snag in 2016, when its Galaxy Note 7 mobile phone was recalled and the product eliminated. Defective batteries in the Note 7 made them catch fire and cause serious damage. Samsung eventually killed the entire line of Note 7 phones, recalling nearly 3 million phones, which cost the company more than $5 billion. *How do businesses determine the optimum quantity of products or services to make available to consumers?* (Credit: Paul Sullivan/ flickr/ Attribution-NoDerivs 2.0 Generic (CC BY-ND 2.0))

The Nature of Demand

Demand is the quantity of a good or service that people are willing to buy at various prices. The higher the price, the lower the quantity demanded, and vice versa. A graph of this relationship is called a **demand curve**.

Let's assume you own a store that sells jackets for snowboarders. From past experience, you know how many jackets you can sell at different prices. The demand curve in **Exhibit 1.11** depicts this information. The *x*-axis (horizontal axis) shows the quantity of jackets, and the *y*-axis (vertical axis) shows the related price of those jackets. For example, at a price of $100, customers will buy (demand) 600 snowboard jackets.

In the graph, the demand curve slopes downward and to the right because as the price falls, people will want to buy more jackets. Some people who were not going to buy a jacket will purchase one at the lower price. Also, some snowboarders who already have a jacket will buy a second one. The graph also shows that if you put a large number of jackets on the market, you will have to reduce the price to sell all of them.

Understanding demand is critical to businesses. Demand tells you *how much you can sell* and *at what price*—in other words, how much money the firm will take in that can be used to cover costs and hopefully earn a profit. Gauging demand is difficult even for the very largest corporations, but particularly for small firms.

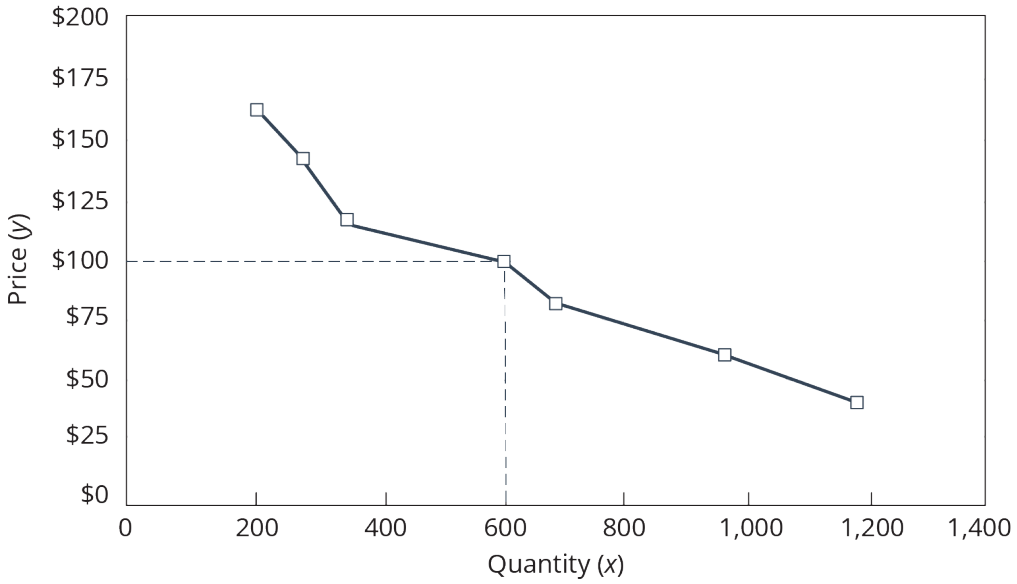


Exhibit 1.11: Demand Curve for Jackets for Snowboarders (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The Nature of Supply

Demand alone is not enough to explain how the market sets prices. We must also look at **supply**, the quantity of a good or service that businesses will make available at various prices. The higher the price, the greater the number of jackets a supplier will supply, and vice versa. A graph of the relationship between various prices and the quantities a business will supply is a **supply curve**.

We can again plot the quantity of jackets on the *x*-axis and the price on the *y*-axis. As **Exhibit 1.12** shows, 800 jackets will be available at a price of $100. Note that the supply curve slopes upward and to the right, the opposite of the demand curve. If snowboarders are willing to pay higher prices, suppliers of jackets will buy more inputs (for example, Gore-Tex® fabric, dye, machinery, labor) and produce more jackets. The quantity supplied will be higher at higher prices, because manufacturers can earn higher profits.

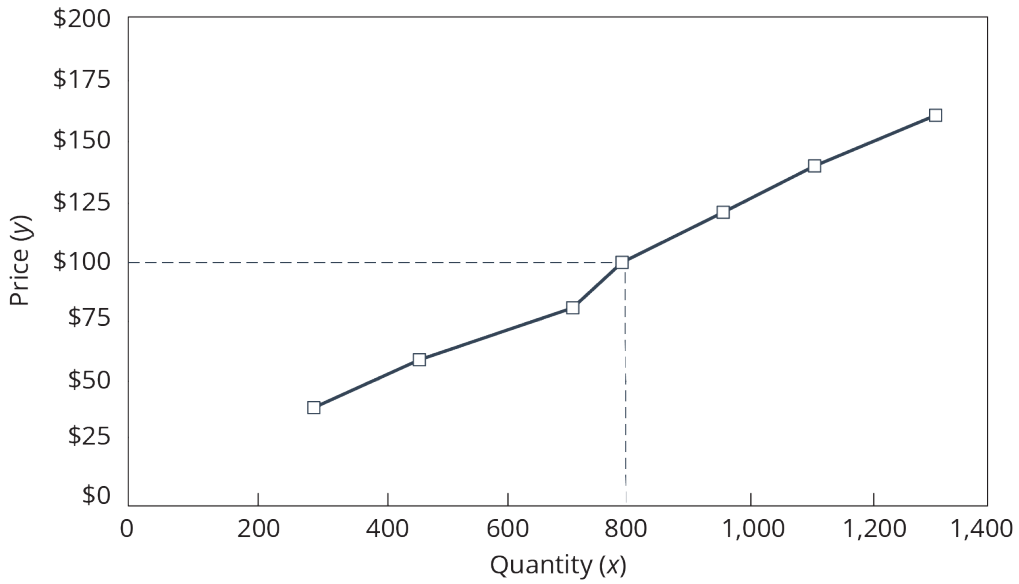


Exhibit 1.12: Supply Curve for Jackets for Snowboarders (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

How Demand and Supply Interact to Determine Prices

In a stable economy, the number of jackets that snowboarders demand depends on the jackets' price. Likewise, the number of jackets that suppliers provide depends on price. But at what price will consumer demand for jackets match the quantity suppliers will produce?

To answer this question, we need to look at what happens when demand and supply interact. By plotting both the demand curve and the supply curve on the same graph in **Exhibit 1.13**, we see that they cross at a certain quantity and price. At that point, labeled E, the quantity demanded equals the quantity supplied. This is the point of **equilibrium**. The equilibrium price is $80; the equilibrium quantity is 700 jackets. At that point, there is a balance between the quantity consumers will buy and the quantity suppliers will make available.

Market equilibrium is achieved through a series of quantity and price adjustments that occur automatically. If the price increases to $160, suppliers produce more jackets than consumers are willing to buy, and a surplus results. To sell more jackets, prices will have to fall. Thus, a surplus pushes prices downward until equilibrium is reached. When the price falls to $60, the quantity of jackets demanded rises above the available supply. The resulting shortage forces prices upward until equilibrium is reached at $80.

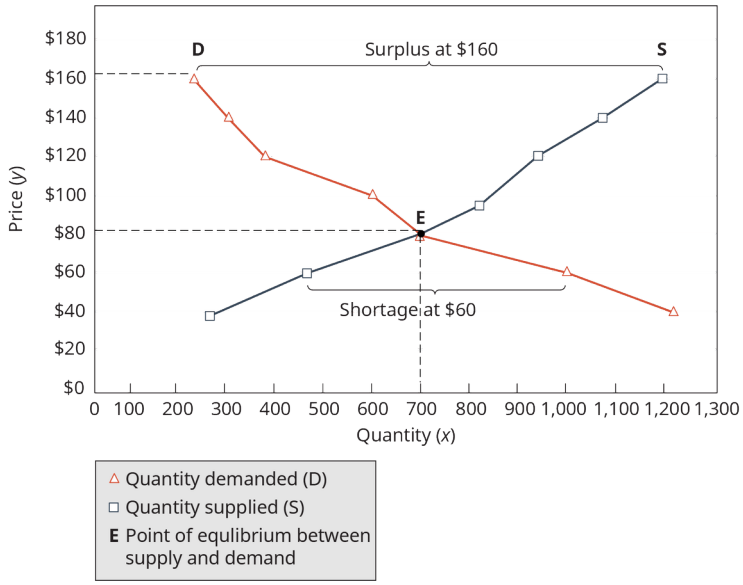


Exhibit 1.13: Equilibrium Price and Quantity for Jackets for Snowboarders (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The number of snowboard jackets supplied and bought at $80 will tend to rest at equilibrium unless there is a shift in either demand or supply. If demand increases, more jackets will be purchased at every price, and the demand curve shifts to the right (as illustrated by line D_2 in **Exhibit 1.14**). If demand decreases, less will be bought at every price, and the demand curve shifts to the left (D_1). When demand decreased, snowboarders bought 500 jackets at $80 instead of 700 jackets. When demand increased, they purchased 800.

Changes in Demand

A number of things can increase or decrease demand. For example, if snowboarders' incomes go up, they may decide to buy a second jacket. If incomes fall, a snowboarder who was planning to purchase a jacket may wear an old one instead. Changes in fashion or tastes can also influence demand. If snowboarding were suddenly to go out of fashion, demand for jackets would decrease quickly. A change in the price of related products can also influence demand. For example, if the average price of a snowboard rises to $1,000, people will quit snowboarding, and jacket demand will fall.

Another factor that can shift demand is expectations about future prices. If you expect jacket prices to increase significantly in the future, you may decide to go ahead and get one today. If you think prices will fall, you will postpone your purchase. Finally, changes in the number of buyers will affect demand. Snowboarding is a young person's sport, and the number of teenagers will increase in the next few years. Therefore, the demand for snowboard jackets should increase.

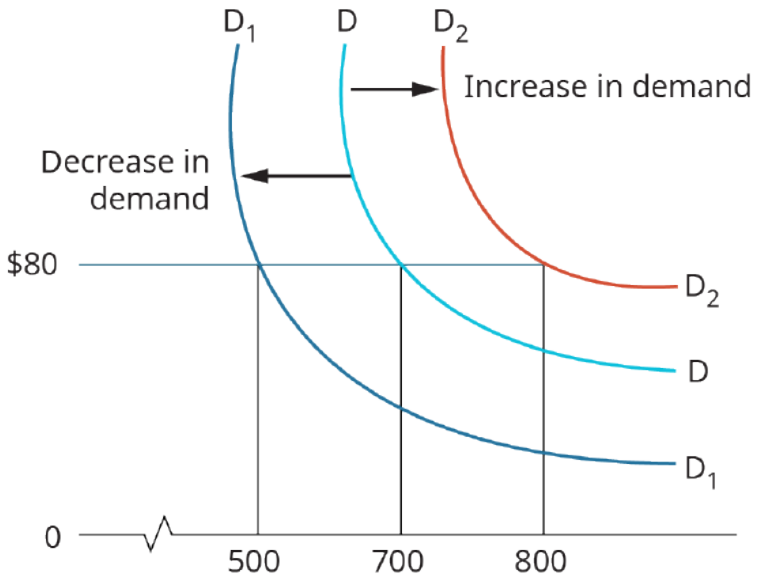


Exhibit 1.14: Shifts in Demand for Jackets for Snowboarders (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Changes in Supply

Other factors influence the supply side of the picture. New technology typically lowers the cost of production. For example, North Face, a supplier of ski and snowboard jackets, purchased laser-guided pattern-cutting equipment and computer-aided pattern-making equipment. Each jacket was cheaper to produce, resulting in a higher profit per jacket. This provided an incentive to supply more jackets at every price. If the price of resources such as labor or fabric goes up, North Face will earn a smaller profit on each jacket, and the amount supplied will decrease at every price. The reverse is also true. Changes in the prices of other goods can also affect supply.

Let's say that snow skiing becomes a really hot sport again. The number of skiers jumps dramatically, and the price of ski jackets soars. North Face can use its machines and fabrics to produce either ski or snowboard jackets. If the company can make more profit from ski jackets, it will produce fewer snowboard jackets at every price. Also, a change in the number of producers will shift the supply curve. If the number of jacket suppliers increases, they will place more jackets on the market at every price. If any suppliers stop making jackets available, the supply will naturally decrease. Taxes can also affect supply. If the government decides, for some reason, to tax the supplier for every snowboard jacket produced, then profits will fall, and fewer jackets will be offered at every price. **Table 1.2**summarizes the factors that can shift demand and supply curves.

To better understand the relationship between supply and demand across the economy, consider the impact of 2005's Hurricane Katrina on U.S. energy prices. Oil and gas prices were already at high levels before Hurricane Katrina disrupted production in the Gulf Coast. Most U.S. offshore drilling sites are located in the Gulf of Mexico, and almost 30 percent of U.S. refining capacity is in Gulf States that were hit hard by the storm. Prices rose almost immediately as supplies fell while demand remained at the same levels.

The storm drove home the vulnerability of the U.S. energy supply to not only natural disasters, but also terrorist attacks and price increases from foreign oil producers. Many energy policy experts questioned the wisdom of having such a high concentration of oil facilities—about 25 percent of the oil and natural gas infrastructure—in hurricane-prone states. Refiners were already almost at capacity before Katrina's devastation.[27]

Table 1.2: Factors That Cause Demand and Supply Curves to Shift

	Shift Demand	
Factor	**To the Right If**	**To the Left If**
Buyers' incomes	Increase	Decrease
Buyers' preferences/tastes	Increase	Decrease
Prices of substitute products	Increase	Decrease

Expectations about future prices	Will rise	Will fall
Number of buyers	Increases	Decreases
	Shift Supply	
	To the Right If	**To the Left If**
Technology	Lowers cost	Increases cost
Resource prices	Fall	Rise
Changes in prices of other products that can be produced with the same resources	Profit of other product falls	Profit of other product rises
Number of suppliers	Increases	Decreases
Taxes	Decreases	Increases

High energy prices affect the economy in many ways. With oil at the time costing $50 to $60 a barrel—more than double the 2003 price—both businesses and consumers across the United States felt the pinch in their wallets. Midwestern agricultural businesses export about 70 percent of their grain production through Gulf of Mexico port facilities. With fewer usable docking spaces, barges couldn't unload and return for more crops. The supply of both transportation services and grain products was inadequate to meet demand, pushing up transportation and grain costs. Higher gas prices also contributed to rising prices, as 80 percent of shipping costs are related to fuel.

More than a decade after Katrina, U.S. gas prices have fluctuated dramatically, with the cost of a gallon of regular gas peaking in 2014 at $3.71, dropping as low as $1.69 in early 2015, and moderating to $2.36 in mid-2017. Recent research by JP Morgan Chase revealed that consumers spend roughly 80 percent of their savings from lower gas prices, which helps the overall economy.[28]

CONCEPT CHECK

1. What is the relationship between prices and demand for a product?
2. How is market equilibrium achieved? Describe the circumstances under which the price for gasoline would have returned to equilibrium in the United States after Hurricane Katrina.
3. Draw a graph that shows an equilibrium point for supply and demand.

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3.6: Competing in a Free Market

What are the four types of market structure?

One of the characteristics of a free-market system is that suppliers have the right to compete with one another. The number of suppliers in a market defines the **market structure**. Economists identify four types of market structures: (1) perfect competition, (2) pure monopoly, (3) monopolistic competition, and (4) oligopoly. **Table 1.3** summarizes the characteristics of each of these market structures.

Perfect Competition

Characteristics of **perfect (pure) competition** include:

- A large number of small firms are in the market.
- The firms sell similar products; that is, each firm's product is very much like the products sold by other firms in the market.
- Buyers and sellers in the market have good information about prices, sources of supply, and so on.
- It is easy to open a new business or close an existing one.

Table 1.3: Comparison of Market Structures

Characteristics	Perfect Competition	Pure Monopoly	Monopolistic Competition	Oligopoly
Number of firms in market	Many	One	Many, but fewer than perfect competition	Few
Firm's ability to control price	None	High	Some	Some
Barriers to entry	None	Subject to government regulation	Few	Many
Product differentiation	Very little	No products that compete directly	Emphasis on showing perceived differences in products	Some differences
Examples	Farm products such as wheat and corn	Utilities such as gas, water, cable television	Retail specialty clothing stores	Steel, automobiles, airlines, aircraft manufacturers

In a perfectly competitive market, firms sell their products at prices determined solely by forces beyond their control. Because the products are very similar and each firm contributes only a small amount to the total quantity supplied by the industry, price is determined by supply and demand. A firm that raised its price even a little above the going rate would lose customers. In the wheat market, for example, the product is essentially the same from one wheat producer to the next. Thus, none of the producers has control over the price of wheat.

Perfect competition is an ideal. No industry shows all its characteristics, but the stock market and some agricultural markets, such as those for wheat and corn, come closest. Farmers, for example, can sell all of their crops through national commodity exchanges at the current market price.

Pure Monopoly

At the other end of the spectrum is **pure monopoly**, the market structure in which a single firm accounts for all industry sales of a particular good or service. The firm *is* the industry. This market structure is characterized by **barriers to entry**—factors that prevent new firms from competing equally with the existing firm. Often the barriers are technological or legal conditions. Polaroid, for example, held major patents on instant photography for years. When Kodak tried to market its own instant camera, Polaroid sued, claiming patent violations. Polaroid collected millions of dollars from Kodak. Another barrier may be one firm's control of a

natural resource. DeBeers Consolidated Mines Ltd., for example, controls most of the world's supply of uncut diamonds.

Public utilities, such as gas and water companies, are pure monopolies. Some monopolies are created by a government order that outlaws competition. The U.S. Postal Service is currently one such monopoly.

Monopolistic Competition

Three characteristics define the market structure known as **monopolistic competition**:

- Many firms are in the market.
- The firms offer products that are close substitutes but still differ from one another.
- It is relatively easy to enter the market.

Under monopolistic competition, firms take advantage of product differentiation. Industries where monopolistic competition occurs include clothing, food, and similar consumer products. Firms under monopolistic competition have more control over pricing than do firms under perfect competition because consumers do not view the products as perfect substitutes. Nevertheless, firms must demonstrate product differences to justify their prices to customers. Consequently, companies use advertising to distinguish their products from others. Such distinctions may be significant or superficial. For example, Nike says "Just Do It," and Tylenol is advertised as being easier on the stomach than aspirin.

Oligopoly

An **oligopoly** has two characteristics:

- A few firms produce most or all of the output.
- Large capital requirements or other factors limit the number of firms.

Boeing and Airbus Industries (aircraft manufacturers) and Apple and Google (operating systems for smartphones) are major players in different oligopolistic industries.

With so few firms in an oligopoly, what one firm does has an impact on the other firms. Thus, the firms in an oligopoly watch one another closely for new technologies, product changes and innovations, promotional campaigns, pricing, production, and other developments. Sometimes they go so far as to coordinate their pricing and output decisions, which is illegal. Many antitrust cases—legal challenges arising out of laws designed to control anticompetitive behavior—occur in oligopolies.

The market structure of an industry can change over time. Take, for example, telecommunications. At one time, AT&T had a monopoly on long-distance telephone service nationwide. Then the U.S. government divided the company into seven regional phone companies in 1984, opening the door to greater competition. Other companies such as MCI and Sprint entered the fray and built state-of-the-art fiber-optic networks to win customers from the traditional providers of phone service. The 1996 Telecommunications Act changed the competitive environment yet again by allowing local phone companies to offer long-distance service in exchange for letting competition into their local markets. Today, the broadcasting, computer, telephone, and video industries are converging as companies consolidate through merger and acquisition.

CONCEPT CHECK

1. What is meant by market structure?
2. Compare and contrast perfect competition and pure monopoly. Why is it rare to find perfect competition?
3. How does an oligopoly differ from monopolistic competition?

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3.7: Trends in the Business Environment and Competition

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

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

Changing Workforce Demographics

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

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

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

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

MANAGING CHANGE

EY Makes Diversity and Inclusion a Top Priority

As older workers continue to leave the U.S. labor force and younger individuals begin work or move to other jobs to further their careers, businesses must recognize the importance of diversity and inclusion as key corporate strategies. This is particularly critical as multicultural millennials become the dominant group in the U.S. workforce. One leader in embracing diversity as an

important part of corporate life is EY (formerly Ernst & Young), a global leader in assurance, tax, and advisory services.

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

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

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

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

Questions for Discussion

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

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

Global Energy Demands

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

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

Countries and companies worldwide are seeking additional sources of supply to prevent being held captive to one supplier. For example, the relatively new technology of extracting oil from shale rock formations in the United States (known as fracking) has help create an important resource for the country's oil industry. This innovative approach to finding new sources of energy now

accounts for more than half of the country's oil output, which can help reduce U.S. dependence on foreign oil and create new jobs.[36]

Meeting Competitive Challenges

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

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

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

CONCEPT CHECK

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

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4: ENTREPENEURSHIP

4.1: Introduction

4.2: Entrepreneurship Today

4.3: Characteristics of Successful Entrepreneurs

4.4: Small Business- Driving America's Growth

4.5: Ready, Set, Start Your Own Business

4.6: Managing a Small Business

4.7: Small Business, Large Impact

4.8: The Small Business Administration

4.9: Trends in Entrepreneurship and Small-Business Ownership

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4.1: Introduction



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EXPLORING BUSINESS CAREERS

Natalie Tessler, Spa Space

Natalie Tessler has always had an entrepreneurial spirit. After she graduated from New York University's law school, she began working as a tax attorney for a large firm in Chicago. But Tessler soon realized that this left her feeling unfulfilled. She didn't want to practice law, and she didn't want to work for someone else. "I wanted to wake up and be excited for my day," Tessler said. Not until one night, though, when she was having dinner with a friend who recently had begun a writing career, did she realize it was time. "I was listening to her talk about how much she loved her job. Her passion and excitement—I wanted that. I wanted something that grabbed me and propelled me through the day—and being a lawyer wasn't it."

She began searching for what "it" was. She had a tremendous passion and talent for hospitality, entertaining others, and presentation. Seeking an outlet for that flair, she found the spa industry, and the idea for Spa Space was born.

"People think that, owning a spa, I'm able to live this glamorous lifestyle," she laughs. "Owning a spa is nothing like going to one—my nails always are broken from fixing equipment; my back is usually in pain from sitting hunched over a computer trying to figure out the budget or our next marketing promotion." Tessler is a true entrepreneur, embodying the spirit and drive necessary to see her vision become a reality.

Tessler wanted to design a spa that focused on something new: creating a comfortable, personalized environment of indulgence while not neglecting the medical technology of proper skin care. "My father's a dermatologist, so we discussed the importance of making this more than a spa where you can get a frou-frou, smell-good treatment that might actually harm your skin. We both thought it was important to create an experience that is as beneficial for people's skin as it is for their emotional well-being." To address this need, Spa Space has a medical advisory board that helps with product selection, treatment design, and staff training.

Armed with a vision and a plan, Tessler turned her sights toward making it a reality. Spa Space opened in 2001 and has received a great deal of national recognition for its service excellence, unique treatments and products, and its fresh approach to appealing to both men and women. But it hasn't always been smooth sailing for Spa Space. Tessler had to steer the business through several obstacles, including the 9/11 tragedy just three months after the spa's grand opening, and then the Great Recession. Tessler learned to adapt her strategy by refining her target market and the services Spa Space offered. Her resiliency enabled the company to not only survive difficult economic periods, but to thrive and grow 17 years later into what the press recognizes as Chicago's best spa.

Tessler recently turned the reins over to Ilana Alberico, another entrepreneur and founder of Innovative Spa Management, a company that has been named twice to *Inc.* magazine's list of fastest growing companies. When Alberico met Natalie Tessler and learned about her vision, she was inspired to invest in Spa Space. "Natalie's vision still resonates . . . I'm inspired to champion her vision into the future."

Sources: "Our Team," https://spaspace.com, accessed February 1, 2018; Jennifer Keishin Armstrong, "Spa Reviews: Spa Space in Chicago," *Day Spa* magazine, http://www.dayspamagazine.com, accessed February 1, 2018; "About Us," https://ismspa.com, accessed February 1, 2018.

Typical of many who catch the entrepreneurial bug, Natalie Tessler had a vision and pursued it single-mindedly. She is just one of thousands of entrepreneurs from all age groups and backgrounds. Even kids are starting businesses and high-tech firms. College graduates are shunning the corporate world to head out on their own. Downsized employees, midcareer executives, and retirees who have worked for others all their lives are forming the companies they have always wanted to own.

Companies started by entrepreneurs and small-business owners make significant contributions to the U.S. and global economies. Hotbeds of innovation, these small businesses take leadership roles in technological change and the development of new goods and services. Just how important are small businesses to our economy? **Table 5.1** provides insight into the role of small business in today's economy.

You may be one of the millions of Americans who's considering joining the ranks of business owners. As you read this chapter, you'll learn why entrepreneurship continues to be one of the hottest areas of business activity. Then you'll get the information and tools you need to help you decide whether owning your own company is the right career path for you. Next you'll discover what characteristics you'll need to become a successful entrepreneur. Then we'll look at the importance of small businesses in the economy, guidelines for starting and managing a small business, the many reasons small businesses continue to thrive in the United States, and the role of the Small Business Administration. Finally, the chapter explores the trends that shape entrepreneurship and small-business ownership today.

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4.2: Entrepreneurship Today

Why do people become entrepreneurs, and what are the different types of entrepreneurs?

Brothers Fernando and Santiago Aguerre exhibited entrepreneurial tendencies at an early age. At 8 and 9 years old respectively, they sold strawberries and radishes from a vacant lot near their parents' home in Plata del Mar on the Atlantic coast of Argentina. At 11 and 12, they provided a surfboard repair service from their garage. As teenagers, Fer and Santi, as they call each other, opened Argentina's first surf shop, which led to their most ambitious entrepreneurial venture of all.

The flat-footed brothers found that traipsing across hot sand in flip-flops was uncomfortable, so in 1984 they sank their $4,000 savings into manufacturing their own line of beach sandals. Now offering sandals and footwear for women, men, and children, as well as clothing for men, Reef sandals have become the world's hottest beach footwear, with a presence in nearly every surf shop in the United States.[1]

Table 5.1: The Economic Impact of Small Business

Most U.S. Businesses Are Small:
• 80% (approximately 23.8 million) of the nearly 29.7 million businesses have no employees (businesses run by individuals or small groups of partners, such as married couples). • 89% (approximately 5.2 million) of the nearly 5.8 million businesses with employees have fewer than 20 employees. • 99.6% (approximately 5.7 million) of all businesses have 0–99 employees—98% have 0–20 workers. • Approximately 5.8 million businesses have fewer than 500 employees. • Only about 19,000 businesses in the United States have more than 500 employees. • Companies with fewer than 50 employees pay more than 20% of America's payroll. • Companies with fewer than 500 employees pay more than 41% of America's payroll. • 32.5 million people (1 employee in 4) work for businesses with fewer than 50 employees. • These businesses also pay tens of millions of owners, not included in employment statistics.

Source: "Firm Size Data: 2014," https://www.sba.gov, accessed February 1, 2018.

CATCHING THE ENTREPRENEURIAL SPIRIT

Young Entrepreneur Living the Dream

Jack Bonneau is the quintessential entrepreneur. In the three years he has been in business, he has expanded his product line, opened multiple locations, established strategic partnerships, and secured sponsorship from several national brands. His business has garnered publicity from *The New York Times, The Denver Post, The Today Show*, *Good Morning America*, and numerous other media. He has shared his business success on several stages, speaking at TechStars and the Aspen Ideas Festival, and recently delivered the closing keynote speech at a national STEM conference. He even landed a gig on *Shark Tank*.

Jack Bonneau is smart, charismatic, an excellent spokesperson, and persistent in his mission. And he is only 11 years old—which also makes him very adorable.

Jack's business was born from a need that most kids have: a desire for toys. He asked his dad, Steve Bonneau, for a LEGO Star Wars Death Star. The problem was that it cost $400. Jack's dad said he could have it but only if he paid for it himself. This led Jack to do what a lot of kids do to earn some extra cash. He opened a lemonade stand. But he quickly learned that this would never help him realize his dream, so, with the advice and help of his father, he decided to open a lemonade stand at a local farmers market. "There were lots of people who wanted to buy great lemonade from an eight-year-old," says Jack. In no time, Jack had earned enough to buy his LEGO Death Star. "I had sales of around $2,000, and my total profit was $900," Jack said.

Jack realized that he was on to something. Adults love to buy things from cute kids. What if he could make even more money by opening more locations? Jack developed an expansion plan to open three new "Jack Stands" the following spring. Realizing that he would need more working capital, he secured a $5,000 loan from Young Americas Bank, a bank in Denver that specializes in loans to children. Jack made $25,000 in 2015.

The following year, Jack wanted to expand operations, so he secured a second loan for $12,000. He opened stands in several more locations, including shopping malls during the holiday season, selling apple cider and hot chocolate instead of lemonade. He also added additional shop space and recruited other young entrepreneurial kids to sell their products in his space, changing the name to Jack's Stands and Marketplace. One of his first partnerships was Sweet Bee Sisters, a lip balm and lotion company founded by Lily, Chloe, and Sophie Warren. He also worked with 18 other young entrepreneurs who sell a range of products from organic dog treats to scarves and headbands.

Jack's strategy worked, and the business brought in more than $100,000 last year. This year, he became the spokesperson for Santa Cruz Organic Lemonade, and he's now looking at expanding into other cities such as Detroit and New Orleans.

Even though Jack is only 11 years old, he has already mastered financial literacy, customer service, marketing and sales, social skills, and other sound business practices—all the qualities of a successful entrepreneur.

Critical Thinking Questions

1. What do you think enabled Jack Bonneau to start and grow a successful business at such a young age?
2. What personal characteristics and values will Jack need to continue running his business while also attending school full-time?

Sources: "About Jack's Stands & Marketplaces," www.jackstands.com, accessed February 1, 2018; Peter Gasca, "This 11-Year-Old Founder's Advice Is As Profound as Any You Could Receive," *Inc.,* https://www.inc.com, July 27, 2017; Claire Martin, "Some Kids Sell Lemonade. He Starts a Chain," *The New York Times,* https://www.nytimes.com, February 26, 2016.

Christy Glass Lowe, who monitors surf apparel for USBX Advisory Services LLC, notes, "They [Reef] built a brand from nothing and now they're the dominant market share leader."

The Aguerres, who currently live two blocks from each other in La Jolla, California, sold Reef to VF Corporation for more than $100 million in 2005. In selling Reef, "We've finally found our freedom," Fernando says. "We traded money for time," adds Santiago. Fernando remains active with surfing organizations, serving as president of the International Surfing Association, where he became known as "Ambassador of the Wave" for his efforts in getting all 90 worldwide members of the International Olympic Committee to unanimously vote in favor of including surfing in the 2020 Olympic Games.[2] He has also been named "Waterman of the Year" by the Surf Industry Manufacturers Association two times in 24 years.[3] Santi raises funds for his favorite not-for-profit, SurfAid. Both brothers are enjoying serving an industry that has served them so well.

The United States is blessed with a wealth of entrepreneurs such as the Aguerres who want to start a **small business**. According to research by the Small Business Administration, two-thirds of college students intend to be entrepreneurs at some point in their careers, aspiring to become the next Bill Gates or Jeff Bezos, founder of Amazon.com. But before you put out any money or expend energy and time, you'd be wise to check out Table 5.2 for some preliminary advice.

The desire to be one's own boss cuts across all age, gender, and ethnic lines. Results of a recent U.S. Census Bureau survey of business owners show that minority groups and women are becoming business owners at a much higher rate than the national average. Table 5.3 illustrates these minority-owned business demographics.

Why has entrepreneurship remained such a strong part of the foundation of the U.S. business system for so many years? Because today's global economy rewards innovative, flexible companies that can respond quickly to changes in the business environment. Such companies are started by **entrepreneurs**, people with vision, drive, and creativity, who are willing to take the risk of starting and managing a business to make a profit.

Table 5.2 Sources: Jess Ekstrom, "5 Questions to Ask Yourself Before You Start a Business," Entrepreneur, https://www.entrepreneur.com, accessed February 1, 2018; "Resources," http://www.marketsmarter.com, accessed February 1, 2018; Monique Reece, Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution (Upper Saddle River, NJ: FT Press/Pearson, 2010); Mike Collins, "Before You Start–Innovator's Inventory," The Wall Street Journal, May 9, 2005, p. R4.

Are You Ready to Be an Entrepreneur?

Here are some questions would-be entrepreneurs should ask themselves:

1. What is new and novel about your idea? Are you solving a problem or unmet need?
2. Are there similar products/services out there? If so, what makes yours better?
3. Who is your target market? How many people would use your product or service?
4. Have you talked with potential customers to get their feedback? Would they buy your product/service?
5. What about production costs? How much do you think the market will pay?
6. How defensible is the concept? Is there good intellectual property?
7. Is this innovation strategic to my business?
8. Is the innovation easy to communicate?
9. How might this product evolve over time? Would it be possible to expand it into a product line? Can it be updated/enhanced in future versions?
10. Where would someone buy this product/service?
11. How will the product/service be marketed? What are the costs to sell and market it?
12. What are the challenges involved in developing this product/service?

Table 5.3 Sources: Robert Bernstein, "Hispanic-Owned Businesses on the Upswing," International Trade Management Division, U.S. Census, https://www.census.gov, December 1, 2016; The Kauffman Index of Main Street Entrepreneurship, https://www.kauffman.org, November 2016.

Statistics for Minority-Owned Businesses

- The number of Hispanic-owned businesses almost tripled between 1997 (1.2 million) and 2012 (3.3 million).
- The percentage of U.S. businesses with 1 to 50 employees owned by African Americans increased by 50% between 1996 and 2015.
- Almost a million firms with employees are minority owned: 53% are Asian American owned, 11% are African American owned, and almost a third are Hispanic owned.
- 19% of all companies with employees are owned by women.

Entrepreneur or Small-Business Owner?

The term *entrepreneur* is often used in a broad sense to include most small-business owners. The two groups share some of the same characteristics, and we'll see that some of the reasons for becoming an entrepreneur or a small-business owner are very similar. But there is a difference between entrepreneurship and small-business management. Entrepreneurship involves taking a risk, either to create a new business or to greatly change the scope and direction of an existing one. Entrepreneurs typically are innovators who start companies to pursue their ideas for a new product or service. They are visionaries who spot trends.

Although entrepreneurs may be small-business owners, not all small-business owners are entrepreneurs. Small-business owners are managers or people with technical expertise who started a business or bought an existing business and made a conscious decision to stay small. For example, the proprietor of your local independent bookstore is a small-business owner. Jeff Bezos, founder of Amazon.com, also sells books. But Bezos is an entrepreneur: He developed a new model—web-based book retailing—that revolutionized the bookselling world and then moved on to change retailing in general. Entrepreneurs are less likely to accept the status quo, and they generally take a longer-term view than the small-business owner.

Types of Entrepreneurs

Entrepreneurs fall into several categories: classic entrepreneurs, multipreneurs, and intrapreneurs.

Classic Entrepreneurs

Classic entrepreneurs are risk-takers who start their own companies based on innovative ideas. Some classic entrepreneurs are *micropreneurs* who start small and plan to stay small. They often start businesses just for personal satisfaction and the lifestyle. Miho Inagi is a good example of a micropreneur. On a visit to New York with college friends in 1998, Inagi fell in love with the city's bagels. "I just didn't think anything like a bagel could taste so good," she said. Her passion for bagels led the young office assistant to quit her job and pursue her dream of one day opening her own bagel shop in Tokyo. Although her parents tried to talk her out of it, and bagels were virtually unknown in Japan, nothing deterred her. Other trips to New York followed, including an unpaid six-month apprenticeship at Ess-a-Bagel, where Inagi took orders, cleared trays, and swept floors. On weekends, owner Florence Wilpon let her make dough.

In August 2004, using $20,000 of her own savings and a $30,000 loan from her parents, Inagi finally opened tiny Maruichi Bagel. The timing was fortuitous, as Japan was about to experience a bagel boom. After a slow start, a favorable review on a local bagel website brought customers flocking for what are considered the best bagels in Tokyo. Inagi earns only about $2,300 a month after expenses, the same amount she was making as a company employee. "Before I opened this store I had no goals," she says, "but now I feel so satisfied."[4]

In contrast, *growth-oriented entrepreneurs* want their business to grow into a major corporation. Most high-tech companies are formed by growth-oriented entrepreneurs. Jeff Bezos recognized that with Internet technology he could compete with large chains of traditional book retailers. Bezos's goal was to build his company into a high-growth enterprise—and he chose a name that reflected his strategy: Amazon.com. Once his company succeeded in the book sector, Bezos applied his online retailing model to other product lines, from toys and house and garden items to tools, apparel, music, and services. In partnership with other retailers, Bezos is well on his way to making Amazon's vision "to be Earth's most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online."—a reality.[5]

Multipreneurs

Then there are *multipreneurs,* entrepreneurs who start a series of companies. They thrive on the challenge of building a business and watching it grow. In fact, over half of the chief executives at *Inc.* 500 companies say they would start another company if they sold their current one. Brothers Jeff and Rich Sloan are a good example of multipreneurs, having turned numerous improbable ideas into successful companies. Over the past 20-plus years, they have renovated houses, owned a horse breeding and marketing business, invented a device to prevent car batteries from dying, and so on. Their latest venture, a multimedia company called StartupNation, helps individuals realize their entrepreneurial dreams. And the brothers know what company they want to start next: yours.[6]



Exhibit 5.2: If there is one person responsible for the mainstream success of solar energy and electric vehicles in the past 10 years, it's Elon Musk, founder and CEO of Tesla. Since the 2000s when he founded Tesla, launching innovation in solar technology, and commercial space exploration with SpaceX, Musk has pioneered countless innovations and has challenged traditional automobile, trucking, and energy companies to challenge and rethink their businesses. *What entrepreneurial type best describes Elon Musk?* (Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Intrapreneurs

Some entrepreneurs don't own their own companies but apply their creativity, vision, and risk-taking within a large corporation. Called **intrapreneurs**, these employees enjoy the freedom to nurture their ideas and develop new products, while their employers provide regular salaries and financial backing. Intrapreneurs have a high degree of autonomy to run their own minicompanies within the larger enterprise. They share many of the same personality traits as classic entrepreneurs, but they take less personal risk. According to Gifford Pinchot, who coined the term *intrapreneur* in his book of the same name, large companies provide seed funds that finance in-house entrepreneurial efforts. These include Intel, IBM, Texas Instruments (a pioneering intrapreneurial company), Salesforce.com, and Xerox.

Why Become an Entrepreneur?

As the examples in this chapter show, entrepreneurs are found in all industries and have different motives for starting companies. The most common reason cited by CEOs of the *Inc.* 500, the magazine's annual list of fastest-growing private companies, is the challenge of building a business, followed by the desire to control their own destiny. Other reasons include financial independence and the frustration of working for someone else. Two important motives mentioned in other surveys are a feeling of personal satisfaction with their work, and creating the lifestyle that they want. Do entrepreneurs feel that going into business for themselves was worth it? The answer is a resounding yes. Most say they would do it again.

CONCEPT CHECK

1. Describe several types of entrepreneurs.
2. What differentiates an entrepreneur from a small-business owner?
3. What are some major factors that motivate entrepreneurs to start businesses?

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4.3: Characteristics of Successful Entrepreneurs

What characteristics do successful entrepreneurs share?

Do you have what it takes to become an entrepreneur? Having a great concept is not enough. An entrepreneur must be able to develop and manage the company that implements his or her idea. Being an entrepreneur requires special drive, perseverance, passion, and a spirit of adventure, in addition to managerial and technical ability. Entrepreneurs *are* the company; they tend to work longer hours, take fewer vacations, and cannot leave problems at the office at the end of the day. They also share other common characteristics as described in the next section.

The Entrepreneurial Personality

Studies of the entrepreneurial personality find that entrepreneurs share certain key traits. Most entrepreneurs are

- *Ambitious:* They are competitive and have a high need for achievement.
- *Independent:* They are individualists and self-starters who prefer to lead rather than follow.
- *Self-confident:* They understand the challenges of starting and operating a business and are decisive and confident in their ability to solve problems.
- *Risk-takers:* Although they are not averse to risk, most successful entrepreneurs favor business opportunities that carry a moderate degree of risk where they can better control the outcome over highly risky ventures where luck plays a large role.
- *Visionary:* Their ability to spot trends and act on them sets entrepreneurs apart from small-business owners and managers.
- *Creative:* To compete with larger firms, entrepreneurs need to have creative product designs, bold marketing strategies, and innovative solutions to managerial problems.
- *Energetic:* Starting and operating a business takes long hours. Even so, some entrepreneurs start their companies while still employed full-time elsewhere.
- *Passionate*. Entrepreneurs love their work, as Miho Inagi demonstrated by opening a bagel shop in Tokyo despite the odds against it being a success.
- *Committed*. Because they are so committed to their companies, entrepreneurs are willing to make personal sacrifices to achieve their goals.

CUSTOMER SATISFACTION AND QUALITY

Ethical Choices Transform Family Business into International Brand

Ever since Apollonia Poilâne was a young girl growing up in Paris, she always knew what she wanted to do when she grew up: take over the family business. But she didn't anticipate how quickly this would happen. When her father—Lionel Poilâne—and her mother died in a helicopter crash in 2002, France lost its most celebrated baker, and Apollonia stepped into the role. She was just 18 years old at the time with plans to matriculate to Harvard in the fall, but the moment her parents had prepared her for had come. As her Harvard admissions essay said, "The work of several generations is at stake."

With organization and determination, Apollonia managed one of the best French bakeries in the world—based in Paris—from her apartment in Cambridge, Massachusetts. She would usually wake up an extra two hours before classes to make sure she would get all the phone calls done for work. "After classes I check on any business regarding the company and then do my homework," she says. "Before I go to bed I call my production manager in Paris to check the quality of the bread." Because the name Poilâne has earned a place with a very small group of prestige bakers, the 18-year-old was determined to continue the tradition of customer satisfaction and quality her grandfather established in 1932. When her grandfather suffered a stroke in 1973, his 28-year-old son, Lionel, poured his heart into the business and made the family bread into the global brand it is today. Lionel opened two more bakeries in Paris and another in London. He developed and nurtured a worldwide network of retailers and celebrities where bread is shipped daily via FedEx to upscale restaurants and wealthy clients around the world.

Experimenting with sourdough is what distinguished Poilâne's products from bread produced by Paris's other bakers, and it has remained the company's signature product. It is baked with a "P" carved into the crust, a throwback to the days when the use of communal ovens forced bakers to identify their loaves, and it also ensures that the loaf doesn't burst while it's baking. Today,

Poilâne also sells croissants, pastries, and a few specialty breads, but the company's signature item is still the four-pound *miche*, a wheel of sourdough, a country bread, *pain Poilâne*.

"Apollonia is definitely passionate about her job," says Juliette Sarrazin, manager of the successful Poilâne Bakery in London. "She really believes in the work of her father and the company, and she is looking at the future, which is very good."

Apollonia's work ethic and passion fueled her drive even when she was a student. Each day presented a juggling act of new problems to solve in Paris while other Harvard students slept. As Apollonia told a student reporter from *The Harvard Crimson* writing a story about her, "The one or two hours you spend procrastinating I spend working. It's nothing demanding at all. It was always my dream to run the company."

Her dedication paid off, and Apollonia retained control of important decisions, strategy, and business goals, describing herself as the "commander of the ship," determining the company's overall direction. Today, Poilâne is an $18 million business that employs 160 people. Poilâne runs three restaurants called Cuisine de Bar in Paris and in London, serving casual meals such as soups, salads, and open-faced *tartines*. The company ships more than 200,000 loaves a year to clients in 20 countries, including the United States, Japan, and Saudi Arabia. "More people understand what makes the quality of the bread, what my father spent years studying, so I am thrilled about that," says Apollonia.

Critical Thinking Questions

1. What type of entrepreneur is Apollonia Poilâne?
2. What personal ethics drove Apollonia's decision to take over the family business?

Sources: "About Us," https://www.poilane.com, accessed February 1, 2018; Meg Bortin, "Apollonia Poilâne Builds on Her Family's Legacy," *The New York Times,* https://www.nytimes.com, accessed February 1, 2018; Lauren Collins, "Bread Winner: A Daughter Upholds the Traditions of France's Premier Baking Dynasty," *The New Yorker,*https://www.newyorker.com, December 3, 2012; Gregory Katz, "Her Daily Bread," *American Way* magazine, July 15, 2005, p. 34; Clarel Antoine, "No Time to Loaf Around," *Harvard Crimson,* http://www.thecrimson.com, October 16, 2003.

Most entrepreneurs combine many of the above characteristics. Sarah Levy, 23, loved her job as a restaurant pastry chef but not the low pay, high stress, and long hours of a commercial kitchen. So she found a new one—in her parents' home—and launched Sarah's Pastries and Candies. Part-time staffers help her fill pastry and candy orders to the soothing sounds of music videos playing in the background. Cornell University graduate Conor McDonough started his own web design firm, OffThePathMedia.com, after becoming disillusioned with the rigid structure of his job. "There wasn't enough room for my own expression," he says. "Freelancing keeps me on my toes," says busy graphic artist Ana Sanchez. "It forces me to do my best work because I know my next job depends on my performance."[7]



Exhibit **5.3:** Celebrity Ashton Kutcher is more than just a pretty face. The actor-mogul is an active investor in technology-based start-ups such as Airbnb, Skype, and Foursquare with an empire estimated at $200 million dollars. *What personality traits are common to successful young entrepreneurs such as Kutcher?* (Credit: TechCrunch/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Managerial Ability and Technical Knowledge

A person with all the characteristics of an entrepreneur might still lack the necessary business skills to run a successful company. Entrepreneurs need the technical knowledge to carry out their ideas and the managerial ability to organize a company, develop operating strategies, obtain financing, and supervise day-to-day activities. Jim Crane, who built Eagle Global Logistics from a start-up into a $250 million company, addressed a group at a meeting saying, "I have never run a $250 million company before so you guys are going to have to start running this business."[8]

Good interpersonal and communication skills are important in dealing with employees, customers, and other business associates such as bankers, accountants, and attorneys. As we will discuss later in the chapter, entrepreneurs believe they can learn these much-needed skills. When Jim Steiner started his toner cartridge remanufacturing business, Quality Imaging Products, his initial investment was $400. He spent $200 on a consultant to teach him the business and $200 on materials to rebuild his first printer cartridges. He made sales calls from 8:00 a.m. to noon and made deliveries to customers from noon until 5:00 p.m. After a quick dinner, he moved to the garage, where he filled copier cartridges until midnight, when he collapsed into bed, sometimes covered with carbon soot. And this was not something he did for a couple of months until he got the business off the ground—this was his life for 18 months.[9] But entrepreneurs usually soon learn that they can't do it all themselves. Often they choose to focus on what they do best and hire others to do the rest.

CONCEPT CHECK

1. Describe the personality traits and skills characteristic of successful entrepreneurs.
2. What does it mean when we say that an entrepreneur should work on the business, not in it?

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4.4: Small Business- Driving America's Growth

How do small businesses contribute to the U.S. economy?

Although large corporations dominated the business scene for many decades, in recent years small businesses have once again come to the forefront. Downsizings that accompany economic downturns have caused many people to look toward smaller companies for employment, and they have plenty to choose from. Small businesses play an important role in the U.S. economy, representing about half of U.S. economic output, employing about half the private sector workforce, and giving individuals from all walks of life a chance to succeed.

What Is a Small Business?

How many small businesses are there in the United States? Estimates range from 5 million to over 22 million, depending on the size limits government agencies and other groups use to define a small business or the number of businesses with or without employees. The Small Business Administration (SBA) established size standards to define whether a business entity is small and therefore eligible for government programs and preferences that are reserved for "small businesses." Size standards are based on the types of economic activity or industry, generally matched to the North American Industry Classification System (NAICS).[10]

Small businesses are defined in many ways. Statistics for small businesses vary based on criteria such as new/start-up businesses, the number of employees, total revenue, length of time in business, nonemployees, businesses with employees, geographic location, and so on. Due to the complexity and need for consistent statistics and reporting for small businesses, several organizations are now working together to combine comprehensive data sources to get a clear and accurate picture of small businesses in the United States. Table 5.4 provides a more detailed look at small-business owners.

Table 5.4 Sources: "The Kauffman Index: Main Street Entrepreneurship: National Trends," http://www.kauffman.org, November 2016; "Kauffman Index of Startup Activity, 2016 (calculations based from CPS, BDS, and BED)," http://www.kauffman.org; "America's Entrepreneurs: September 2016," https://www.census.gov; "Nearly 1 in 10 Businesses with Employees Are New, According to Inaugural Annual Survey of Entrepreneurs," https://www.census.gov, September 1, 2016.

Snapshot of Small-Business Owners

- Start-up activity has risen sharply over the last three years, from an all-time low of minus 0.87% in 2013 to positive 0.48% in 2016.
- Between 1996 and 2011, the rate of business ownership dropped for both men and women; however, business ownership has increased every year since 2014.
- The Kauffman Index of Startup Activity, an early indicator of new entrepreneurship in the United States, rose again slightly in 2016 following sharp increases two years in a row.
- New entrepreneurs who started businesses to pursue opportunity rather than from necessity reached 86.3%, more than 12 percentage points higher than in 2009 at the height of the Great Recession.
- For the first time, Main Street entrepreneurship activity was higher in 2016 than before the onset of the Great Recession. This increase was driven by a jump in business survival rates, which reached a three-decade high of 48.7%. Nearly half of new businesses are making it to their fifth year of operation.
- 47% of U.S. businesses have been in business for 11 or more years.
- In 2016, about 25% of all employing firms had revenues over $1 million, but 2% had revenues under $10,000.

One of the best sources to track U.S. entrepreneurial growth activity is the Ewing Marion Kauffman Foundation. The Kauffman Foundation is among the largest private foundations in the country, with an asset base of approximately $2 billion, and focuses on projects that encourage entrepreneurship and support education through grants and research activities. They distributed over $17 million in grants in 2013.[11]

The Kauffman Foundation supports new business creation in the United States through two research programs. The annual Kauffman Index of Entrepreneurship series measures and interprets indicators of U.S. entrepreneurial activity at the national,

state, and metropolitan level. The foundation also contributes to the cost of the Annual Survey of Entrepreneurs (ASE), which is a public–private partnership between the foundation, the U.S. Census Bureau, and the Minority Business Development Agency. The ASE provides annual data on select economic and demographic characteristics of employer businesses and their owners by gender, ethnicity, race, and veteran status.[12] The Kauffman Index of Entrepreneurship series is an umbrella of annual reports that measures how people and businesses contribute to America's overall economy. What is unique about the Kauffman reports is that the indexes don't focus on only inputs (as most small-business reporting has been done in the past); it reports primarily on entrepreneurial outputs—the actual results of entrepreneurial activity, such as new companies, business density, and growth rates. The reports also include comprehensive, interactive data visualizations that enable users to slice and dice a myriad of data nationally, at the state level, and for the 40 largest metropolitan areas.[13]

The Kauffman Index series consists of three in-depth studies—Start-up Activity, Main Street Entrepreneurship, and Growth Entrepreneurship.

- The Kauffman Index of Startup Activity is an early indicator of new entrepreneurship in the United States. It focuses on new business creation activity and people engaging in business start-up activity, using three components: the rate of new entrepreneurs, the opportunity share of new entrepreneurs, and start-up density.
- The Kauffman Index of Main Street Entrepreneurship measures established small-business activity—focusing on U.S. businesses more than five years old with less than 50 employees from 1997 to 2016. Established in 2015, it takes into account three components of local, small-business activity: the rate of businesses owners in the economy, the five-year survival rate of businesses, and the established small-business density.
- The Kauffman Growth Entrepreneurship Index is a composite measure of entrepreneurial business growth in the United States that captures growth entrepreneurship in all industries and measures business growth from both revenue and job perspectives. Established in 2016, it includes three component measures of business growth: rate of start-up growth, share of scale-ups, and high-growth company density.

Data sources for the Kauffman Index calculations are based on Current Population Survey (CPS), with sample sizes of more than 900,000 observations, and the Business Dynamics Statistics (BDS), which covers approximately 5 million businesses. The Growth Entrepreneurship Index also includes *Inc.* 500/5000 data).

Small businesses in the United States can be found in almost every industry, including services, retail, construction, wholesale, manufacturing, finance and insurance, agriculture and mining, transportation, and warehousing. Established small businesses are defined as companies that have been in business at least five years and employ at least one, but less than 50, employees. Table 5.5 provides the number of employees by the size of established business. More than half of small businesses have between one and four employees.

Table 5.5: Number of Employees, by Percentage of Established Small Businesses. Established small businesses are defined as businesses over the age of five employing at least one, but less than 50, employees. Source: Kauffman Foundation calculations from Business Dynamics Statistics, yearly measures. November 2016.

Number of Employees	Percentage of Businesses
1–4 employees	53.07%
5–9 employees	23.23%
10–19 employees	14.36%
20–49 employees	9.33%

CONCEPT CHECK

1. What are three ways small businesses can be defined?
2. What social and economic factors have prompted the rise in small business?

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4.5: Ready, Set, Start Your Own Business

What are the first steps to take if you are starting your own business?

You have decided that you'd like to go into business for yourself. What is the best way to go about it? Start from scratch? Buy an existing business? Or buy a franchise? About 75 percent of business start-ups involve brand-new organizations, with the remaining 25 percent representing purchased companies or franchises. Franchising may have been discussed elsewhere in your course, so we'll cover the other two options in this section.

Getting Started

The first step in starting your own business is a self-assessment to determine whether you have the personal traits you need to succeed and, if so, what type of business would be best for you. Table 5.6 provides a checklist to consider before starting your business.

Finding the Idea

Entrepreneurs get ideas for their businesses from many sources. It is not surprising that about 80 percent of *Inc.* 500 executives got the idea for their company while working in the same or a related industry. Starting a firm in a field where you have experience improves your chances of success. Other sources of inspiration are personal experiences as a consumer; hobbies and personal interests; suggestions from customers, family, and friends; industry conferences; and college courses or other education.

Table 5.6: Checklist for Starting a Business Source: "10 Steps to Start Your Business," https://www.sba.gov, accessed February 2, 2018.

Before you start your own small business, consider the following checklist:
• Identify your reasons • Self-analysis • Personal skills and experience • Finding a niche • Conduct market research • Plan your start-up: write a business plan • Finances: how to fund your business

An excellent way to keep up with small-business trends is by reading entrepreneurship and small-business magazines and visiting their websites. With articles on everything from idea generation to selling a business, they provide an invaluable resource and profile some of the young entrepreneurs and their successful business ventures (Table 5.7).[14]

Table 5.7: Successful Entrepreneurs

Name and Age	Company and Description
Philip Kimmey, 27	Kimmey's dog-sitting and dog-walking network, Rover.com, raised almost $100 million in venture capital and was valued at $300 million in 2017.
Max Mankin, 27	Mankin cofounded Modern Electron and raised $10 million in venture capital to create "advanced thermionic energy converters" that will generate "cheap, scalable, and reliable electricity." Modern Electron will turn every home into a power station.
Alexandra Cristin White, 28	In her early 20s, White founded Glam Seamless, which sells tape-in hair extensions. In 2016, her self-funded company grossed $2.5 million.

Name and Age	Company and Description
Steph Korey, 29; Jen Rubio, 29	Korey and Rubio founded Away, selling “first-class luggage at a coach price” in 2015. They raised $31 million in funding and grossed $12 million in sales in 2016.
Allen Gannet, 26	Gannet founded TrackMaven, a web-marketing analytics company, in 2012; by 2016, his company was grossing $6.7 million a year.
Jake Kassan, 25; Kramer LaPlante, 25	Kassan and Kramer launched their company, MVMT, through Indiegogo, raising $300,000, and in 2016 grossed $60 million, selling primarily watches and sunglasses.
Brian Streem, 29	Streem’s company, Aerobo, provides drone services to the film industry, selling “professional aerial filming and drone cinematography.” Aerobo grossed $1 million in 2016, its first full year of business.
Natalya Bailey, 30; Louis Perna, 29	Accion Systems began in 2014, raised $10 million in venture funding, and grossed $4.5 million in 2016, making tiny propulsion systems for satellites.
Jessy Dover, 29	Dover is the cofounder of Dagne Dover, a company making storage-efficient handbags for professional women. She and her cofounders grossed $4.5 million in 2016 and debuted on Nordstrom.com in 2017.

These dynamic individuals, who are already so successful in their 20s and 30s, came up with unique ideas and concepts and found the right niche for their businesses.

Interesting ideas are all around you. Many successful businesses get started because someone identifies a need and then finds a way to fill it. Do you have a problem that you need to solve? Or a product that doesn’t work as well as you’d like? Raising questions about the way things are done and seeing opportunity in adversity are great ways to generate ideas.

Choosing a Form of Business Organization

A key decision for a person starting a new business is whether it will be a sole proprietorship, partnership, corporation, or limited liability company. As discussed earlier, each type of business organization has advantages and disadvantages. The choice depends on the type of business, number of employees, capital requirements, tax considerations, and level of risk involved.

Developing the Business Plan

Once you have the basic concept for a product or service, you must develop a plan to create the business. This planning process, culminating in a sound **business plan**, is one of the most important steps in starting a business. It can help to attract appropriate loan financing, minimize the risks involved, and be a critical determinant in whether a firm succeeds or fails. Many people do not venture out on their own because they are overwhelmed with doubts and concerns. A comprehensive business plan lets you run various “what if” analyses and evaluate your business without any financial outlay or risk. You can also develop strategies to overcome problems well before starting the business.

Taking the time to develop a good business plan pays off. A venture that seems sound at the idea stage may not look so good on paper. A well-prepared, comprehensive, written business plan forces entrepreneurs to take an objective and critical look at their business venture and analyze their concept carefully; make decisions about marketing, sales, operations, production, staffing, budgeting and financing; and set goals that will help them manage and monitor its growth and performance.



Exhibit 5.4: Each year, a variety of organizations hold business plan competitions to engage the growing number of college students starting their own businesses. The University of Essex and the iLearn entrepreneurship curriculum developed by the University of Texas in Austin, which partnered with Trisakti University in Jakarta, Indonesia, and the U.S. embassy to help run an entrepreneurship course and competition are examples of such competitions. Seven students from "iLearn: Entrepreneurship" were selected as finalists to pitch their business plans to a panel of Indonesian business leaders and embassy representatives. The winning business plan, which was an ecotourism concept, earned $1,000 in seed money. *What research goes into a winning business plan?* (Credit: University of Essex /flickr/ Attribution 2.0 Generic (CC BY 2.0))

The business plan also serves as the initial operating plan for the business. Writing a good business plan takes time. But many businesspeople neglect this critical planning tool in their eagerness to begin doing business, getting caught up in the day-to-day operations instead.

The key features of a business plan are a general description of the company, the qualifications of the owner(s), a description of the products or services, an analysis of the market (demand, customers, competition), sales and distribution channels, and a financial plan. The sections should work together to demonstrate why the business will be successful, while focusing on the uniqueness of the business and why it will attract customers. Table 5.8 describes the essential elements of a business plan.

A common use of a business plan is to persuade lenders and investors to finance the venture. The detailed information in the plan helps them assess whether to invest. Even though a business plan may take months to write, it must capture potential investors' interest within minutes. For that reason, the basic business plan should be written with a particular reader in mind. Then you can fine-tune and tailor it to fit the investment goals of the investor(s) you plan to approach.

Table 5.8 Sources: "7 Elements of a Business Plan," https://quickbooks.intuit.com, accessed February 2, 2018; David Ciccarelli, "Write a Winning Business Plan with These 8 Key Elements," Entrepreneur, https://www.entrepreneur.com, accessed February 2, 2018; Patrick Hull, "10 Essential Business Plan Components," Forbes, https://www.forbes.com, accessed February 2, 2018; Justin G. Longenecker, J. William Petty, Leslie E. Palich, and Frank Hoy, Small Business Management: Launching & Growing Entrepreneurial Ventures, 18th edition (Mason, OH: Cengage, 2017); Monique Reece, Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution (Upper Saddle River, NJ: FT Press/Pearson, 2010).

Key Elements of a Business Plan
Executive summary provides an overview of the total business plan. Written after the other sections are completed, it highlights significant points and, ideally, creates enough excitement to motivate the reader to continue reading.
Vision and mission statement concisely describe the intended strategy and business philosophy for making the vision happen. Company values can also be included in this section.
Company overview explains the type of company, such as manufacturing, retail, or service; provides background information on the company if it already exists; and describes the proposed form of organization—sole proprietorship, partnership, or corporation. This section should include company name and location, company objectives, nature and primary product or service of the business, current status (start-up, buyout, or expansion) and history (if applicable), and legal form of organization.

Key Elements of a Business Plan
Product and/or service plan describes the product and/or service and points out any unique features, as well as explains why people will buy the product or service. This section should offer the following descriptions: product and/or service; features and benefits of the product or service that provide a competitive advantage; available legal protection—patents, copyrights, and trademarks.
Marketing plan shows who the firm's customers will be and what type of competition it will face; outlines the marketing strategy and specifies the firm's competitive edge; and describes the strengths, weaknesses, opportunities, and threats of the business. This section should offer the following descriptions: analysis of target market and profile of target customer; methods of identifying, attracting, and retaining customers; a concise description of the value proposition; selling approach, type of sales force, and distribution channels; types of marketing and sales promotions, advertising, and projected marketing budget; product and/or service pricing strategy; and credit and pricing policies.
Management plan identifies the key players—active investors, management team, board members, and advisors— citing the experience and competence they possess. This section should offer the following descriptions: management team, outside investors and/or directors and their qualifications, outside resource people and their qualifications, and plans for recruiting and training employees.
Operating plan explains the type of manufacturing or operating system to be used and describes the facilities, labor, raw materials, and product-processing requirements. This section should offer the following descriptions: operating or manufacturing methods, operating facilities (location, space, and equipment), quality-control methods, procedures to control inventory and operations, sources of supply, and purchasing procedures.
Financial plan specifies financial needs and contemplated sources of financing, as well as presents projections of revenues, costs, and profits. This section should offer the following descriptions: historical financial statements for the last 3–5 years or as available; pro forma financial statements for 3–5 years, including income statements, balance sheets, cash flow statements, and cash budgets (monthly for first year and quarterly for second year); financial assumptions; breakeven analysis of profits and cash flows; and planned sources of financing.
Appendix of supporting documents provides materials supplementary to the plan. This section should offer the following descriptions: management team biographies; the company's values; information about the company culture (if it's unique and contributes to employee retention); and any other important data that support the information in the business plan, such as detailed competitive analysis, customer testimonials, and research summaries.

But don't think you can set aside your business plan once you obtain financing and begin operating your company. Entrepreneurs who think their business plan is only for raising money make a big mistake. Business plans should be dynamic documents, reviewed and updated on a regular basis—monthly, quarterly, or annually, depending on how the business progresses and the particular industry changes.

Owners should adjust their sales and profit projections up or down as they analyze their markets and operating results. Reviewing your plan on a constant basis will help you identify strengths and weaknesses in your marketing and management strategies and help you evaluate possible opportunities for expansion in light of both your original mission and goals, current market trends, and business results. The Small Business Administration (SBA) offers sample business plans and online guidance for business plan preparation under the "Business Guide" tab at https://www.sba.gov.

Financing the Business

Once the business plan is complete, the next step is to obtain financing to set up your company. The funding required depends on the type of business and the entrepreneur's own investment. Businesses started by lifestyle entrepreneurs require less financing than growth-oriented businesses, and manufacturing and high-tech companies generally require a large initial investment.

Who provides start-up funding for small companies? Like Miho Inagi and her Tokyo bagel shop, 94 percent of business owners raise start-up funds from personal accounts, family, and friends. Personal assets and money from family and friends are important for new firms, whereas funding from financial institutions may become more important as companies grow. Three-quarters of *Inc.* 500 companies have been funded on $100,000 or less.[15]

The two forms of business financing are **debt**, borrowed funds that must be repaid with interest over a stated time period, and **equity**, funds raised through the sale of stock (i.e., ownership) in the business. Those who provide equity funds get a share of the business's profits. Because lenders usually limit debt financing to no more than a quarter to a third of the firm's total needs,

equity financing often amounts to about 65 to 75 percent of total start-up financing.



Exhibit 5.5: FUBU started when a young entrepreneur from Hollis, Queens, began making tie-top skullcaps at home with some friends. With funding from a $100,000 mortgage and a later investment from the Samsung Corporation, CEO Daymond John, turned his home into a successful sportswear company. The FUBU brand tops the list for today's fashionistas who don everything from FUBU's classic Fat Albert line to swanky FUBU suits and tuxedos. *How do start-ups obtain funding?* (Credit: U.S. Embassy Nairobi/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

One way to finance a start-up company is bootstrapping, which is basically funding the operation with your own resources. If the resources needed are not available to an individual, there are other options. Two sources of equity financing for young companies are angel investors and venture-capital firms. **Angel investors** are individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own money, often referred to as "seed capital." This gives the investors more flexibility on what they can and will invest in, but because it is their own money, angels are careful. Angel investors often invest early in a company's development, and they want to see an idea they understand and can have confidence in. Table 5.9 offers some guidelines on how to attract angel financing.

Table 5.9 Sources: Guy Kawasaki, "The Art of Raising Angel Capital," https://guykawasaki.com, accessed February 2, 2018; Murray Newlands, "How to Raise an Angel Funding Round," Forbes, https://www.forbes.com, March 16, 2017; Melinda Emerson, "5 Tips for Attracting Angel Investors," Small Business Trends, https://smallbiztrends.com, July 26, 2016; Nicole Fallon, "5 Tips for Attracting Angel Investors," Business News Daily, https://www.businessnewsdaily.com, January 2, 2014; Stacy Zhao, "9 Tips for Winning over Angels," Inc., https://www.inc.com, June 15, 2005; Rhonda Abrams, "What Does It Take to Impress an Angel Investor?" Inc., https://www.inc.com, March 29, 2001.

Making a Heavenly Deal

You need financing for your start-up business. How do you get angels interested in investing in your business venture?

- Show them something they understand, ideally a business from an industry they've been associated with.
- Know your business details: Information important to potential investors includes annual sales, gross profit, profit margin, and expenses.
- Be able to describe your business—what it does and who it sells to—in less than a minute. Limit PowerPoint presentations to 10 slides.
- Angels can always leave their money in the bank, so an investment must interest them. It should be something they're passionate about. And timing is important—knowing when to reach out to an angel can make a huge difference.
- They need to see management they trust, respect, and like. Present a competent management team with a strong, experienced leader who can explain the business and answer questions from potential investors with specifics.
- Angels prefer something they can bring added value to. Those who invest could be involved with your company for a long time or perhaps take a seat on your board of directors.
- They are more partial to deals that don't require huge sums of money or additional infusions of angel cash.
- Emphasize the likely exits for investors and know who the competition is, why your solution is better, and how you are going to gain market share with an infusion of cash.

Venture capital is financing obtained from *venture capitalists,* investment firms that specialize in financing small, high-growth companies. Venture capitalists receive an ownership interest and a voice in management in return for their money. They typically invest at a later stage than angel investors. We'll discuss venture capital in greater detail when discussing financing the enterprise.

Buying a Small Business

Another route to small-business ownership is buying an existing business. Although this approach is less risky, many of the same steps for starting a business from scratch apply to buying an existing company. It still requires careful and thorough analysis. The potential buyer must answer several important questions: Why is the owner selling? Does he or she want to retire or move on to a new challenge, or are there problems with the business? Is the business operating at a profit? If not, can this be corrected? On what basis has the owner valued the company, and is it a fair price? What are the owner's plans after selling the company? Will he or she be available to provide assistance through the change of ownership of the business? And depending on the type of business it is, will customers be more loyal to the owner than to the product or service being offered? Customers could leave the firm if the current owner decides to open a similar business. To protect against this, many purchasers include a *noncompete clause* in the contract of sale, which generally means that the owner of the company being sold may not be allowed to compete in the same industry of the acquired business for a specific amount of time.

You should prepare a business plan that thoroughly analyzes all aspects of the business. Get answers to all your questions, and determine, via the business plan, whether the business is a sound one. Then you must negotiate the price and other terms of purchase and obtain appropriate financing. This can be a complicated process and may require the use of a consultant or business broker.

Risky Business

Running your own business may not be as easy as it sounds. Despite the many advantages of being your own boss, the risks are great as well. Over a period of five years, nearly 50% percent of small businesses fail according to the Kauffman Foundation.[16]

Businesses close down for many reasons—and not all are failures. Some businesses that close are financially successful and close for nonfinancial reasons. But the causes of business failure can be interrelated. For example, low sales and high expenses are often directly related to poor management. Some common causes of business closure are:

- Economic factors—business downturns and high interest rates
- Financial causes—inadequate capital, low cash balances, and high expenses
- Lack of experience—inadequate business knowledge, management experience, and technical expertise
- Personal reasons—the owners may decide to sell the business or move on to other opportunities

Inadequate early planning is often at the core of later business problems. As described earlier, a thorough feasibility analysis, from market assessment to financing, is critical to business success. Yet even with the best plans, business conditions change and unexpected challenges arise. An entrepreneur may start a company based on a terrific new product only to find that a larger firm with more marketing, financing, and distribution clout introduces a similar item.

The stress of managing a business can also take its toll. The business can consume your whole life. Owners may find themselves in over their heads and unable to cope with the pressures of business operations, from the long hours to being the main decision maker. Even successful businesses have to deal with ongoing challenges. Growing too quickly can cause as many problems as sluggish sales. Growth can strain a company's finances when additional capital is required to fund expanding operations, from hiring additional staff to purchasing more raw material or equipment. Successful business owners must respond quickly and develop plans to manage its growth.

So, how do you know when it is time to quit? "Never give up" may be a good motivational catchphrase, but it is not always good advice for a small-business owner. Yet, some small-business owners keep going no matter what the cost. For example, Ian White's company was trying to market a new kind of city map. White maxed out 11 credit cards and ran up more than $100,000 in debt after starting his company. He ultimately declared personal bankruptcy and was forced to find a job so that he could pay his bills. Maria Martz didn't realize her small business would become a casualty until she saw her tax return showing her company's losses in black and white—for the second year in a row. It convinced her that enough was enough and she gave up her gift-basket business to become a full-time homemaker. But once the decision is made, it may be tough to stick to. "I got calls from people asking how come I wasn't in business anymore. It was tempting to say I'd make their basket but I had to tell myself it is finished now."[17]

CONCEPT CHECK

1. How can potential business owners find new business ideas?
2. Why is it important to develop a business plan? What should such a plan include?
3. What financing options do small-business owners have? What risks do they face?

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4.6: Managing a Small Business

Why does managing a small business present special challenges for the owner?

Managing a small business is quite a challenge. Whether you start a business from scratch or buy an existing one, you must be able to keep it going. The small-business owner must be ready to solve problems as they arise and move quickly if market conditions change.

MANAGING CHANGE

Learning How to Pivot

Most small business owners either use, or at least know of, the iconic email service MailChimp, a company that is growing by more than $120 million every year and is on track to bring in $525 million over the coming year. But Ben Chestnut, the CEO and cofounder, says it took MailChimp several years to figure out what it did well.

When Chestnut was laid off from his job at the Cox Media Group in Atlanta, he founded Rocket Science Group, a web design firm. Cofounder Dan Kurzius (who taught himself to code) joined Chestnut, and they began to focus their sales efforts on tech companies. But when the tech bubble burst, they pivoted to focus on selling to airline and travel companies. Then 9/11 hit, and they needed to change focus again, this time on the real estate market. However, both Chestnut and Kurzius discovered they didn't enjoy sales (and they weren't very good at it), nor did they like the bureaucracy of working with large companies. "The only companies we could relate to were small businesses, and they always asked for email marketing."

This insight helped Chestnut to recall a product feature the Rocket Science Group had previously developed for an email greeting card project. So Chestnut and Kurzius evaluated the marketing software and began to test it with small businesses. "Our day jobs felt like going to these big organizations and pitching to them, and it was miserable," Chestnut says. "But we really loved our nighttime jobs, which were helping the small businesses use this email marketing app." Their passion, along with market feedback, led to their decision to completely focus on email marketing for small businesses. But it wasn't until almost 2009 that MailChimp found its sweet spot. The founders initially wanted to give away one product that collected subscribers and then charge for another, which was sending emails, but it would have been very difficult to divide the product into two pieces. That's when they landed on the Freemium idea. "Let's just make the whole thing free," said Chestnut.

The idea was that if they made it cheap and easy for small businesses to try MailChimp, their business would grow and they would be happy to pay for MailChimp services. MailChimp allows customers to send an email for free to 1,999 people at once but charges for emails sent to over 2,000 people and for premium features. MailChimp charges a monthly recurring fee starting at $10 for sending more than 12,000 emails a month.

The idea quickly proved to be a huge success. MailChimp went from a few hundred thousand users to 1 million users in a year. The next year they added another million users.

The MailChimp founders learned a lot of lessons during their 17 years in business. One of their most important lessons is knowing when to change. When you see an opportunity, don't be afraid to pivot and change course, especially if it means focusing on a market you're passionate about. Listening to market feedback and following their passion earned MailChimp's founders \recognition as "2017 Business of the Year" by *Inc.* magazine.

Critical Thinking Questions 4.6.1

1. What led MailChimp's founders to change its focus on the customers they were selling to?
2. What was MailChimp's "big idea" that changed the business, and why was it so successful?

Sources: Maria Aspan, "Want Proof That Patience Pays Off? Ask the Founders of This 17-Year-Old $525 Million Email Empire,"

Inc., https://www.inc.com, Winter 2017/January 2018 issue; "MailChimp: From Startup to Inc. Magazine's Top Company," *CNBC,* https://www.cnbc.com, December 12, 2017; Farhad Manjoo, "MailChimp and the Un-Silicon Valley Way to Make It as a Start-Up," *The New York Times,* https://www.nytimes.com, October 5, 2016.

A sound business plan is key to keeping the small-business owner in touch with all areas of his or her business. Hiring, training, and managing employees is another important responsibility because the owner's role may change over time. As the company grows, others will make many of the day-to-day decisions while the owner focuses on managing employees and planning for the firm's long-term success. The owner must constantly evaluate company performance and policies in light of changing market and economic conditions and develop new policies as required. He or she must also nurture a continual flow of ideas to keep the business growing. The types of employees needed may change too as the firm grows. For instance, a larger firm may need more managerial talent and technical expertise.

Using Outside Consultants

One way to ease the burden of managing a business is to hire outside consultants. Nearly all small businesses need a good certified public accountant (CPA) who can help with financial record keeping, decision-making, and tax planning. An accountant who works closely with the owner to help the business grow is a valuable asset. An attorney who knows about small-business law can provide legal advice and draw up essential contracts and documents. Consultants in areas such as marketing, employee benefits, and insurance can be used on an as-needed basis. Outside directors with business experience are another way for small companies to get advice. Resources such as these free the small-business owner to concentrate on medium- and long-range planning and day-to-day operations.

Some aspects of business can be outsourced or contracted out to specialists. Among the more common departments that use outsourcing are information technology, marketing, customer service, order fulfillment, payroll, and human resources. Hiring an outside company—in many cases another small business—can save money because the purchasing firm buys just the services it needs and makes no investment in expensive technology. Management should review outsourced functions as the business grows because at some point it may be more cost-effective to bring them in-house.

Hiring and Retaining Employees

It is important to identify all the costs involved in hiring an employee to make sure your business can afford it. Recruiting, help-wanted ads, extra space, and taxes will easily add about 10–15 percent to their salary, and employee benefits will add even more. Hiring an employee may also mean more work for you in terms of training and management. It's a catch-22: To grow you need to hire more people, but making the shift from solo worker to boss can be stressful.

Attracting good employees is more difficult for a small firm, which may not be able to match the higher salaries, better benefits, and advancement potential offered by larger firms. Small companies need to be creative to attract the right employees and convince applicants to join their firm. Once they hire an employee, small-business owners must make employee satisfaction a top priority in order to retain good people. A company culture that nurtures a comfortable environment for workers, flexible hours, employee benefit programs, opportunities to help make decisions, and a share in profits and ownership are some ways to do this.

Duane Ruh figured out how to build a $1.2 million business in a town with just 650 residents. It's all about treating employees right. The log birdhouse and bird feeder manufacturer, Little Log Co., located in Sargent, Nebraska, boasts employee-friendly policies you read about but rarely see put into practice. Ruh offers his employees a flexible schedule that gives them plenty of time for their personal lives. During a slow period last summer, Ruh cut back on hours rather than lay anyone off. There just aren't that many jobs in that part of Nebraska that his employees could go to, so when he received a buyout offer that would have closed his facility but kept him in place with an enviable salary, he turned it down. Ruh also encourages his employees to pursue side or summer jobs if they need to make extra money, assuring them that their Little Log jobs are safe.[18]

Going Global with Exporting

More and more small businesses are discovering the benefits of looking beyond the United States for market opportunities. The global marketplace represents a huge opportunity for U.S. businesses, both large and small. Small businesses' decision to export is driven by many factors, one of which is the desire for increased sales and higher profits. U.S. goods are less expensive for overseas buyers when the value of the U.S. dollar declines against foreign currencies, and this creates opportunities for U.S. companies to sell globally. In addition, economic conditions such as a domestic recession, foreign competition within the United

States, or new markets opening up in foreign countries may also encourage U.S. companies to export.

Like any major business decision, exporting requires careful planning. Small businesses may hire international-trade consultants or distributors to get started selling overseas. These specialists have the time, knowledge, and resources that most small businesses lack. Export trading companies (ETCs) buy goods at a discount from small businesses and resell them abroad. Export management companies (EMCs) act on a company's behalf. For fees of 5–15 percent of gross sales and multiyear contracts, they handle all aspects of exporting, including finding customers, billing, shipping, and helping the company comply with foreign regulations.

Many online resources are also available to identify potential markets for your goods and services, as well as to decipher the complexities involved in preparing to sell in a foreign country. The Small Business Association's Office of International Trade has links to many valuable sites. The Department of Commerce offers services for small businesses that want to sell abroad. Contact its Trade Information Center, 1-800-USA-TRADE, or its Export Center (**http://www.export.gov**).

CONCEPT CHECK

1. How does the small-business owner's role change over time?
2. How does managing a small business contribute to its growth?
3. What are the benefits to small firms of doing business internationally, and what steps can small businesses take to explore their options?

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4.7: Small Business, Large Impact

What are the advantages and disadvantages facing owners of small businesses?

An uncertain economy has not stopped people from starting new companies. The National Federation of Independent Businessesreports that 85 percent of Americans view small businesses as a positive influence on American life. This is not surprising when you consider the many reasons why small businesses continue to thrive in the United States:

- *Independence and a better lifestyle:* Large corporations no longer represent job security or offer the fast-track career opportunities they once did. Mid-career employees leave the corporate world—either voluntarily or as a result of downsizing—in search of the new opportunities that self-employment provides. Many new college and business school graduates shun the corporate world altogether to start their own companies or look for work in smaller firms.
- *Personal satisfaction from work:* Many small-business owners cite this as one of the primary reasons for starting their companies. They love what they do.
- *Best route to success:* Business ownership provides greater advancement opportunities for women and minorities, as we will discuss later in this chapter. It also offers small-business owners the potential for profit.
- *Rapidly changing technology:* Technology advances and decreased costs provide individuals and small companies with the power to compete in industries that were formerly closed to them.
- *Major corporate restructuring and downsizing:* These force many employees to look for other jobs or careers. They may also provide the opportunity to buy a business unit that a company no longer wants.
- *Outsourcing:* As a result of downsizing, corporations may contract with outside firms for services they used to provide in-house. Outsourcing creates opportunities for smaller companies that offer these specialized goods and services.
- *Small businesses are resilient:* They are able to respond fairly quickly to changing economic conditions by refocusing their operations.

There are several cities and regions that are regarded as the best locations for start-up businesses and entrepreneurs. Among them are Tulsa, Oklahoma; Tampa, Florida; Atlanta, Georgia; Raleigh, North Carolina; Oklahoma City, Oklahoma; Seattle, Washington; Minneapolis, Minnesota; and Austin, Texas.[19]

Why Stay Small?

Owners of small businesses recognize that being small offers special advantages. Greater flexibility and an uncomplicated company structure allow small businesses to react more quickly to changing market forces. Innovative product ideas can be developed and brought to market more quickly, using fewer financial resources and personnel than would be needed in a larger company. And operating more efficiently keeps costs down as well. Small companies can also serve specialized markets that may not be cost-effective for large companies. Another feature is the opportunity to provide a higher level of personal service. Such attention brings many customers back to small businesses such as gourmet restaurants, health clubs, spas, fashion boutiques, and travel agencies.

Steve Niewulis played in baseball's minor leagues before an injury to his rotator cuff cut short his career. Niewulis decided to combine his love of the game with a clever idea that has elevated him to the big leagues. The fact that players had trouble keeping their hands dry while batting inspired his big idea: a sweat-busting rosin bag attached to a wristband so that a player can dry the bat handle between pitches. In less than two years, Niewulis's Fort Lauderdale, Florida, company, Tap It! Inc., sold thousands of Just Tap It! wristbands. The product, which retails for $12.95, is used by baseball players, basketball players, tennis players, golfers, and even rock climbers. His secret to success? Find a small distribution network that allows small companies, with just one product line, to succeed.[20]

On the other hand, being small is not always an asset. The founders may have limited managerial skills or encounter difficulties obtaining adequate financing, potential obstacles to growing a company. Complying with federal regulations is also more expensive for small firms. Those with fewer than 20 employees spend about twice as much per employee on compliance than do larger firms. In addition, starting and managing a small business requires a major commitment by the owner. Long hours, the need for owners to do much of the work themselves, and the stress of being personally responsible for the success of the

business can take a toll.

But managing your company's growing pains doesn't need to be a one-person job. Four years after he started DrinkWorks (now Whirley DrinkWorks), a company that makes custom drinking cups, Richard Humphrey was logging 100-hour weeks. "I was concerned that if I wasn't there every minute, the company would fall apart." Humphrey got sick, lost weight, and had his engagement fall apart. When forced by a family emergency to leave the company in the hands of his five employees, Humphrey was amazed at how well they managed in his absence. "They stepped up to the plate and it worked out," he says. "After that the whole company balanced out."[21]

CONCEPT CHECK 4.7.1

1. Why are small businesses becoming so popular?
2. Discuss the major advantages and disadvantages of small businesses.

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4.8: The Small Business Administration

How does the Small Business Administration help small businesses?

Many small-business owners turn to the **Small Business Administration (SBA)** for assistance. The SBA's mission is to speak on behalf of small business, and through its national network of local offices it helps people start and manage small businesses, advises them in the areas of finance and management, and helps them win federal contracts. Its toll-free number—1-800-U-ASK-SBA (1-800-827-5722)—provides general information, and its website at **http://www.sba.gov** offers details on all its programs.[22]

Financial Assistance Programs

The SBA offers financial assistance to qualified small businesses that cannot obtain financing on reasonable terms through normal lending channels. This assistance takes the form of guarantees on loans made by private lenders. (The SBA no longer provides direct loans.) These loans can be used for most business purposes, including purchasing real estate, equipment, and materials. The SBA has been responsible for a significant amount of small-business financing in the United States. In the fiscal year ending on September 30, 2017, the SBA backed more than $25 billion in loans to almost 68,000 small businesses, including about $9 billion to minority-owned firms and $7.5 billion in loans to businesses owned by women. It also provided more than $1.7 billion in home and business disaster loans.[23]

Other SBA programs include the New Markets Venture Capital Program, which promotes economic development and job opportunities in low-income geographic areas, while other programs offer export financing and assistance to firms that suffer economic harm after natural or other disasters.

More than 300 SBA-licensed **Small Business Investment Companies (SBICs)** provide about $6 billion each year in long-term financing for small businesses. The SBA's website suggests seeking angel investors and using SBA-guaranteed loans as a way to fund the start-up. These privately owned and managed investment companies hope to earn a substantial return on their investments as the small businesses grow.

SCORE-ing with Management Assistance Programs

The SBA also provides a wide range of management advice. Its Business Development Library has publications on most business topics. Its "Starting Out" series offers brochures on how to start a wide variety of businesses—from ice-cream stores to fish farms.

Business development officers at the Office of Business Development and local Small Business Development Centers counsel many thousands of small-business owners each year, offering advice, training, and educational programs. The SBA also offers free management consulting through two volunteer groups: the Service Corps of Retired Executives (SCORE), and the Active Corps of Executives (ACE). Executives in these programs use their own business backgrounds to help small-business owners. SCORE has expanded its outreach into new markets by offering email counseling through its website (**http://www.score.org**). The SBA also offers free online resources and courses for small-business owners and aspiring entrepreneurs in its Learning Center, located on the SBA website under the "Learning Center" tab.

Assistance for Women and Minorities

The SBA is committed to helping women and minorities increase their business participation. It offers a minority small-business program, microloans, and the publication of Spanish-language informational materials. It has increased its responsiveness to small businesses by giving regional offices more decision authority and creating high-tech tools for grants, loan transactions, and eligibility reviews.

The SBA offers special programs and support services for socially and economically disadvantaged persons, including women, Native Americans, and Hispanics through its Minority Business Development Agency. It also makes a special effort to help veterans go into business for themselves.

CONCEPT CHECK

1. What is the Small Business Administration (SBA)?
2. Describe the financial and management assistance programs offered by the SBA.

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4.9: Trends in Entrepreneurship and Small-Business Ownership

What trends are shaping entrepreneurship and small-business ownership?

Entrepreneurship has changed since the heady days of the late 1990s, when starting a dot-com while still in college seemed a quick route to riches and stock options. Much entrepreneurial opportunity comes from major changes in demographics, society, and technology, and at present there is a confluence of all three. A major demographic group is moving into a significantly different stage in life, and minorities are increasing their business ownership in remarkable numbers. We have created a society in which we expect to have our problems taken care of, and the technological revolution stands ready with already-developed solutions. Evolving social and demographic trends, combined with the challenge of operating in a fast-paced technology-dominated business climate, are changing the face of entrepreneurship and small-business ownership.

Into the Future: Start-ups Drive the Economy

Did new business ventures drive the economic recovery from the 2001–2002 and 2007–2009 to recessions, and are they continuing to make significant contributions to the U.S. economy? The economists who review Department of Labor employment surveys and SBA statistics think so. “Small business drives the American economy,” says Dr. Chad Moutray, former chief economist for the SBA’s Office of Advocacy. “Main Street provides the jobs and spurs our economic growth. American entrepreneurs are creative and productive.” Numbers alone do not tell the whole story, however. Are these newly self-employed workers profiting from their ventures, or are they just biding their time during a period of unemployment?

U.S. small businesses employed 57.9 million people in 2016, representing nearly 48 percent of the workforce. The number of net new jobs added to the economy was 1.4 million.[24]

The highest rate of growth is coming from women-owned firms, which continues to rise at rates higher than the national average—and with even stronger growth rates since the recession. There were an estimated 11.6 million women-owned businesses employing nearly 9 million people in 2016, generating more than $1.7 trillion in revenue.[25]

Between 2007 and 2017, women-owned firms increased by 114 percent, compared to a 44 percent increase among all businesses. This means that growth rates for women-owned businesses are 2.5 times faster than the national average. Employment growth was also stronger than national rates. Women-owned businesses increased 27 percent over the past 20 years, while overall business employment has increased by 13 percent since 2007.[26]

These trends show that more workers are striking out on their own and earning money doing it. It has become very clear that encouraging small-business activity leads to continued strong overall economic growth.

Changing Demographics Create Entrepreneurial Diversity

The mantra, “60 is the new 40,” describes today’s Baby Boomers who indulge in much less knitting and golf in their retirement years. The AARP predicts that silver-haired entrepreneurs will continue to rise in the coming years. According to a recent study by the Kauffman Foundation, Baby Boomers are twice as likely as Millennials to start a new business. In fact, close to 25 percent of all new entrepreneurs fall between the ages of 55 and 64.[27] This has created a ripple effect in the way we work. Boomers have accelerated the growing acceptance of working from home, adding to the millions of U.S. workers already showing up to work in their slippers. In addition, the ongoing corporate brain drain could mean that small businesses will be able to tap into the expertise of seasoned free agents at less-than-corporate prices—and that seniors themselves will become independent consultants to businesses of all sizes.[28]

The growing numbers of Baby Boomer entrepreneurs has prompted some forward-thinking companies to recognize business opportunities in technology. At one time there was a concern that the aging of the population would create a drag on the economy.

Conventional wisdom says that the early parenthood years are the big spending years. As we age, we spend less and, because Boomers are such a big demographic group, this was going to create a long-term economic decline. Not true, it now appears. The Boomer generation has built sizable wealth, and they are not afraid to spend it to make their lives more comfortable.

Minorities are also adding to the entrepreneurial mix. As we saw in **Table 5.3**, minority groups and women are increasing business ownership at a much faster rate than the national average, reflecting their confidence in the U.S. economy. These overwhelming increases in minority business ownership paralleled the demand for U.S. Small Business Administration loan products. Loans to minority business owners in fiscal year 2017 set a record—more than $9.5 billion, or 31 percent, of SBA's total loan portfolio.[29]

The latest Kauffman Foundation Index of Startup Activity found that immigrants and Latinos have swelled the growing numbers of self-employed Americans in recent years, increasing the diversity of the country's entrepreneurial class. Overall, minority-owned businesses increased 38 percent. The SBA notes that the number of Hispanic-owned businesses has increased more than 46 percent between 2007 and 2012.[30]



Exhibit 5.6: The popularity of home businesses such as Rodan+Fields, eBay, and other e-commerce sites has given rise to a new kind of entrepreneur: the "mompreneur." Typically ex-corporate professionals, these web-driven women launch home businesses specializing in the sale of antiques, jewelry, thrift-store fashions, and other items. Aided by digital photography, wireless technology, and friendly postal workers, these savvy moms are one of the fastest-growing segments of entrepreneurs building successful businesses on the web. *Why are many professional women leaving the workplace to start entrepreneurial ventures online?* (Credit: Amanda nobles/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

How Far Will You Go to Get Rich?

With enough intelligence and determination, people can get rich almost anywhere in the United States. Whether you own chains of dry cleaners in Queens, car dealerships in Chicago, or oil wells in West Texas, fortunes have been made in every state in the Union. There are some places, however, where the chances of creating wealth are much greater than others. That is the reason why people who hope to strike it rich move to places such as Manhattan or Palo Alto. It's not because the cost of living is low or the quality of life as a struggling entrepreneur is fun. Whether starting a software or soft-drink company, entrepreneurs tend to follow the money

But not all companies follow the herd. Guild Education, founded in 2015 by Rachel Carlson and Brittany Stich at Stanford University, left San Francisco due to the high cost of living that could slow down the company's growth. "We have a lot of women who are executives and department heads here, starting with myself and my cofounder," CEO Rachel Carlson said. "So when we left, we deliberately chose a place where you can have a family."[31] Guild Education's mission is to help large employers offer college education and tuition reimbursement as a benefit to the 64 million working-age adults who lack a college degree.

Since moving to Denver, Guild Education has raised another $21 million in venture capital, bringing the total funding to $31.5 million with a company valuation of $125 million.[32] The company headquarters in Denver is next door to a Montessori school

and employs 58 employees. “We were joking that we’re the polar opposite of Apple,” said Carlson. “Remember when the new ‘mothership’ came out? Every single parent noticed that it had a huge gym but not a day care.”

According to PwC’s quarterly venture capital study, “MoneyTree Report,” the top regions in the United States for venture-backed deals in the third quarter of 2017 were San Francisco ($4.1 billion), New York Metro ($4.2 billion), Silicon Valley (Bay Area $2.2 billion), and New England ($1.8 billion). [33]

In 2017, equity financing in U.S. start-ups rose for the third straight quarter, reaching $19 billion, according to the PwC/CB Insights “MoneyTree Report Q3 2017.” “Financing was boosted by a large number of mega-rounds,” says Tom Ciccolella, Partner, U.S. Ventures Leader at PwC.[34] Twenty-six mega-rounds of $100 million in companies such as WeWork, 23andMe, Fanatics, and NAUTO contributed to the strong activity levels in the first three quarters of 2017. The top five U.S. industry sectors with the most deals and funding were Internet, Healthcare, Mobile and Telecommunications, Software (Non-Internet/Mobile), and Consumer Products.

CONCEPT CHECK

1. What significant trends are occurring in the small-business arena?
2. How is entrepreneurial diversity impacting small business and the economy?
3. How do ethics impact decision-making with small-business owners?

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5: FORMS OF BUSINESS OWNERSHIP

5.1: Introduction

5.2: Going It Alone- Sole Proprietorships

5.3: Partnerships- Sharing the Load

5.4: Corporations- Limiting Your Liability

5.5: Specialized Forms of Business Organization

5.6: Franchising- A Popular Trend

5.7: Mergers and Acquisitions

5.8: Trends in Business Ownership

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5.1: Introduction



Exhibit 4.1: (Credit: pxhere / Attribution CC0 Public Domain)

EXPLORING BUSINESS CAREERS

Jessica MacLean

Sole Proprietor In most any elementary school classroom, at least one child's answer to the question, "What do you want to do with your life?" will be, "A lawyer." One of the most popular careers, lawyers are powerful figures in society, shaping our laws and ensuring that we adhere to them. Their prominence and power have led to the stereotype of rich, career-driven lawyers, often leaving no room in our minds for those who truly want to bring justice to the world. However, Jessica MacLean, a lawyer focusing primarily on women's rights, is quick to say that, as with many stereotypes, that is only one side of the story. "I know because I lived that—I was on my way to being a successful corporate lawyer. But I realized what I was doing and how different that was from why I'd started practicing. So I walked away from it all to start my own practice."

Nervous about the prospect of private practice, she has chosen to operate as a sole proprietorship for now. Sole proprietorships are easy to set up for people who want to work on their own, prefer direct control of the business, and desire the flexibility to sell the business or close the doors at any time. "For me, it's the best choice because I am not responsible for or to anyone else. I can easily dissolve the business if I find it is not proceeding how I'd planned. More positively, too, if it does succeed, I know that success is due to my hard work.

Indeed MacLean's law career was not always in corporate law. She turned her sights toward law after a gender and communications professor at DePaul University suggested her argumentative style might be an asset in that profession. "She said I needed to tone it down for class—that the other students seemed afraid to speak up—but then asked if I'd ever considered being a lawyer." MacLean, who had always been interested in issues of justice and legality surrounding women, took her professor's advice and made the leap into law.

While in law school, she clerked for the city of Chicago in their department of personnel's sexual harassment office and volunteered for the Cook County state's attorney's office in the domestic violence division. The cases she worked on were emotionally trying. Despite the difficulty of the cases, she was drawn to them, compelled by the people she helped and the change she was able to effect. After school, she continued in related practice, working first for the Cook County state's attorney's office.

After several years with the state's attorney's office, she needed a change. It was then that MacLean decided to work for a corporation, a form of business that you will learn about in this chapter. "Why did I switch to corporate law? I think I was burnt out, to some extent. It's so hard to work on those cases, day after day. I needed to see if I would be better somewhere else."

Having enjoyed the rewards of working with the state's attorney's office and a corporation and being a sole proprietor, in 2014 MacLean joined a limited liability partnership (LLP, a form of business that you will learn about in this chapter) firm in Chicago. As her needs changed, the form and type of business organization she has worked for has changed also.

This chapter discusses sole proprietorships, as well as several other forms of business ownership, including partnerships and corporations, and compares the advantages and disadvantages of each.

With a good idea and some cash in hand, you decide to start a business. But before you get going, you need to ask yourself some questions that will help you decide what form of business organization will best suit your needs.

Would you prefer to go it alone as a *sole proprietorship,* or do you want others to share your burdens and challenges in a *partnership*? Or would the limited liability protection of a *corporation,* or perhaps the flexibility of a *limited liability company (LLC),* make more sense?

There are other questions you need to consider too: Will you need financing? How easy will it be to obtain? Will you attract employees? How will the business be taxed, and who will be liable for the company's debts? If you choose to share ownership with others, how much operating control would they want, and what costs would be associated with that?

As **Table 4.1** illustrates, sole proprietorships are the most popular form of business ownership, accounting for 72 percent of all businesses, compared with 10 percent for partnerships and 18 percent for corporations. Because most sole proprietorships and partnerships remain small, corporations generate approximately 81 percent of total business revenues and 58 percent of total profits.

Most start-up businesses select one of these major ownership forms. In the following pages, we will discover the advantages and disadvantages of each form of business ownership and the factors that may make it necessary to change from one form of organization to another as the needs of the business change. As a company expands from small to midsize or larger, the form of business structure selected in the beginning may no longer be appropriate.

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5.2: Going It Alone- Sole Proprietorships

What are the advantages and disadvantages of the sole proprietorship form of business organization?

Jeremy Shepherd was working full-time for an airline when, at the age of 22, he wandered into an exotic pearl market in China, searching for a gift for his girlfriend. The strand of pearls he handpicked by instinct was later valued by a jeweler back in the States at 20 times what he paid for it. Jeremy cashed his next paycheck and hurried back to Asia, buying every pearl he could afford. Founded in 1996, his company Pearl Paradise was brought online in 2000. Shepherd chose the **sole proprietorship** form of business organization—a business that is established, owned, operated, and often financed by one person—because it was the easiest to set up. He did not want partners, and low liability exposure made incorporating unnecessary.

Fluent in Mandarin Chinese, Japanese, and Spanish and immersed in Asian culture, Shepherd believed the internet was the way to market his pearls (**http://www.pearlparadise.com**). Offering a wide range of pearl jewelry through 14 websites worldwide, his company sells as many as 1,000 items per day. The recent addition of an exclusive Los Angeles showroom allows celebrity customers to shop by appointment. With $20 million in sales annually, PearlParadise.com is the industry leader in terms of sales and volume.[1]

Table 4.1: Comparison of Forms of Business Organization

Form	Number	Sales	Profits
Sole Proprietorships	72 percent	4 percent	15 percent
Partnerships	10 percent	15 percent	27 percent
Corporations	18 percent	81 percent	58 percent

Source: Internal Revenue Service, as reported in Table 746, U.S. Bureau of the Census, *Statistical Abstract of the United States, 2012,* 131st ed. (Washington, DC: U.S. Government Printing Office, 2012), p. 492. Note: US Bureau of Census stopped collecting and publishing this data after 2012.

Advantages of Sole Proprietorships

Sole proprietorships have several advantages that make them popular:

- *Easy and inexpensive to form*. As Jeremy Shepherd discovered, sole proprietorships have few legal requirements (local licenses and permits) and are not expensive to form, making them the business organization of choice for many small companies and start-ups.
- *Profits all go to the owner*. The owner of a sole proprietorship obtains the start-up funds and gets all the profits earned by the business. The more efficiently the firm operates, the higher the company's profitability.
- *Direct control of the business*. All business decisions are made by the sole proprietorship owner without having to consult anyone else.
- *Freedom from government regulation*. Sole proprietorships have more freedom than other forms of business with respect to government controls.
- *No special taxation*. Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.
- *Ease of dissolution*. With no co-owners or partners, the sole proprietor can sell the business or close the doors at any time, making this form of business organization an ideal way to test a new business idea.

Disadvantages of Sole Proprietorships

Along with the freedom to operate the business as they wish, sole proprietors face several disadvantages:

- *Unlimited liability*. From a legal standpoint, the sole proprietor and the company are one and the same, making the business owner personally responsible for all debts the company incurs, even if they exceed the company's value. The owner may need to sell other personal property—their car, home, or other investments—to satisfy claims against the business.
- *Difficulty raising capital*. Business assets are unprotected against claims of personal creditors, so business lenders view sole proprietorships as high risk due to the owner's unlimited liability. Owners must often use personal funds—borrowing on credit cards, second-mortgaging their homes, or selling investments—to finance their business. Expansion plans can also be affected by an inability to raise additional funding.
- *Limited managerial expertise*. The success of a sole proprietorship rests solely with the skills and talents of the owner, who must wear many different hats and make all decisions. Owners are often not equally skilled in all areas of running a business. A graphic designer may be a wonderful artist but not know bookkeeping, how to manage production, or how to market their work.
- *Trouble finding qualified employees*. Sole proprietors often cannot offer the same pay, fringe benefits, and advancement as larger companies, making them less attractive to employees seeking the most favorable employment opportunities.
- *Personal time commitment*. Running a sole proprietorship business requires personal sacrifices and a huge time commitment, often dominating the owner's life with 12-hour workdays and 7-day workweeks.
- *Unstable business life*. The life span of a sole proprietorship can be uncertain. The owner may lose interest, experience ill health, retire, or die. The business will cease to exist unless the owner makes provisions for it to continue operating or puts it up for sale.
- *Losses are the owner's responsibility*. The sole proprietor is responsible for all losses, although tax laws allow these to be deducted from other personal income.

The sole proprietorship may be a suitable choice for a one-person start-up operation with no employees and little risk of liability exposure. For many sole proprietors, however, this is a temporary choice, and as the business grows, the owner may be unable to operate with limited financial and managerial resources. At this point, the owner may decide to take in one or more partners to ensure that the business continues to flourish.

CATCHING THE ENTREPRENEURIAL SPIRIT

Work-Life Balance Important in Small Business

According to a survey released by the Wells Fargo/Gallup Small Business Index, about two-thirds of small business owners are satisfied with how they balance their personal lives and work schedules, and the New York Enterprise Report survey found that they work twice as much as regular employees. The survey also found that 33 percent of small business owners work more than 50 hours per week, while 25 percent reported working over 60 hours per week. A survey by Gallup finds 39 percent of small business owners working over 60 hours per week.

The 2016 Annual Bank of the West Small Business Growth Survey found that 62 percent of the respondents reported the stress of ownership as worse than what they had originally imagined. At the same time, the same people indicated that being a small business owner puts them in charge of their destiny, offers freedom, and is more rewarding than ever imagined. Over two-thirds of small business owners, according to a survey, said they were satisfied with their personal work-life balance, and almost 90 percent said they were satisfied with being a small business owner in general. Dennis Jacobe, chief economist at Gallup, argues, "People see the benefits more closely tied to them when they're the owner," he says. "Working hard and long is a natural aspect of the kind of people willing to start their own business."

But if employees have trouble balancing work and life, odds are they will have less confidence in you as a leader, a recent study shows. The study, which polled more than 50,000 U.S. workers from various markets including professional services, consumer goods, and financial services, found that employees who strike a positive balance between home and work were 11 percent more likely to praise their leaders' ability to set a clear direction.

The Society for Human Resource Management's (SHRM) research also shows work-life balance has a great impact on how employees feel about their leaders. Jennifer Schramm, a manager in SHRM's workplace trends and forecasting research department, predicts that as companies try to maximize the productivity of each employee, work-life balance and the resulting employee satisfaction will become increasingly more important. And research shows that happy employees can yield happy returns for businesses.

Critical Thinking Questions

1. Many small business owners expect their employees to be as committed and to work as hard as they do. How would you avoid falling into that trap while still demanding the best from your workers?
2. As a small business owner, consider some strategies to ensure an appropriate work-life balance for your employees.

Sources: Brian Sutter, “How Hard Small Business Owners Work,” SCORE, https://www.score.org, accessed August 17, 2017; The Hartford Insurance Company, “2015 Small Business Success Study,” accessed August 17, 2017; Michelle Di Gangi, "Attitude check: Small business owners say it's all worth it," July 26, 2016, Bank of the West; 2016 Annual Bank of the West Small Business Growth Survey, conducted by Harris Poll, July 26, 2016; Jena Wuu, “Work-Life Not an Issue for Owners,” *Inc.*, http://www.inc.com, August 10, 2005; Christina Galoozis, “Employees View Leadership Through Lens of Work-Life Balance,” *Inc.*,http://www.inc.com, June 8, 2005.

CONCEPT CHECK

1. What is a sole proprietorship?
2. Why is this a popular form of business organization?
3. What are the drawbacks to being a sole proprietor?

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5.3: Partnerships- Sharing the Load

What are the advantages of operating as a partnership, and what downside risks should partners consider?

Can **partnerships**, an association of two or more individuals who agree to operate a business together for profit, be hazardous to a business's health? Let's assume partners Ron and Liz own a stylish and successful beauty salon. After a few years of operating the business, they find they have contrasting visions for their company. Liz is happy with the status quo, while Ron wants to expand the business by bringing in investors and opening salons in other locations.

How do they resolve this impasse? By asking themselves some tough questions. Whose view of the future is more realistic? Does the business actually have the expansion potential Ron believes it does? Where will he find investors to make his dream of multiple locations a reality? Is he willing to dissolve the partnership and start over again on his own? And who would have the right to their clients?

Ron realizes that expanding the business in line with his vision would require a large financial risk and that his partnership with Liz offers many advantages he would miss in a sole proprietorship form of business organization. After much consideration, he decides to leave things as they are.

For those individuals who do not like to "go it alone," a partnership is relatively simple to set up. Offering a shared form of business ownership, it is a popular choice for professional-service firms such as lawyers, accountants, architects, stockbrokers, and real estate companies.

The parties agree, *either orally or in writing,* to share in the profits and losses of a joint enterprise. A *written partnership agreement,* spelling out the terms and conditions of the partnership, *is recommended* to prevent later conflicts between the partners. Such agreements typically include the name of the partnership, its purpose, and the contributions of each partner (financial, asset, skill/talent). It also outlines the responsibilities and duties of each partner and their compensation structure (salary, profit sharing, etc.). It should contain provisions for the addition of new partners, the sale of partnership interests, and procedures for resolving conflicts, dissolving the business, and distributing the assets.

There are two basic types of partnerships: *general and limited*. In a **general partnership**, all partners share in the management and profits. They co-own the assets, and each can act on behalf of the firm. Each partner also has unlimited liability for all the business obligations of the firm. A **limited partnership** has two types of partners: one or more **general partners**, who have unlimited liability, and one or more **limited partners**, whose liability is limited to the amount of their investment. In return for limited liability, limited partners agree not to take part in the day-to-day management of the firm. They help to finance the business, but the general partners maintain operational control.

There are also limited liability partnerships (LLP), which are similar to a general partnership except that partners are not held responsible for the business debt and liabilities. Another type is a limited liability limited partnership (LLLP), which is basically a limited partnership with addition of limited liability, hence protecting the general partner from the debt and liabilities of the partnership.

Advantages of Partnerships

Some advantages of partnerships come quickly to mind:

- *Ease of formation.* Like sole proprietorships, partnerships are easy to form. The partners agree to do business together and draw up a *partnership agreement*. For most partnerships, applicable state laws are not complex.
- *Availability of capital*. Because two or more people contribute financial resources, partnerships can raise funds more easily for operating expenses and business expansion. The partners' combined financial strength also increases the firm's ability to raise funds from outside sources.
- *Diversity of skills and expertise*. Partners share the responsibilities of managing and operating the business. Combining partner skills to set goals, manage the overall direction of the firm, and solve problems increases the chances for the partnership's success. To find the right partner, you must examine your own strengths and weaknesses and know what you

need from a partner. Ideal partnerships bring together people with complementary backgrounds rather than those with similar experience, skills, and talents. In Table 4.2 you'll find some advice on choosing a partner.
- *Flexibility.* General partners are actively involved in managing their firm and can respond quickly to changes in the business environment.
- *No special taxes.* Partnerships pay no income taxes. A partnership must file a partnership return with the Internal Revenue Service, reporting how profits or losses were divided among the partners. Each partner's profit or loss is then reported on the partner's personal income tax return, with any profits taxed at personal income tax rates.
- *Relative freedom from government control*. Except for state rules for licensing and permits, the government has little control over partnership activities.

Table 4.2

Perfect Partners
Picking a partner is both an art and a science. Someone may have all the right credentials on paper, but does that person share your vision and the ideas you have for your company? Are they a straight shooter? Honesty, integrity, and ethics are important, because you may be liable for what your partner does. Be prepared to talk about everything, and trust your intuition and your gut feelings—they're probably right. Ask yourself and your potential partner the following questions—then see how well your answers match up: 1. Why do you want a partner? 2. What characteristics, talents, and skills does each person bring to the partnership? 3. How will you divide responsibilities—from long-range planning to daily operations? Who will handle such tasks as marketing, sales, accounting, and customer service? 4. What is your long-term vision for the business—its size, life span, financial commitment, etc.? 5. What are your personal reasons for forming this company? Are you looking to create a small company or build a large one? Are you seeking a steady paycheck or financial independence? 6. Will all parties put in the same amount of time, or is there an alternative arrangement that is acceptable to everyone? 7. Do you have similar work ethics and values? 8. What requirements will be in the partnership agreement?

Disadvantages of Partnerships

Business owners must consider the following disadvantages of setting up their company as a partnership:

- *Unlimited liability*. All general partners have unlimited liability for the debts of the business. In fact, any one partner can be held personally liable for all partnership debts and legal judgments (such as malpractice)—regardless of who caused them. As with sole proprietorships, business failure can lead to a loss of the general partners' personal assets. To overcome this problem, many states now allow the formation of *limited liability partnerships (LLPs),*which protect each individual partner from responsibility for the acts of other partners and limit their liability to harm resulting from their own actions.
- *Potential for conflicts between partners*. Partners may have different ideas about how to run their business, which employees to hire, how to allocate responsibilities, and when to expand. Differences in personalities and work styles can cause clashes or breakdowns in communication, sometimes requiring outside intervention to save the business.
- *Complexity of profit sharing.* Dividing the profits is relatively easy if all partners contribute equal amounts of time, expertise, and capital. But if one partner puts in more money and others more time, it might be more difficult to arrive at a fair profit-sharing formula.
- *Difficulty exiting or dissolving a partnership.* As a rule, partnerships are easier to form than to leave. When one partner wants to leave, the value of their share must be calculated. To whom will that share be sold, and will that person be acceptable to the other partners? If a partner who owns more than 50 percent of the entity withdraws, dies, or becomes disabled, the partnership must reorganize or end. To avoid these problems, most partnership agreements include specific guidelines for transferring partnership interests and buy–sell agreements that make provision for surviving partners to buy a deceased partner's interest. Partners can also purchase special life insurance policies designed to fund such a purchase.

Business partnerships are often compared to marriages. As with a marriage, choosing the right partner is critical. So if you are considering forming a partnership, allow plenty of time to evaluate your and your potential partner's goals, personality, expertise, and working style before joining forces.

CONCEPT CHECK

1. How does a partnership differ from a sole proprietorship?
2. Describe the four main types of partnerships, and explain the difference between a limited partner and a general partner.
3. What are the main advantages and disadvantages of a partnership?

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5.4: Corporations- Limiting Your Liability

How does the corporate structure provide advantages and disadvantages to a company, and what are the major types of corporations?

When people think of corporations, they typically think of major, well-known companies, such as Apple, Alphabet (parent company of Google), Netflix, IBM, Microsoft, Boeing, and General Electric. But corporations range in size from large multinationals with thousands of employees and billions of dollars in sales to midsize or even smaller firms with few employees and revenues under $25,000.

A **corporation** is a legal entity subject to the laws of the state in which it is formed, where the right to operate as a business is issued by state charter. A corporation can own property, enter into contracts, sue and be sued, and engage in business operations under the terms of its charter. Unlike sole proprietorships and partnerships, corporations are taxable entities with a life separate from their owners, who are not personally liable for its debts.

When launching her company, Executive Property Management Services, Inc., 32-year-old Linda Ravden realized she needed the liability protection of the corporate form of business organization. Her company specialized in providing customized property management services to mid- and upper-level corporate executives on extended work assignments abroad, often for three to five years or longer. Taking care of substantial properties in the million-dollar range and above was no small responsibility for Ravden's company. Therefore, the protection of a corporate business structure, along with carefully detailed contracts outlining the company's obligations, were crucial in providing Ravden with the liability protection she needed—and the peace of mind to focus on running her business without constant worry. Note that an LLC does not provide unlimited protection; you can still get in trouble for such things as mingling personal and business funds.[2]

MANAGING CHANGE

Pacific Sun's Golden Glow

It all started as a little surf shop in 1980 in Newport Beach, California. It wasn't called PacSun then. It wasn't even all that different from other shops carrying surfboards and wax, except for one thing. The founders had a better idea.

During Southern California's wet, cool winters, the beaches got empty, and the surf store business went dry. Where did everyone go? To the mall, of course. Their idea—to be the first surf shop to move into California's popular mall locations—worked. The company soon grew to 21 stores, selling such popular name brands as Billabong, Gotcha, CatchIt, Stussy, and Quiksilver, as well as its own private-label brands.

What began as a little surf shop became a leading mall-based specialty retailer in the fast-growing surf, skate, and hip-hop apparel markets. With close to a thousand stores in the United States and Puerto Rico and sales topping $1 billion, how did the founders make the leap from selling and waxing surfboards to being a major player in the youth apparel market? How has Pacific Sunwear of California, Inc. (**http://www.pacsun.com**) succeeded when thousands of other clothing companies failed?

"We listen and we change," says the CEO of Pacific Sun. "The kids have the answers, so we listen to get the trends, the solutions, and find out what we are doing right." To remain on the cutting edge of teen tastes, the company hosts an open house every Wednesday at its corporate headquarters in Anaheim, California, where vendors present their wares to PacSun's savvy team of buyers. Being able to distinguish between short-lived fads and actual trends is important when making merchandise choices. The company's focus on "active brand management" is what kept its sales climbing.

The founders' philosophy had served their business well. In 1993, the 60-store company sold stock to the public. It had grown to over 1,000 stores in 50 states and Puerto Rico, with 12,000 employees. The company's PacSun stores cater to a completely different customer than its d.e.m.o. hip-hop stores. In April 2006, PacSun launched its third concept, One Thousand Steps, a footwear store.

With changing trends and online shopping challenges facing many brick-and-mortar retailers, companies such as Wet Seal and

Quicksilver filed for bankruptcy in 2015, and PacSun filed for bankruptcy in April 2016. At the time of bankruptcy filing, the company had 593 PacSun stores employing approximately 2,000 employees. In September 2016, PacSun emerged from the bankruptcy after it cut debt and closed stores. The company also turned over all of its stock to the private equity firm Golden Gate Capital, its senior lender.

As its business took off, PacSun successfully made the leap from the small sole proprietorship form of business organization to corporate retailing giant. Facing changing trends and technologies, the firm hit a bump in the road and is working hard to reestablish. The company is indeed a thousand steps away from its humble beginnings.

Critical Thinking Questions

1. How did PacSun manage its evolution from a small, local business to a leading mall-based specialty retailer? What could be the reasons for its missteps resulting in the bankruptcy filing?
2. What form of business organization might PacSun have chosen when it started, and what might have prompted it to change as it grew?

Sources: Marie Driscoll, "Pacific Sun's Golden Glow," *Business Week Online*, November 9, 2004, http://www.businessweek.com; Ron Ehlers (VP Information Services, Pacific Sunwear of California, Inc.) "Pacific Sunwear: Maintain a Fresh Brand by Anticipating Consumer Needs," presentation to the Retail Systems MIX Summit, May 25, 2005, http://www.retailsystems.com; "Corporate Profile," Pacific Sun corporate Web site, http://www.pacsun.com; Samantha Masunaga, "PacSun files for Chapter 11 bankruptcy protection, plans to go private," *Los Angeles Times,* http://www.latimes.com, accessed August 17, 2017; Steven Church, "Pacific Sunwear Has 'Retailer's Dream' as Bankruptcy Wraps Up," *Bloomberg,* https://www.bloomberg.com, accessed August 2017.

Corporations play an important role in the U.S. economy. As **Table 4.1**demonstrated, corporations account for only 18 percent of all businesses but generate 81 percent of all revenues and 58 percent of all profits. Company type and size vary; however, when you look at the top companies by revenue in the United States or globally, they include many familiar names that affect our daily lives.

In the United States, according to *Fortune* magazine, the top three corporations in the 2017 were (1) Walmart Stores (revenue: $485.9 B), (2) Berkshire Hathaway(revenue: $223.6 B), and (3) Apple (revenue: $215.6 B), whereas *Forbes* magazine found that the top three corporations were (1) Berkshire Hathaway (revenue: $222.9B), (2) Apple (revenue: $217.5B), and (3) JPMorgan Chase (revenue: $102.5B). By comparison, the top three companies in 2017 according to the *World Economic Forum* were (1) Apple, (2) Alphabet, and (3) Microsoft. These corporations rise and fall on the various lists based on their revenue in a given year and how the organizations measure revenue and the time frames that they use.[3]

The Incorporation Process

Setting up a corporation is more complex than starting a sole proprietorship or partnership. Most states base their laws for chartering corporations on the Model Business Corporation Act of the American Bar Association, although registration procedures, fees, taxes, and laws that regulate corporations vary from state to state.



Exhibit 4.2: Incorporated in 1969, Walmart is one of America's most popular retail stores. Opened as Walmart Discount City by retailer Sam Walton in 1962, the retailer quickly established a strong brand image. Today, Walmart operates in more than 28 countries, and the Walmart icon is among the most recognizable trademarks in all of business. *What steps must companies take to become incorporated?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

A firm does not have to incorporate in the state where it is based and may benefit by comparing the rules of several states before choosing a state of incorporation. Although Delaware is a small state with few corporations actually based there, its procorporate policies make it the state of incorporation for many companies, including about half the Fortune 500. Incorporating a company involves five main steps:

- Selecting the company's name
- Writing the *articles of incorporation* (see Table 4.3) and filing them with the appropriate state office, usually the secretary of state
- Paying required fees and taxes
- Holding an organizational meeting
- Adopting bylaws, electing directors, and passing the first operating resolutions

The state issues a corporate charter based on information in the articles of incorporation. Once the corporation has its charter, it holds an organizational meeting to adopt bylaws, elect directors, and pass initial operating resolutions. Bylaws provide legal and managerial guidelines for operating the firm.

Table 4.3

Articles of Incorporation
Articles of incorporation are prepared on a form authorized or supplied by the state of incorporation. Although they may vary slightly from state to state, all articles of incorporation include the following key items: • Name of corporation • Company's goals • Types of stock and number of shares of each type to issue • Life of the corporation (usually "perpetual," meaning with no time limit) • Minimum investment by owners • Methods for transferring shares of stock • Address of the corporate office • Names and addresses of the first board of directors

The Corporate Structure

As **Exhibit 4.4** shows, corporations have their own organizational structure with three important components: stockholders, directors, and officers.

Stockholders (or shareholders) are the owners of a corporation, holding shares of stock that provide them with certain rights. They may receive a portion of the corporation's profits in the form of dividends, and they can sell or transfer their ownership in the corporation (represented by their shares of stock) at any time. Stockholders can attend annual meetings, elect the board of directors, and vote on matters that affect the corporation in accordance with its charter and bylaws. Each share of stock generally carries one vote.

The stockholders elect a **board of directors** to govern and handle the overall management of the corporation. The directors set major corporate goals and policies, hire corporate officers, and oversee the firm's operations and finances. Small firms may have as few as 3 directors, whereas large corporations usually have 10 to 15.

The boards of large corporations typically include both corporate executives and outside directors (not employed by the organization) chosen for their professional and personal expertise. Outside directors often bring a fresh view to the corporation's activities because they are independent of the firm.

Hired by the board, the *officers* of a corporation are its top management and include the president and chief executive officer (CEO), vice presidents, treasurer, and secretary, who are responsible for achieving corporate goals and policies. Officers may also be board members and stockholders.

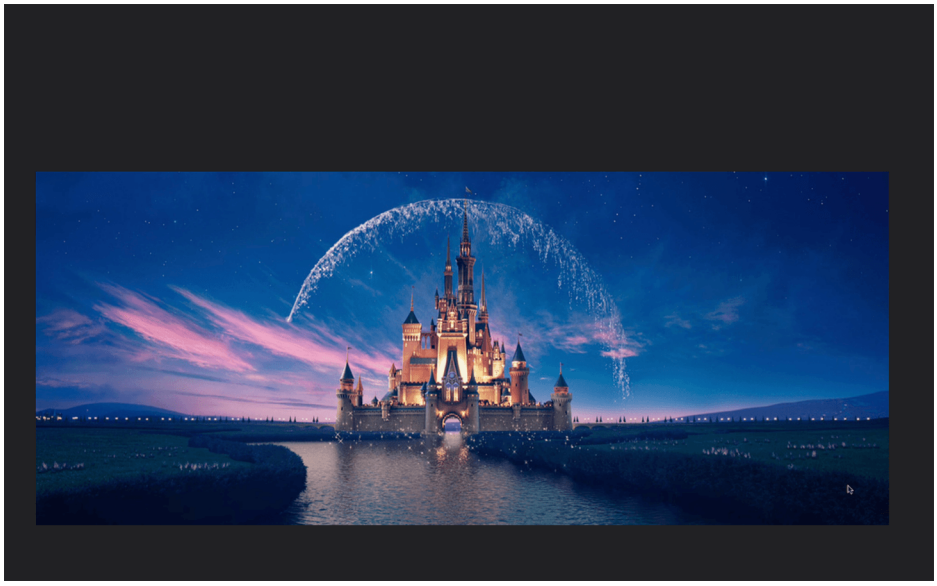


Exhibit 4.3: When Walt Disney cast his now-famous mouse as Steamboat Willie back in the 1920s, he had little idea that his animation project would turn into one of the largest entertainment companies in the world. The house that Walt built, with its magical theme parks, movie studios, and product lines, is overseen today by visionary directors with accomplished backgrounds in media, technology, and government. *What important tasks and responsibilities are entrusted to Disney's board of directors?* (Marc Levin/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Advantages of Corporations

The corporate structure allows companies to merge financial and human resources into enterprises with great potential for growth and profits:

- *Limited liability*. A key advantage of corporations is that they are separate legal entities that exist apart from their owners. Owners' (stockholders') liability for the obligations of the firm is limited to the amount of the stock they own. If the corporation goes bankrupt, creditors can look only to the assets of the corporation for payment.
- *Ease of transferring ownership*. Stockholders of public corporations can sell their shares at any time without affecting the status of the corporation.

- *Unlimited life*. The life of a corporation is unlimited. Although corporate charters specify a life term, they also include rules for renewal. Because the corporation is an entity separate from its owners, the death or withdrawal of an owner does not affect its existence, unlike a sole proprietorship or partnership.
- *Tax deductions*. Corporations are allowed certain tax deductions, such as operating expenses, which reduces their taxable income.
- *Ability to attract financing*. Corporations can raise money by selling new shares of stock. Dividing ownership into smaller units makes it affordable to more investors, who can purchase one or several thousand shares. The large size and stability of corporations also helps them get bank financing. All these financial resources allow corporations to invest in facilities and human resources and expand beyond the scope of sole proprietorships or partnerships. It would be impossible for a sole proprietorship or partnership to make automobiles, provide nationwide telecommunications, or build oil or chemical refineries.

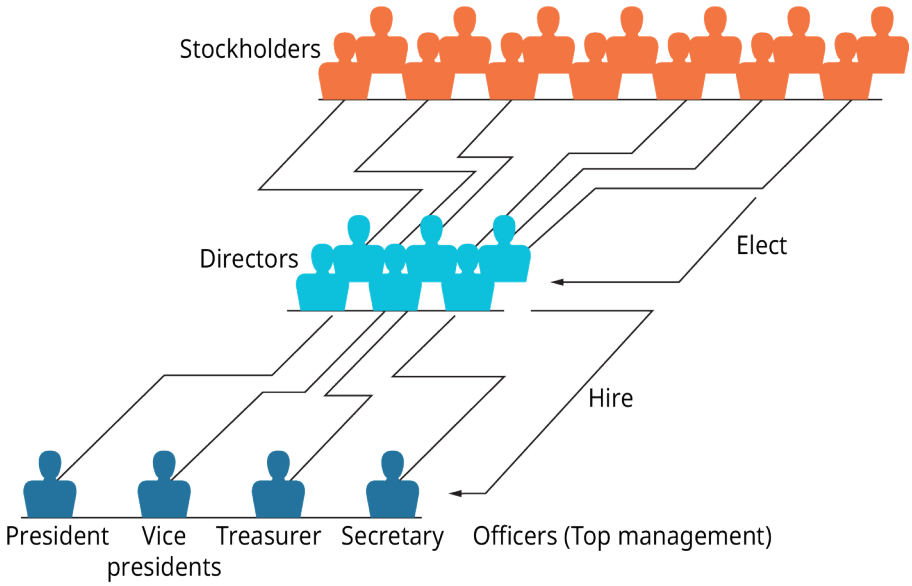


Exhibit 4.4: **Organizational Structure of Corporations** Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license

Disadvantages of Corporations

Although corporations offer companies many benefits, they have some disadvantages:

- *Double taxation of profits*. Corporations must pay federal and state income taxes on their profits. In addition, any profits (dividends) paid to stockholders are taxed as personal income, although at a somewhat reduced rate.
- *Cost and complexity of formation*. As outlined earlier, forming a corporation involves several steps, and costs can run into thousands of dollars, including state filing, registration, and license fees, as well as the cost of attorneys and accountants.
- *More government restrictions*. Unlike sole proprietorships and partnerships, corporations are subject to many regulations and reporting requirements. For example, corporations must register in each state where they do business and must also register with the Securities and Exchange Commission (SEC) before selling stock to the public. Unless it is closely held (owned by a small group of stockholders), a firm must publish financial reports on a regular basis and file other special reports with the SEC and state and federal agencies. These reporting requirements can impose substantial costs, and published information on corporate operations may also give competitors an advantage.

Types of Corporations

Three types of corporate business organization provide limited liability.

The **C corporation** is the conventional or basic form of corporate organization. Small businesses may achieve liability protection through S corporations or limited liability companies (LLCs).

An **S corporation** is a hybrid entity, allowing smaller corporations to avoid double taxation of corporate profits as long as they meet certain size and ownership requirements. Organized like a corporation with stockholders, directors, and officers, an S

corporation is taxed like a partnership. Income and losses flow through to the stockholders and are taxed as personal income. S corporations are allowed a maximum of 100 qualifying shareholders and one class of stock. The owners of an S corporation are not personally liable for the debts of the corporation.

A newer type of business entity, the **limited liability company (LLC)**, is also a hybrid organization. Like S corporations, they appeal to small businesses because they are easy to set up and not subject to many restrictions. LLCs offer the same liability protection as corporations as well as the option of being taxed as a partnership or a corporation. First authorized in Wyoming in 1977, LLCs became popular after a 1988 tax ruling that treats them like partnerships for tax purposes. Today all states allow the formation of LLCs.

Table 4.4 summarizes the advantages and disadvantages of each form of business ownership.

Table 4.4: Advantages and Disadvantages of Major Types of Business Organization

Sole Proprietorship	Partnership	Corporation
Advantages		
Owner receives all profits.	More expertise and managerial skill available.	Limited liability protects owners from losing more than they invest.
Low organizational costs.	Relatively low organizational costs.	Can achieve large size due to marketability of stock (ownership).
Income taxed as personal income of proprietor.	Income taxed as personal income of partners.	Receives certain tax advantages.
Independence.	Fundraising ability is enhanced by more owners.	Greater access to financial resources allows growth.
Secrecy.		Can attract employees with specialized skills.
Ease of dissolution.		Ownership is readily transferable.
		Long life of firm (not affected by death of owners).
Disadvantages		
Owner receives all losses.	Owners have unlimited liability; may have to cover debts of other, less financially sound partners.	Double taxation because both corporate profits and dividends paid to owners are taxed, although the dividends are taxed at a reduced rate.
Owner has unlimited liability; total wealth can be taken to satisfy business debts.	Dissolves or must reorganize when partner dies.	More expensive and complex to form.
Limited fundraising ability can inhibit growth.	Difficult to liquidate or terminate.	Subject to more government regulation.
Proprietor may have limited skills and management expertise.	Potential for conflicts between partners.	Financial reporting requirements make operations public.
Few long-range opportunities and benefits for employees.	Difficult to achieve large-scale operations.	
Lacks continuity when owner dies.		

CONCEPT CHECK

1. What is a corporation? Describe how corporations are formed and structured.
2. Summarize the advantages and disadvantages of corporations. Which features contribute to the dominance of corporations in the business world?
3. Why do S corporations and limited liability companies (LLCs) appeal to small businesses?

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5.5: Specialized Forms of Business Organization

What other options for business organization does a company have in addition to sole proprietorships, partnerships, and corporations?

In addition to the three main forms, several specialized types of business organization also play an important role in our economy. We will look at cooperatives and joint ventures in this section and take a detailed look at franchising in the following section.

Cooperatives

When you eat a Sunkist orange or spread Land O'Lakes butter on your toast, you are consuming foods produced by cooperatives. A **cooperative** is a legal entity with several *corporate features,* such as limited liability, an unlimited life span, an elected board of directors, and an administrative staff. Member-owners pay annual fees to the cooperative and share in the profits, which are distributed to members in proportion to their contributions. Because they do not retain any profits, cooperatives are not subject to taxes.

There are currently 2.6 million cooperatives with one billion members employing more than 12.5 million employees in more than 145 countries worldwide.[4]Cooperatives operate in every industry, including agriculture, childcare, energy, financial services, food retailing and distribution, health care, insurance, housing, purchasing and shared services, and telecommunications, among others. They range in size from large enterprises such as Fortune 500 companies to small local storefronts and fall into four distinct categories: consumer, producer, worker, and purchasing/shared services.

Cooperatives are autonomous businesses owned and democratically controlled by their members—the people who buy their goods or use their services—not by investors. Unlike investor-owned businesses, cooperatives are organized solely to meet the needs of the member-owners, not to accumulate capital for investors. As democratically controlled businesses, many cooperatives practice the principle of "one member, one vote," providing members with equal control over the cooperative.

There are two types of cooperatives. **Buyer cooperatives** combine members' purchasing power. Pooling buying power and buying in volume increases purchasing power and efficiency, resulting in lower prices. At the end of the year, members get shares of the profits based on how much they bought. Obtaining discounts to lower costs gives the corner Ace Hardware store the chance to survive against retailing giants such as Home Depot Inc. and Lowe's.

Founded in 1924, Ace Hardware is one of the nation's largest cooperatives and is wholly owned by its independent hardware retailer members in stores spanning all 50 states and 70 countries. In August 2017, Ace opened its 5,000th store. In 2017, the company reported its revenues in the second quarter were $1.5 billion, which was an increase of 4.6 percent from 2016's second quarter. The net income for the second quarter of 2017 was $51.1 million.[5]

Seller cooperatives are popular in agriculture, wherein individual producers join to compete more effectively with large producers. Member dues support market development, national advertising, and other business activities. In addition to Sunkist and Land O'Lakes, other familiar cooperatives are Calavo (avocados), Ocean Spray (cranberries and juices), and Blue Diamond (nuts). CHS Inc., the largest cooperative in the United States, sells energy, supply, food, and grain.

Cooperatives empower people to improve their quality of life and enhance their economic opportunities through self-help. Throughout the world, cooperatives are providing members with credit and financial services, energy, consumer goods, affordable housing, telecommunications, and other services that would not otherwise be available to them. There are several principles that cooperatives must follow, according to San Luis Valley REC, International Co-operative Alliance, and Daman Prakash, author of *The Principles of Cooperation*. They include (1) open membership, which means that cooperatives are open to all people to use its services; (2) democratic member control, which means that organizations are controlled by their members; (3) members' economic participation, which means that members contribute equally to the capital of the cooperative; (4) autonomy, which means cooperatives are self-help organizations controlled by their members; and (5) education and training, which means that cooperatives provide education and training for their members while also electing representatives, managers, and employees.[6]

Joint Ventures

In a **joint venture**, two or more companies form an alliance to pursue a specific project, usually for a specified time period. There are many reasons for joint ventures. The project may be too large for one company to handle on its own, and joint ventures also afford companies access to new markets, products, or technology. Both large and small companies can benefit from joint ventures.

In 2005, South Korea's Hyundai Motor Company announced it signed a $1.24 billion deal to form a joint venture with China's Guangzhou Automobile Group. The arrangement gave the South Korean automaker access to the commercial vehicle market in China, where its passenger cars are already the top selling foreign brand. Each side will hold equal stakes in the new entity, named Guangzhou Hyundai Motor Company. The new plant began production in 2007 with an annual capacity of 200,000 units producing small to large trucks and buses as well as commercial vehicles. According to Reuters, Hyundai made plans to build a fifth factory in China. With five factories in operation, Hyundai's annual Chinese production capacity will be 1.65 million vehicles.[7]

CONCEPT CHECK

1. Describe the two types of cooperatives and the advantages of each.
2. What are the benefits of joint ventures?

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5.6: Franchising- A Popular Trend

What makes franchising an appropriate form of organization for some types of business, and why does it continue to grow in importance?

When Shep Bostin decided to buy a franchise, he researched the usual suspects: Jiffy Lube, McDonald's, and Quiznos Subs. Bostin, then 38, was a top executive at a dying Gaithersburg, Maryland, technology firm, but instead of becoming another McDonald's franchisee, Bostin chose to remain a geek, albeit one who wheeled around in the signature black PT Cruiser of Geeks On Call, a company that provides on-site computer assistance via a large pool of experienced techies. Bostin made residential and commercial "house calls" for more than a decade as a Geeks On Callfranchisee. There are approximately 123 independently owned and operated Geeks On Call franchise territories in 50 states serving over 250,000 customers.[8]

Choosing the right franchise can be challenging. Franchises come in all sizes and demand different skills and qualifications. And with somewhere around 2,500 different franchised businesses in the United States, Bostin had a lot to choose from—from cookie-bouquet peddlers and dog trainers to acupuncture specialists. Table 4.5 shows the top franchises for 2017 from various sources. *Entrepreneur*'s rankings utilize among other factors costs/fees, brand strength, support, and financial strength. *Franchise Business Review* focuses on owner satisfaction, whereas *Franchise Gator* utilizes a formula with factors such as financial stability and engagement.



Exhibit 4.5: Chance the Rapper was a big winner at the 2017 Grammy Awards. His win was also validation for a new business model. Chance the Rapper does not have a deal with a traditional record label but instead releases his music through streaming services. *How might this approach benefit other aspiring music artists to gain footing and become a force in the music industry?* (Credit: Julio Enriquez/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Table 4.5 Sources: "2017 Franchise 500 Ranking, Franchise 500 2017," https://www.entrepreneur.com/franchise500 (August 17, 2017); "Top Franchise Opportunities for 2017," Franchise Business Review, topfranchises.franchisebusinessreview.com/, (August 17, 2017); "Top 100 Franchises of 2017," Franchise Gator, https://www.franchisegator.com/lists/top-100/, (August 17, 2017).

Top 10 Franchises for 2017	
Entrepreneur Top 10	
Franchise	**Initial investment**
1. 7-Eleven Inc.	$37K to $1.6M
2. McDonald's	$1M to $2.2M

Top 10 Franchises for 2017	
3. Dunkin' Donuts	$229K to $1.7M
4. The UPS Store	$178K to $403K
5. Jimmy John's Gourmet Sandwiches	$330K to $558K
6. Dairy Queen	$1.1M to $1.9M
7. Ace Hardware Corp.	$273K to $1.6M
8. Wingstop Restaurant Inc.	$303K to $923K
9. Sport Clips	$189K to $355K
10. RE/MAX LLC	$38K to $224K
Franchise Business Review Top 10	
Franchise Name/ Industry	**Minimum Investment**
Visiting Angels (Senior care)	$77,985
MaidPro (Cleaning and maintenance)	$74,560
Pinot's Palette (Sports and recreation)	$63,400
Christian Brothers Automotive (Automotive)	$146,693
Home Instead Senior Care (Senior care)	$463,698
Our Town America (Advertising and Sales)	$115,000
FASTSIGNS (Business services)	$63,300
Sandler Training (Business services)	$182,329
Soccer Shots ((Child services)	$88,150
Two Men and a Truck (Services)	$36,000
Franchise Gator Top 10	
Franchise Name	**Minimum Cash Required**
Fast Signs	$100,000
Tropical Smoothie Cafe	$100,000
Marco's Pizza	$100,000
Zoup	$100,000
Mathnasium	$100,000
Christian Brothers Automotive	$80,000
Two Men and a Truck	$150,000
Kiddie Academy	$200,000
Wild Birds Unlimited	$40,000
SportClips	$200,000

Chances are you recognize some of the names listed in Table 4.5 and deal with franchise systems in your neighborhood every day. When you have lunch at **Taco Bell** or Jamba Juice, make copies at FedEx Office, change your oil at Jiffy Lube, buy candles at Wicks 'n' Sticks, or mail a package at The UPS Store, you are dealing with a franchised business. These and other familiar name brands mean quality, consistency, and value to consumers. Franchised businesses provided about 8.9 million direct jobs with a $890 billion economic output for the U.S. economy.[9]

Franchising is a form of business organization that involves a **franchisor**, the company supplying the product or service concept,

and the **franchisee**, the individual or company selling the goods or services in a certain geographic area. The franchisee buys a package that includes a proven product or service, proven operating methods, and training in managing the business. Offering a way to own a business without starting it from scratch and to expand operations quickly into new geographic areas with limited capital investment, franchising is one of the fastest growing segments of the economy. If you are interested in franchising, food companies represent the largest number of franchises.

A **franchise agreement** is a contract that allows the franchisee to use the franchisor's business name, trademark, and logo. The agreement also outlines rules for running the franchise, services provided by the franchisor, and financial terms. The franchisee agrees to follow the franchisor's operating rules by keeping inventory at certain levels, buying a standard equipment package, keeping up sales and service levels, taking part in franchisor promotions, and maintaining a relationship with the franchisor. In return, the franchisor provides the use of a proven company name and symbols, help in finding a site, building plans, guidance and training, management assistance, managerial and accounting systems and procedures, employee training, wholesale prices for supplies, and financial assistance.

Advantages of Franchises

Like other forms of business organization, franchising offers some distinct advantages:

- *Increased ability for franchisor to expand.* Because franchisees finance their own units, franchisors can grow without making a major investment.
- *Recognized name, product, and operating concept.* Consumers know they can depend on products from franchises such as Pizza Hut, Hertz, and Holiday Inn. As a result, the franchisee's risk is reduced and the opportunity for success increased. The franchisee gets a widely known and accepted business with a proven track record, as well as operating procedures, standard goods and services, and national advertising.
- *Management training and assistance.* The franchisor provides a structured training program that gives the new franchisee a crash course in how to start and operate their business. Ongoing training programs for managers and employees are another plus. In addition, franchisees have a peer group for support and sharing ideas.
- *Financial assistance.* Being linked to a nationally known company can help a franchisee obtain funds from a lender. Also, the franchisor typically gives the franchisee advice on financial management, referrals to lenders, and help in preparing loan applications. Many franchisors also offer short-term credit for buying supplies, payment plans, and loans to purchase real estate and equipment. Although franchisors give up a share of profits to their franchisees, they receive ongoing revenues in the form of royalty payments.



Exhibit 4.6: Countless franchise opportunities exist for entrepreneurs with access to start-up capital. Despite the broad range of franchise opportunities available, lists of the fastest-growing franchises are heavily weighted with restaurant chains and cleaning services. Start-up costs for a Quiznos franchise can be pricey; expenses associated with opening a Club Pilates franchise or a Visiting Angels adult care service are significantly lower. *How do entrepreneurs evaluate which franchising opportunity is right for them?* (Credit: Mr. Blue Mau Mau/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Disadvantages of Franchises

Franchising also has some disadvantages:

- *Loss of control*. The franchisor has to give up some control over operations and has less control over its franchisees than over company employees.
- *Cost of franchising*. Franchising can be a costly form of business. Costs will vary depending on the type of business and may include expensive facilities and equipment. The franchisee also pays fees and/or royalties, which are usually tied to a percentage of sales. Fees for national and local advertising and management advice may add to a franchisee's ongoing costs.
- *Restricted operating freedom*. The franchisee agrees to conform to the franchisor's operating rules and facilities design, as well as inventory and supply standards. Some franchises require franchisees to purchase from only the franchisor or approved suppliers. The franchisor may also restrict the franchisee's territory or site, which could limit growth. Failure to conform to franchisor policies could mean the loss of the franchise.

Franchise Growth

Many of today's major franchise brands, such as McDonald's and KFC, started in the 1950s. Through the 1960s and 1970s, many more types of businesses—clothing, convenience stores, business services, and many others—used franchising to distribute their goods and services. Growth comes from expansion of established franchises—for example, Subway, Pizza Hut, and OrangeTheory Fitness—as well as new entrants such as those identified by *Entrepreneur* and *Franchise Gator*among other sources. According to *Entrepreneur* magazine, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Blaze Fast-Fire'd Pizza, and (3) uBreakiFix, whereas according to *Franchise Gator,* the top three new franchises in 2017 are (1) Mosquito Joe, (2) Digital Doc, and (3) Nurse Next Door Home Healthcare Services. On both rankings, Mosquito Joe ranks at the top. Mosquito Joe provides mosquito control treatment services for both residential and commercial clients.[10]

Changing demographics drive franchise industry growth, in terms of who, how, and what experiences the most rapid growth. The continuing growth and popularity of technology and personal computing is responsible for the rapidly multiplying number of eBay drop-off stores, and tech consultants such as Geeks on Call are in greater demand than ever. Other growth franchise industries are the specialty coffee market, children's enrichment and tutoring programs, senior care, weight control, and fitness franchises.

The Next Big Thing in Franchising

All around you, people are talking about the next big thing—Subway is the new miracle weight-loss solution, the workout at OrangeTheory Fitness is the answer to America's fitness needs—and you are ready to take the plunge and buy a trendy franchise. But consumers' desires can change with the tide, so how do you plan an entrance—and exit—strategy when purchasing a franchise that's a big hit today but could be old news by tomorrow? Table 4.6 outlines some tips on purchasing a franchise.

International Franchising

Like other forms of business, franchising is part of our global marketplace economy. As international demand for all types of goods and services grows, most franchise systems are already operating internationally or planning to expand overseas. Restaurants, hotels, business services, educational products, car rentals, and nonfood retail stores are popular international franchises.

Franchisors in foreign countries face many of the same problems as other firms doing business abroad. In addition to tracking markets and currency changes, franchisors must understand local culture, language differences, and the political environment. Franchisors in foreign countries also face the challenge of aligning their business operations with the goals of their franchisees, who may be located half a globe away.

Table 4.6 Sources: "12 Things To Do Before You Buy a Franchise," Forbes,https://www.forbes.com, June 22, 2016; U.S. Small Business Administration, "6 Franchise Purchasing Tips," https://www.sba.gov, August 19, 2014; "5 Tips for Buying a Franchise," Small Business Trends, smalltrends.com, January 29, 2013.

Tips for Purchasing a Franchise
1. Take a personality test to determine the traits that will help and hurt you and assess your strengths and weaknesses. 2. Do your research about the franchise company, its services, and your potential location, and study the field. 3. Seek assistance from tax advisors and contract specialists. 4. Focus on financials: count your money, limit liability with appropriate business structure, and look beyond. 5. Beware of franchise consultants. 6. Use the franchise disclosure document to ensure everything is clear. 7. Utilize your instincts, and follow your gut.

Is Franchising in Your Future?

Are you ready to be a franchisee? Before taking the plunge, ask yourself some searching questions: Are you excited about a specific franchise concept? Are you willing to work hard and put in long hours? Do you have the necessary financial resources? Do you have prior business experience? Do your expectations and personal goals match the franchisor's?

Qualities that rank high on franchisors' lists are passion about the franchise concept, desire to be your own boss, willingness to make a substantial time commitment, assertiveness, optimism, patience, and integrity. Prior business experience is also a definite plus, and some franchisors prefer or require experience in their field.

EXPANDING AROUND THE GLOBE

Setting Up (Sandwich) Shop in China

Lured by China's fast-food industry, estimated today at $180 billion, Jim Bryant, 50, was not the only entrepreneur to discover it is hard to do business in China. In ten years, Bryant has opened 19 Subway stores in Beijing—only half the number he was supposed to have by now—while other companies such as Chili's and Dunkin' Donuts have given up their Chinese operations altogether.

Subway, or Sai Bei Wei (Mandarin for "tastes better than others"), is now the third-largest U.S. fast-food chain in China, right behind McDonald'sand KFC, and all its stores are profitable. Although Bryant had never eaten a Subway sandwich before, Jana Brands, the company Bryant worked for in China, sold $20 million in crab to Subway annually, so he knew it was big business. When Subway founder Fred DeLuca visited Beijing in 1994, Bryant took him to a place not on the official tour: McDonald's. It was Sunday night, and the place was packed. "We could open 20,000 Subways here and not scratch the surface," Bryant remembers DeLuca saying.

Two weeks later, Bryant called Subway's headquarters in Milford, Connecticut, and asked to be the company representative in China. He would recruit local entrepreneurs, train them to become franchisees, and act as a liaison between them and the company. He would receive half the initial $10,000 franchise fee and one-third of their 8 percent royalty fees. He could also open his own Subway restaurants. Steve Forman, the founder of Jana Brands, invested $1 million in return for a 75 percent stake.

All foreign businesses in China had to be joint ventures with local partners, so Bryant used the Chinese business practice of relying on local relationships to find a manager for his first restaurant in Beijing. The project ran into problems immediately. Work on the store was delayed, and construction costs soared. It didn't take Bryant long to realize that he and Forman had been swindled out of $200,000.

When it finally opened, the restaurant was a hit among Americans in Beijing, but the locals weren't sure what to make of it. They didn't know how to order and didn't like the idea of touching their food, so they held the sandwich vertically, peeled off the paper, and ate it like a banana. Most of all, the Chinese didn't seem to want sandwiches.

But Subway did little to alter its menu—something that still irks some Chinese franchisees. "Subway should have at least one item tailored to Chinese tastes to show they respect local culture," says Luo Bing Ling, a Beijing franchisee. Bryant thinks that with time, sandwiches will catch on in China. Maybe he's right: Tuna salad, which he couldn't give away at first, is now the number one

seller. Today there are nearly 600 Subway stores in China, with China's fast-food industry estimated at over $180 billion.

Critical Thinking Questions

1. What are some of the main problems U.S. franchisors encounter when attempting to expand their business in a country such as China?
2. What steps can franchisors take to ensure a smooth and successful launch of a new franchise business in a foreign country?

Sources: Subway, "Explore Our World," www.subway.com, accessed April 2, 2018; "Sales Revenue in Fast Food Restaurants in China 2011–2018," *Statista,* https://www.statista.com, accessed April 2, 2018; Carlye Adler, "How China Eats a Sandwich," *Fortune*, March 21, 2005, p. F210-B; Julie Bennett, "Chinese Market Offers Franchise Challenges," *Startup Journal–The Wall Street Journal Online*, http://www.startupjournal.com.

So what can you do to prepare when considering the purchase of a franchise? When evaluating franchise opportunities, professional guidance can prevent expensive mistakes, so interview advisers to find those that are right for you. Selecting an attorney with franchise experience will hasten the review of your franchise agreement. Getting to know your banker will speed up the loan process if you plan to finance your purchase with a bank loan, so stop by and introduce yourself. The proper real estate is a critical component for a successful retail franchise, so establish a relationship with a commercial real estate broker to begin scouting locations. Doing your homework can spell the difference between success and failure, and some early preparation can help lay the groundwork for the successful launch of your franchised business.

If the franchise route to business ownership seems right for you, begin educating yourself on the franchise process by investigating various franchise opportunities. You should research a franchise company thoroughly before making any financial commitment. Once you've narrowed your choices, ask for the *Uniform Franchise Offering Circular (UFOC)* for that franchisor, and read it thoroughly. The Federal Trade Commission (FTC) requires franchisors to prepare this document, which provides a wealth of information about the franchisor, including its history, operating style, management, past or pending litigation, the franchisee's financial obligations, and any restrictions on the sale of units. Interviewing current and past franchisees is another essential step. And most franchise systems use computers, so if you are not computer literate, take a class in the basics.

Would-be franchisees should also check recent issues of small-business magazines such as *Entrepreneur, Inc., Startups,* and *Success* for industry trends, ideas on promising franchise opportunities, and advice on how to choose and run a franchise. The International Franchise Association website at **http://www.franchise.org** has links to *Franchising World* and other useful sites. (For other franchise-related sites, see the "Working the Net" questions.)

CONCEPT CHECK

1. Describe franchising and the main parties to the transaction.
2. Summarize the major advantages and disadvantages of franchising.
3. Why has franchising proved so popular?

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5.7: Mergers and Acquisitions

Why are mergers and acquisitions important to a company's overall growth?

A **merger** occurs when two or more firms combine to form one new company. For example, in 2016, Johnson Controls, a leading provider of building efficiency solutions, agreed to merge with Ireland's Tyco International, a leading provider of fire and security solutions, resulting in a company that will be a leader in products, technologies, and integrated solutions for the building and energy sectors. The merger is valued at $30 billion, with new Johnson Controls PLC to be based in Ireland. Currently, AT&T and Time Warner have an $85.4 billion merger pending. "Once we complete our acquisition of Time Warner Inc., we believe there is an opportunity to build an automated advertising platform that can do for premium video and TV advertising what the search and social media companies have done for digital advertising," AT&T's CEO Randall Stephenson said in a prepared statement. Mergers such as this one, in a well-established industry, can produce winning results in terms of improved efficiency and cost savings.[11]

In an **acquisition**, a corporation or investor group finds a target company and negotiates with its board of directors to purchase it. In Verizon's recent $4.5 billion acquisition of Yahoo, Verizon was the acquirer, and Yahoo the target company.[12]

Worldwide merger activity in the first quarter of 2017 was mixed. The volume of deals was lower but with higher dollar value. The total number of deals fell by 17.9 percent versus the first quarter of 2016; however, the overall deal value was $678.5 billion.[13] We will discuss the increase in international mergers later in this chapter.

Types of Mergers

The three main types of mergers are horizontal, vertical, and conglomerate. In a **horizontal merger**, companies at the same stage in the same industry merge to reduce costs, expand product offerings, or reduce competition. Many of the largest mergers are horizontal mergers to achieve economies of scale. Its $1.25 billion acquisition of trucking company Overnite allowed UPS, the world's largest shipping carrier, to step up expansion of its heavy freight–delivery business, thus expanding its product offerings.[14]

In a **vertical merger**, a company buys a firm in its same industry, often involved in an earlier or later stage of the production or sales process. Buying a supplier of raw materials, a distribution company, or a customer gives the acquiring firm more control. A good example of this is Google's acquisition of Urchin Software Corp., a San Diego–based company that sells web analytics software and services that help companies track the effectiveness of their websites and online advertising. The move enables Google to bolster the software tools it provides to its advertisers.[15]

A **conglomerate merger** brings together companies in unrelated businesses to reduce risk. Combining companies whose products have different seasonal patterns or respond differently to business cycles can result in more stable sales. The Philip Morris Company, now called Altria Group, started out in the tobacco industry but diversified as early as the 1960s with the acquisition of Miller Brewing Company. It diversified into the food industry with its subsequent purchase of General Foods, Kraft Foods, and Nabisco, among others. Later spinning off many businesses, current product categories include cigarettes, smokeless tobacco such as Copenhagen and Skoal, cigars, e-vapor products such as MarkTen, and wines.

A specialized, financially motivated type of merger, the **leveraged buyout (LBO)**became popular in the 1980s but is less common today. LBOs are corporate takeovers financed by large amounts of borrowed money—as much as 90 percent of the purchase price. LBOs can be started by outside investors or the corporation's management. For example, the private equity firm Apollo Global Management LLC agreed to buy U.S. security company ADT Corp. in the largest leveraged buyout (LBO) of 2016.[16]

Often a belief that a company is worth more than the value of all its stock is what drives an LBO. They buy the stock and take the company private, expecting to increase cash flow by improving operating efficiency or selling off units for cash to pay off debt. Although some LBOs do improve efficiency, many do not live up to investor expectations or generate enough cash to pay their debt.

Merger Motives

Although headlines tend to focus on mega-mergers, “merger mania” affects small companies too, and motives for mergers and acquisitions tend to be similar regardless of the company’s size. The goal is often strategic: to improve overall performance of the merged firms through cost savings, elimination of overlapping operations, improved purchasing power, increased market share, or reduced competition. Oracle Corp. paid $5.85 billion to acquire Siebel Systems, its largest competitor in the sales automation programs market.[17]

Company growth, broadening product lines, acquiring technology or management skills, and the ability to quickly acquire new markets are other motives for acquiring a company. Yahoo Inc.’s $1 billion cash purchase of a 40 percent stake in China’s biggest e-commerce firm, Alibaba.com, instantly strengthened its ties to the world’s second largest internet market.[18]

Purchasing a company can also offer a faster, less risky, less costly option than developing products or markets in-house or expanding internationally. Amazon’s 2017 purchase of Whole Foods Market, an upscale grocery chain, for $13.7 billion was a move to enter the retail grocery sector. In addition to the new product market, this move offers Amazon opportunity to sell Amazon tech products in the grocery stores as well as access to an entirely new set of data on consumers.[19]

Another motive for acquisitions is financial restructuring—cutting costs, selling off units, laying off employees, and refinancing the company to increase its value to stockholders. Financially motivated mergers are based not on the potential to achieve economies of scale, but rather on the acquirer’s belief that the target has hidden value to be unlocked through restructuring. Most financially motivated mergers involve larger companies. In January 2018, Brookfield Business Partners, a subsidiary of Canada’s Brookfield Asset Management, announced that it plans to acquire Westinghouse Electric Co LLC, the bankrupt nuclear services company owned by Toshiba Corp., for $4.6 billion. Brookfield has a history of turning around distressed businesses.[20]

Emerging Truths

Along with the technology boom of the late 1990s, merger activity also soared. Total annual transactions averaged $1.6 trillion a year. Companies were using their stock, which had been pushed to unrealistically high levels, to buy each other. When the technology bubble burst in 2000, the level of merger activity dropped as well. It fell even further after the United States was attacked on September 11, 2001. Then massive corporate wrongdoing began to surface. Stocks plummeted in reaction to these events, and merger transactions, which generally track stock market movements, fell as a result.

Today, merger activity is once again on the rise. Propelled by a solid economy, low interest rates, good credit, rising stock prices, and stockpiles of cash, 2016’s $3.84 trillion of global M&A was historically a very strong year, with several blockbuster deals.[21]

Size is definitely an advantage when competing in the global marketplace, but bigger does not always mean better in the merger business. Study results show that heady mega-mergers can, in fact, be a bust for investors who own those shares. So companies are wise to consider their options before stuffing their dollars in the biggest merger slot machine they can find. In their eagerness to snare a deal, many buyers pay a premium that wipes out the merger’s entire potential economic gain. Often managers envision grand synergies that prove illusory or unworkable or buy a company that isn’t what it seems—not fully understanding what they are getting.

Integrating acquisitions is both an art and a science. Acquirers often underestimate the costs and logistical nightmare of consolidating the operations of merged companies with very different cultures. As a result, they may fail to keep key employees aboard, sales forces selling, and customers happy.

Companies will always continue to seek out acquisition candidates, but the fundamental business case for merging will have to be strong. So what should companies look for to identify mergers with a better-than-even chance of turning out well?

- A purchase price that is low enough—a 10 percent premium over market as opposed to 50 percent—so the buyer doesn’t need heroic synergies to make the deal work.
- A target that is significantly smaller than the buyer—and in a business the buyer understands. The more “transformational” the deal, such as entering a new business arena, the bigger the risk.
- A buyer who pays in cash and not overinflated stock.
- Evidence that the deal makes both business and financial sense and isn’t purely the brainchild of an empire-building CEO. Mergers are tough—culturally, commercially, and logistically. The most important quality a company can bring to a merger

may be humility.

CONCEPT CHECK

1. Differentiate between a merger and an acquisition.
2. What are the most common motives for corporate mergers and acquisitions?
3. Describe the different types of corporate mergers.

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5.8: Trends in Business Ownership

What current trends will affect the business organizations of the future?

As we learned earlier, an awareness of trends in the business environment is critical to business success. Many social, demographic, and economic factors affect how businesses organize. When reviewing options for starting or organizing a business or choosing a career path, consider the following trends.

"Baby Boomers" and "Millennials" Drive Franchise Trends

We all hear and read a great deal about the "graying of America," which refers to the "baby boomer" generation heading toward retirement age. This unprecedented demographic phenomenon—in 2006 the first of 78 million members of the baby boomer generation turned 60—is driving the ongoing battle to stay young, slim, and healthy. Every day, 10,000 boomers are turning 65, and the trend is likely to continue until 2030. Boomers have transformed every life stage they've touched so far, and their demographic weight means that business opportunities are created wherever they go.

With their interest in staying fit, Boomers are contributing to the growth of fitness and weight-loss franchises. In just the past year, this category in *Entrepreneur's*Franchise 500 has grown to over 50 franchisors. And according to the IHRSA, 52.9 million Americans belong to a health club—up from 39.4 million 10 years ago—so there are plenty of consumers feeding this growing trend.[22]

Another area of boomer-driven franchise growth is eldercare. Founded in 1994, Home Instead Senior Care is recognized as one of the world's fastest growing franchise companies in the eldercare market, with a network of over 1,000 independently owned and operated franchises in 12 countries. And as the world's population continues to age, the need for its unique services will continue to increase.

Home Instead Senior Care provides a meaningful solution for the elderly who prefer to remain at home. Compared with the annual cost for a nursing home placement ($72,000–$92,000), home care at around $45,000–$60,000 a year is somewhat more affordable. Elder quality of life is enhanced by Home Instead Senior Care's part-time, full-time, and around-the-clock services, designed for people who are capable of managing their physical needs but require some assistance and supervision. Home Instead Senior Care provides meal preparation, companionship, light housekeeping, medication reminders, incidental transportation, and errands. These services make it possible for the elderly to remain in the familiar comfort of their own homes for a longer period of time.[23]

But the best deal yet may be adult day services, one of the fastest-growing franchises and "still one of the best-kept secrets around" according to *Entrepreneur*magazine. Based on the concept of day care services for children, Sarah Adult Day Services, Inc. offers a franchising opportunity that meets the two criteria for a successful and socially responsible business: a booming demographic market with great potential for growth, and excellent elder care. Programs such as SarahCare centers are highly affordable for its clients, costing around $17,900 a year. The SarahCare franchise allows entrepreneurs to become part of an expanding industry while restoring a sense of dignity and vibrancy to the lives of older adults.[24]

Millennials—individuals born between 1980 and 2000—are the largest living generation in the United States, according to Pew Research. Millennials spend more money in restaurants per capita than any previous generation. They have been recognized as changing the restaurant scene by looking for brands that offer customized food choices, quality ingredients, freshness, authenticity, transparency, and environmental and social responsibility. According to the U.S. Chamber of Commerce Foundation's report, two out of three millennials are interested in entrepreneurship. According to *Forbes* magazine, 72 percent of millennials would like to be their own boss, 74 percent want flexible work schedules, and 88 percent want "work–life integration." When it comes to owning a franchise, growth potential and meeting a flexible, fulfilling lifestyle are both something that attracts Millennials. A survey by the CT Corporation found that 60 percent of college graduates wanted to start a business after graduation, 67 percent lacked the know-how, 45 percent didn't think they could come up with a name, and 30 percent were not knowledgeable about how to market the business. Franchising is the perfect solution to these issues. For example, Chicago area native and millennial Sal Rehman grew up working in his family's diner. Sal had a dream of operating his own restaurant, and he decided to take the franchising path. In 2015, at the age of 27, Sal opened his first Wing Zone store in suburban Glendale Heights, Illinois.

He currently owns five Wing Zones.[25]

Boomers Rewrite the Rules of Retirement

At age 64, Bob Drucker could be the poster child for retirement except that the concept makes him recoil. Drucker is living his dream. He and his wife have a large house on Long Island where Drucker kicks back by floating in his pool when he's not spoiling his granddaughters with trips to Disneyland.

"The only way you can get me out of here is to carry me out," Drucker says, referring to RxUSA, the online pharmacy he founded and runs in Port Washington, New York. "I love my work, and I cannot imagine sitting home and doing nothing."

Drucker is not alone. Today's boomers are working longer at their jobs and embracing postretirement second careers, which often means starting their own small business.[26] As retirees opt to go into business for themselves, they are choosing different forms of business organizations depending on their needs and goals. Some may start small consulting businesses using the simple sole proprietorship form of business organization, while couples or friends might choose to become partners in a retail or franchise venture.

The more healthy and energetic the baby boomer generation remains, the more interested it is in staying active and engaged—and that may mean postponing retirement or not retiring at all. The annual retirement survey by Transamerica Center for Retirement Studies found that as this record number of Americans approaches retirement age, many are not slowing down. In fact, 51 percent of boomers plan to work in some capacity during their retirement years, and 82 percent indicated that they will not retire at or before age 65.[27]

Mergers and Foreign Investment Boom, Too

After shunning big deals for more than three years, corporate America has launched a new merger wave. In 2016, North American companies announced deals totaling almost $2.0 trillion. Many of these deals were large ones, with the largest deal, announced in 2016, AT&T's merger with Time Warner for over $85 billion. In addition, foreign merger activity has reached a new high. Worldwide deal volume in 2015 was 44,000 transactions totaling $4.5 trillion. In 2016, the number of transactions increased to over 48,000, one of the most active periods of merger activity to date. Non-U.S. companies accounted for about two-thirds of the transactions. European companies' cross-border transactions led the way, with deals totaling more than one trillion dollars. The increase is the result of improving economic growth and better stock prices.[28]

This current boom in mergers feels different from earlier merger mania, however. New players are entering the arena, and the number of U.S. and foreign companies making cross-border acquisitions has increased. Whether these new mergers will be good for the global economy remains to be seen. Transactions that lead to cost savings, streamlined operations, and more funding for research and capital investment in new facilities will have positive effects on profitability. Many deals, however, may fail to live up to the acquirers' expectations.

Foreign investment in U.S. companies has also increased dramatically. Annual foreign direct investment reached $373.4 billion in 2016.[29] The jump is the result of a worldwide boom in mergers and acquisitions and the need to finance America's growing trade deficit, as well as the continued attraction of the U.S. economy to investors worldwide.

And what about American investment in foreign economies? It is skyrocketing as U.S. businesses seek out opportunities in developing countries. According to the Congressional Research Service Reports, the outflows from the United States into foreign countries now exceeds $6.4 trillion a year.[30] In addition to the attraction of cheap labor and resources, U.S. companies of all sizes continue to tap the intellectual capital of developing economies such as China and India, outsourcing such functions as payroll, information technology (IT), web/email hosting, customer relationship management (CRM), and human resources (HR) to keep costs under control and enhance profitability.

CONCEPT CHECK

1. What are some of the demographic trends currently impacting American business?
2. As a prospective business owner, what could you do to capitalize on these trends?
3. What other economic trends are influencing today's business organizations?

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6: OPERATIONS MANAGEMENT IN MANUFACTURING AND SERVICE INDUSTRIES

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6.4: Graphical Tools- PERT and Gantt Charts

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6.1: Operations Management in Manufacturing

Learning Objectives

1. Define operations management, and discuss the role of the operations manager in a manufacturing company.
2. Describe the decisions made in planning the production process in a manufacturing company.

Like PowerSki, every organization—whether it produces goods or provides services—sees Job 1 as furnishing customers with quality products. Thus, to compete with other organizations, a company must convert resources (materials, labor, money, information) into goods or services as efficiently as possible. The upper-level manager who directs this transformation process is called an *operations manager*. The job of operations management (OM), then, consists of all the activities involved in transforming a product idea into a finished product, as well as those involved in planning and controlling the systems that produce goods and services. In other words, operations managers manage the process that transforms inputs into outputs. Figure 11.1 illustrates this traditional function of operations management.

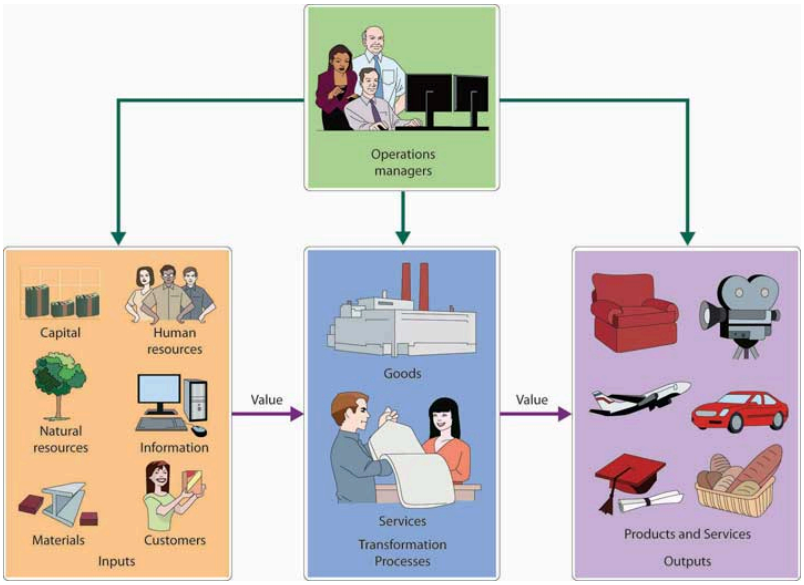


Figure 11.1 The Transformation Process

In the rest of this chapter, we'll discuss the major activities of operations managers. We'll start by describing the role that operations managers play in the various processes designed to produce goods and offer services. Next, we'll look at the production of goods in manufacturing firms; then, we'll describe operations management activities in companies that provide services. We'll wrap up the chapter by explaining the role of operations management in such processes as quality control and outsourcing.

Operations Management in Manufacturing

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

- *Production planning*. During production planning, managers determine how goods will be produced, where production will take place, and how manufacturing facilities will be laid out.
- *Production control*. Once the production process is under way, managers must continually schedule and monitor the activities that make up that process. They must solicit and respond to feedback and make adjustments where needed. At this stage,

they also oversee the purchasing of raw materials and the handling of inventories.
- *Quality control*. Finally, the operations manager is directly involved in efforts to ensure that goods are produced according to specifications and that quality standards are maintained.

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

Planning the Production Process

The decisions made in the planning stage have long-range implications and are crucial to a firm's success. Before making decisions about the operations process, managers must consider the goals set by marketing managers. Does the company intend to be a low-cost producer and to compete on the basis of price? Or does it plan to focus on quality and go after the high end of the market? Perhaps it wants to build a reputation for reliability. What if it intends to offer a wide range of products? To make things even more complicated, all these decisions involve trade-offs. Upholding a reputation for reliability isn't necessarily compatible with offering a wide range of products. Low cost doesn't normally go hand in hand with high quality.

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

Production-Method Decisions

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

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

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

Make-to-Order

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

Mass Production



Figure 11.2: Automakers produce a high volume of cars in anticipation of future demand. (Dawn Endico – Dealer Prep – CC BY-SA 2.0.)

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

Mass Customization

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

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

The list of companies devoting at least a portion of their operations to mass customization is growing steadily. One of the best-known mass customizer is Nike, which has achieved success by allowing customers to configure their own athletic shoes, apparel, and equipment through Nike's iD program. The Web has a lot to do with the growth of mass customization. Levi's, for instance, lets a woman find a pair of perfect fitting jeans by going through an online fitting process that first identifies her "curve" type: *slight* (straight figure), *demi* (evenly proportioned), *bold* (curvy figure, which experiences waist gapping in the back), and supreme (curviest shape, which needs a higher rise in the back). Oakley offers customized sunglasses, goggles, watches, and backpacks, while Mars, Inc. can make M&M's in any color the customer wants (say, school colors) as well as add text and pictures to the candy[1].

Naturally, mass customization doesn't work for all types of goods. Most people don't care about customized detergents or paper products (although a customized Kleenex tissue box with your picture on it and a statement that says, "go ahead...cry over me!" might come in handy after a relationship breakup with your significant other (Windisman, 2008).) And while many of us like the idea of customized clothes, footwear, or sunglasses from Levi's, Nike, or Oakley, we often aren't willing to pay the higher prices they command.

Facilities Decisions

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

Site Selection

In choosing a location, managers must consider several factors:

- To minimize shipping costs, both for raw materials coming into the plant and for finished goods going out, managers often want to locate plants close to suppliers, customers, or both.
- They generally want to locate in areas with ample numbers of skilled workers.
- They naturally prefer locations where they and their families will enjoy living.
- They want locations where costs for resources and other expenses—land, labor, construction, utilities, and taxes—are low.
- They look for locations with a favorable business climate—one in which, for example, local governments might offer financial incentives (such as tax breaks) to entice them to do business in their locales.

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

Capacity Planning

Now that you know *where* you're going to locate, you have to decide on the quantity of products that you'll produce. You begin by *forecasting* demand for your product. As we discussed in Chapter 10 "Product Design and Development", forecasting isn't easy. To estimate the number of units that you're likely to sell over a given period, you have to understand the industry that you're in and estimate your likely share of the market by reviewing industry data and conducting other forms of research.

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

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

Key Takeaways

The job of **operations management** is to oversee the process of transforming resources into goods and services.

- The role of operations managers in the manufacturing sector includes production planning, production control, and quality control.
- During production planning, managers determine how goods will be produced (production process), where production will take place (site selection), and how manufacturing facilities will be laid out (layout planning).
- In selecting the appropriate production process, managers compare three basic methods: **make-to-order strategy** (goods are made to customer specifications), **mass production** or **make-to-stock strategy** (high volumes of goods are made and held in inventory for later sale), and **mass customization** (high volumes of customized goods are made).
- In choosing the site for a company's manufacturing operations, managers look for locations that minimize shipping costs, have an ample supply of skilled workers, provide a favorable community for workers and their families, offer resources at low cost, and have a favorable business climate.
- Managers estimate the quantity of products to be produced by forecasting demand for their product and then calculating the capacity requirements of the production facility—the maximum number of goods that it can produce over a given period

under normal working conditions.

Exercises

(AACSB) Analysis

Two former surfers invented a material for surfboards that's lighter and stronger than anything manufacturers now use. They have received funding to set up a production facility, and they want you to help them select a location. In addition to your recommendation, identify the factors that you considered in reaching your decision.

(AACSB) Analysis

Compare and contrast three common types of production processes: make-to-order, make-to-stock, and mass customization. What are the advantages and disadvantages of each? Why are more companies devoting at least a portion of their operations to mass customization? Identify three goods that could probably be adapted to mass customization and three that probably couldn't.

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6.2: Facility Layouts

Learning Objective

- Describe four major types of facility layouts: process, product, cellular, and fixed position.

The next step in production planning is deciding on plant layout—how equipment, machinery, and people will be arranged to make the production process as efficient as possible. In this section, we'll examine four common types of facility layouts: process, product, cellular, and fixed position.

The process layout groups together workers or departments that perform similar tasks. *Goods in process* (goods not yet finished) move from one workstation to another. At each position, workers use specialized equipment to perform a particular step in the production process. To better understand how this layout works, we'll look at the production process at the Vermont Teddy Bear Company. Let's say that you just placed an order for a personalized teddy bear—a "hiker bear" with khaki shorts, a white T-shirt with your name embroidered on it, faux-leather hiking boots, and a nylon backpack with sleeping bag. Your bear begins at the fur-cutting workstation, where its honey-brown "fur" coat is cut. It then moves to the stuffing and sewing workstation to get its insides and have its sides stitched together. Next, it moves to the dressing station, where it's outfitted with all the cool clothes and gear that you ordered. Finally, it winds up in the shipping station and starts its journey to your house. For a more colorful "Online Mini-Tour" of this process, log on to the Vermont Teddy Bear Web site at http://www.vermontteddybear.com/Stat...mestation.aspx (or see Figure 11.3).

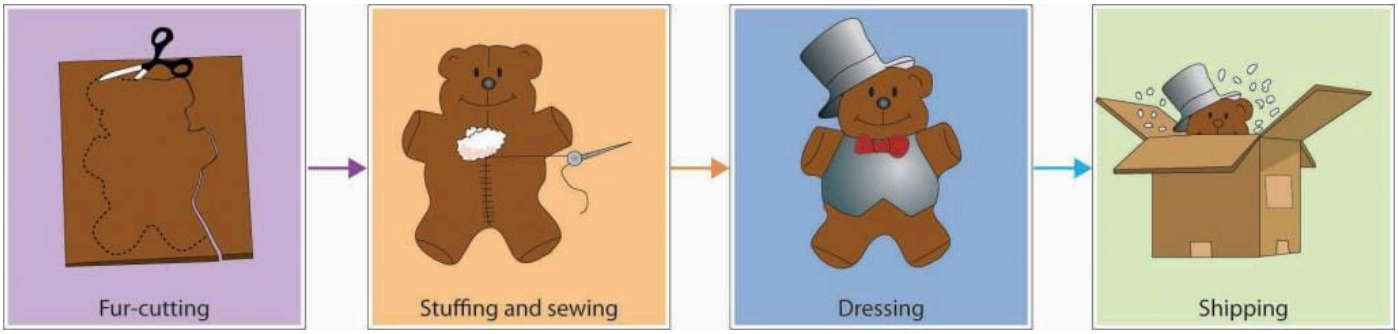


Figure 11.3 Process Layout at Vermont Teddy Bear Company

In a product layout, high-volume goods are produced efficiently by people, equipment, or departments arranged in an *assembly line*—that is, a series of workstations at which already-made parts are *assembled*. Just Born, a candy maker located in Bethlehem, Pennsylvania, makes a product called Marshmallow Peeps on an assembly line. First, the ingredients are combined and whipped in huge kettles. Then, sugar is added for color. At the next workstation, the mixture—colored warm marshmallow—is poured into baby-chick–shaped molds carried on conveyor belts. The conveyor-belt parade of candy pieces then moves forward to stations where workers add eyes or other details. When the finished candy reaches the packaging area, it's wrapped for shipment to stores around the world. To take an online tour of the Marshmallow Peeps production process, log on to the Just Born Web site at www.justborn.com/get-to-know-us/our-factory (or see Figure 11.4).

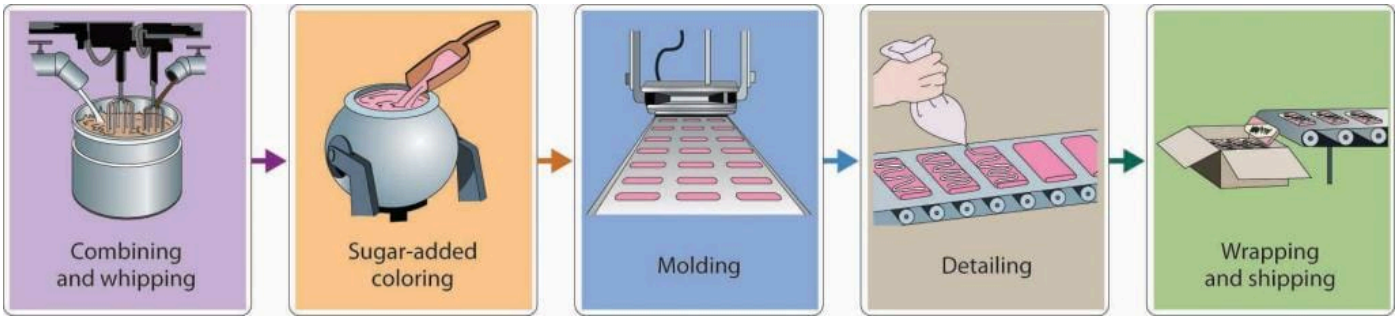


Figure 11.4 Product Layout at Just Born, Inc.

Both product and process layouts arrange work by *function*. At the Vermont Teddy Bear Company, for example, the cutting function is performed in one place, the stuffing-and-sewing function in another place, and the dressing function in a third place. If you're a cutter, you cut all day; if you're a sewer, you sew all day: that's your function. The same is true for the production of Marshmallow Peeps at Just Born: if your function is to decorate peeps, you stand on an assembly line and decorate all day; if your function is packing, you pack all day.

Arranging work by function, however, isn't always efficient. Production lines can back up, inventories can build up, workers can get bored with repetitive jobs, and time can be wasted in transporting goods from one workstation to another. To counter some of these problems, many manufacturers have adopted a cellular layout, in which small teams of workers handle all aspects of building a component, a "family" of components, or even a finished product. Each team works in a small area, or cell, equipped with everything that it needs to function as a self-contained unit. Machines are sometimes configured in a U-shape, with people working inside the U. Because team members often share duties, they're trained to perform several different jobs. Teams monitor both the quantity and the quality of their own output. This arrangement often results in faster completion time, lower inventory levels, improved quality, and better employee morale. Cellular manufacturing is used by large manufacturers, such as Boeing, Raytheon, and Pratt & Whitney (Chaneski, 1998), as well as by small companies, such as Little Enterprise, which makes components for robots (Modern Machine Shop Magazine, 2001; Little Enterprises, Inc., 2011). Figure 11.5 illustrates a typical cellular layout.

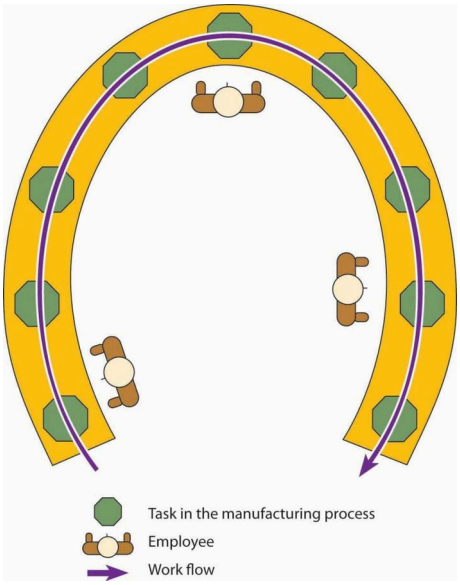


Figure 11.5 Cellular Layout

It's easy to move teddy bears and marshmallow candies around the factory while you're making them, but what about airplanes or ships? In producing large items, manufacturers use fixed-position layout in which the product stays in one place and the workers (and equipment) go to the product. This is the arrangement used by General Housing Corporation in constructing modular homes. Each house is constructed at the company's factory in Bay City, Michigan, according to the customer's design. Because carpenters, electricians, plumbers, and others work on each building inside the climate-controlled factory, the process can't be hindered by weather. Once it's done, the house is transported in modules to the owner's building site and set up in one day. For a closer view of General Housing Corporation's production process, go to the General Housing Web site at http://www.genhouse.com.

Key Takeaways

- Managers have several production **layout** choices, including process, product, cellular, and fixed-position.
- The process layout groups together workers or departments that perform similar tasks. At each position, workers use specialized equipment to perform a particular step in the production process.
- In a product layout, high-volume goods are produced in assembly-line fashion—that is, a series of workstations at which already-made parts are assembled.
- In a cellular layout, small teams of workers handle all aspects of building a component, a "family of components," or even a finished product.
- A fixed-position layout is used to make large items (such as ships or buildings) that stay in one place while workers and

equipment go to the product.

Exercise

(AACSB) Analysis

As purchasing manager for a company that flies corporate executives around the world, you're responsible for buying everything from airplanes to onboard snacks. You plan to visit all the plants that make the things you buy: airplanes, passenger seats, TV/DVDs that go in the back of the passenger seats, and the specially designed uniforms (with embroidered company logos) worn by the flight attendants. What type of layout should you expect to find at each facility—process, product, or fixed-position? What will each layout look like? Why is it appropriate for the company's production process? Could any of these plants switch to a cellular layout? What would this type of layout look like? What would be its advantages?

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6.3: Managing the Production Process in a Manufacturing Company

Learning Objective

- Identify the activities undertaken by the operations manager in overseeing the production process in a manufacturing company.

Once the production process is in place, the attention of the operations manager shifts to the daily activities of materials management, which encompass the following activities: purchasing, inventory control, and work scheduling.

Purchasing and Supplier Selection

The process of acquiring the materials and services to be used in production is called purchasing (or *procurement*). For many products, the costs of materials make up about 50 percent of total manufacturing costs. Not surprisingly, then, materials acquisition gets a good deal of the operations manager's time and attention.

As a rule, there's no shortage of vendors willing to supply parts and other materials, but the trick is finding the *best* suppliers. In selecting a supplier, operations managers must consider such questions as the following:

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

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

E-Purchasing

Technology is changing the way businesses buy things. Through *e-purchasing* (or *e-procurement*), companies use the Internet to interact with suppliers. The process is similar to the one you'd use to find a consumer good—say, a forty-two-inch LCD high-definition TV—over the Internet. You might start by browsing the Web sites of TV manufacturers, such as Sony or Samsung, or electronics retailers, such as Best Buy. To gather comparative prices, you might go to a comparison-shopping Web site, such as Amazon.com, the world's largest online retailer. You might even consider placing a bid on eBay, an online marketplace where sellers and buyers come together to do business through auctions. Once you've decided where to buy your TV, you'd complete your transaction online, even paying for it electronically.

If you were a purchasing manager using the Internet to buy parts and supplies, you'd follow basically the same process. You'd identify potential suppliers by going directly to private Web sites maintained by individual suppliers or to public Web sites that collect information on numerous suppliers. You could do your shopping through online catalogs, or you might participate in an online marketplace by indicating the type and quantity of materials you need and letting suppliers bid on prices. (Some of these e-marketplaces are quite large. Covisint, for example, which was started by automakers to coordinate online transactions in the auto industry, is used by more than two hundred and fifty thousand suppliers in the auto industry, as well as suppliers in the health care field.) (Jingzhi, 2011) Finally, just as you paid for your TV electronically, you could use a system called electronic data interchange (EDI) to process your transactions and transmit all your purchasing documents.

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

And it's faster for procurement and fosters better communications.

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6.4: Graphical Tools- PERT and Gantt Charts

Learning Objective

1. Explain how to create and use both PERT and Gantt charts.

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

Gantt Charts

A Gantt chart, named after the designer, Henry Gantt, is an easy-to-use graphical tool that helps operations managers determine the status of projects. Let's say that you're in charge of making the "hiking bear" that we ordered earlier from the Vermont Teddy Bear Company. Figure 11.7 is a Gantt chart for the production of one hundred of these bears. As you can see, it shows that several activities must be completed before the bears are dressed: the fur has to be cut, stuffed, and sewn; and the clothes and accessories must be made. Our Gantt chart tells us that by day six, all accessories and clothing have been made. The stuffing and sewing, however (which must be finished before the bears are dressed), isn't scheduled for completion until the end of day eight. As operations manager, you'll have to pay close attention to the progress of the stuffing and sewing operations to ensure that finished products are ready for shipment by their scheduled date.

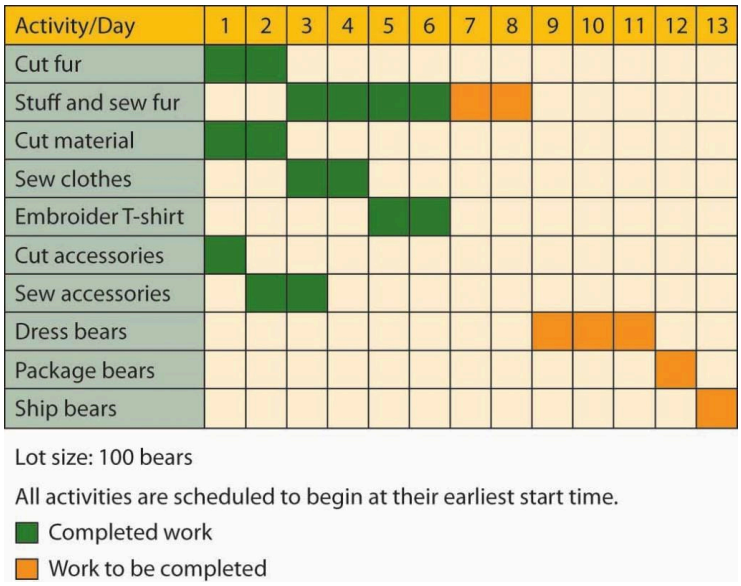


Figure 11.7 Gantt Chart for Vermont Teddy Bear

PERT Charts

Gantt charts are useful when the production process is fairly simple and the activities aren't interrelated. For more complex schedules, operations managers may use **PERT charts**. PERT (which stands for *Program Evaluation and Review Technique*) is designed to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence. It also identifies a *critical path*: the sequence of activities that will entail the greatest amount of time. Figure 11.8 is a PERT diagram showing the same process for producing one "hiker" bear at Vermont Teddy Bear.

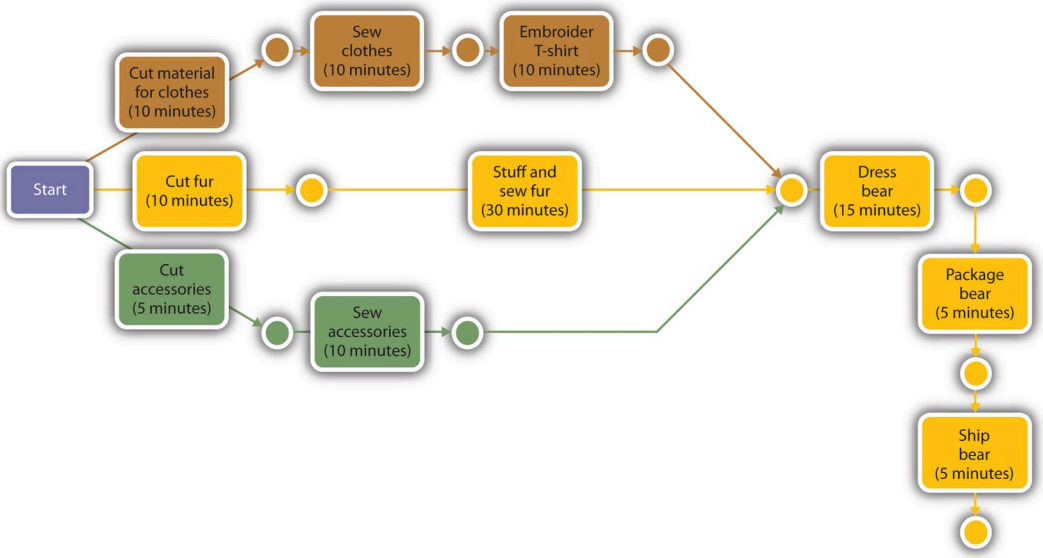


Figure 11.8 PERT Chart for Vermont Teddy Bear

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

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

Key Takeaways

- Gantt and PERT charts are two of the most common graphical tools used by operations managers to diagram the activities involved in producing goods.
- A Gantt chart is an easy-to-use graphical tool that helps operations managers determine the status of projects.
- PERT charts are used to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence.
- A PERT chart identifies a critical path—the sequence of activities that will entail the greatest amount of time.

Exercise

(AACSB) Analysis

Earning a college degree requires not only a lot of hard work but also, as you know, a lot of planning. You must, for example, complete a specified number of credits and take many required courses, particularly in your major. Deciding which courses to take and when to take them can be complicated when some of them have prerequisites. A PERT chart—which diagrams the activities required to complete a goal—might help you determine the order in which you should take courses for your major. Pick a major that interests you and find out what courses you'd need to complete it. Then prepare a PERT chart showing all the courses you'd plan to take each semester to complete your major. (For example, if you select the accounting major, include only accounting courses; don't include your other business courses or your elective courses.) Identify the critical path laid out in your chart. What happens if you fail to take one of your critical-path courses on time?

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6.5: The Technology of Goods Production

Learning Objective

- Explain how manufacturing companies use technology to produce and deliver goods in an efficient, cost-effective manner.

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

Computer-Aided Design

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

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

Computer-Aided Manufacturing

For many companies, the next step is to link CAD to the manufacturing process. A computer-aided manufacturing (CAM) software system determines the steps needed to produce the component and instructs the machines that do the work. Because CAD and CAM programs can "talk" with each other, companies can build components that satisfy exactly the requirements set by the computer-generated model. CAD/CAM systems permit companies to design and manufacture goods faster, more efficiently, and at a lower cost, and they're also effective in helping firms monitor and improve quality. CAD/CAM technology is used in many industries, including the auto industry, electronics, and clothing.

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.

Flexible Manufacturing Systems

Finally, a CIM system is a common element in flexible manufacturing systems (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods. An FMS has immense advantages over traditional production lines in which machines are set up to produce only one type of good. When the firm needs to switch a production line to manufacture a new product, substantial time and money are often spent in modifying equipment. An FMS makes it possible to change equipment setups merely by reprogramming computer-controlled machines. Such flexibility is particularly valuable to companies

that produce customized products.

Key Takeaways

- In addition to creating high-quality products, companies must produce and deliver goods and services in an efficient, cost-effective manner.
- Sophisticated software systems, including **computer-aided design (CAD)**, **computer-aided manufacturing (CAM)**, **computer-integrated manufacturing (CIM)**, and **flexible manufacturing systems (FMS)**, are becoming increasingly important in this area.
- Computer-aided design software (CAD) is used to create models representing the design of a product.
- Many companies link CAD systems to the manufacturing process through computer-integrated manufacturing (CIM) systems that not only determine the steps needed to produce components but also instruct machines to do the necessary work.
- A CAD/CAM system can be expanded by means of computer-integrated manufacturing (CIM), which integrates various operations (from design through production) with functional activities ranging from order taking to shipping.
- A CIM system is a common element in a flexible manufacturing system (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods.

Exercise

(AACSB) Analysis

The design and production of both goods and services can be facilitated by various high-tech tools, including CAD, CAM, CIM, and FMS. What does CAD software do, and how does it improve a design process? What is CAM, and why is it beneficial to integrate CAD and CAM programs? How do CIM systems expand the capabilities of CAD/CAM? What is an FMS, and what are its advantages over traditional manufacturing systems?

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6.6: Operations Management for Service Providers

Learning Objectives

1. List the characteristics that distinguish service operations from manufacturing operations.
2. Describe the decisions made in planning the product delivery process in a service company.
3. Identify the activities undertaken to manage operations in a service organization.

As the U.S. economy has changed from a goods producer to a service provider, the predominance of the manufacturing sector has declined substantially over the last sixty years. Today, only about 9 percent of U.S. workers are employed in manufacturing, in contrast to 30 percent in 1950 (The Global Language Monitor, 2010; Strauss, 2010). Most of us now hold jobs in the service sector, which accounts for 77 percent of U.S. gross domestic product (International Monetary Fund, 2010; Wikipedia, 2011). Wal-Mart is now America's largest employer, followed by IBM, United Parcel Service (UPS), McDonald's, and Target. Not until we drop down to the seventh-largest employer—Hewlett Packard—do we find a company with even a manufacturing component (24/7 Wall Street, 2011).



Figure 11.9: Wal-Mart employs more than a million people in the United States. (Mike Mozart – Walmart – CC BY 2.0.)

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*. Manufactured goods are generally standardized; one twelve-ounce bottle of Pepsi is the same as any other twelve-ounce bottle of Pepsi. Services, by contrast, are often customized to satisfy the specific needs of a customer. When you go to the barber or the hairdresser, you ask for a haircut that looks good on you because of the shape of your face and the texture of your hair. When you go to the dentist, you ask him or her to fill or pull the tooth that's bothering you.
- *Customer contact*. You could spend your entire working life assembling cars in Detroit and never meet a customer who bought a car that you helped to make. But if you were a waitress, you'd interact with customers every day. In fact, their satisfaction with your product would be determined in part by the service that you provided. Unlike manufactured goods, many services are bought and consumed at the same time.



Figure 11.10: 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), home of the Whopper, and the world's second-largest restaurant chain."Press Room," Burger King, http://www.bk.com/en/us/company-info/press/index.html (accessed November 2, 2011). BK has grown substantially since selling the first Whopper (for $0.37) almost half a century ago. The instant success of the fire-grilled burger encouraged the Miami founders of the company to expand by selling franchises. Today, there are 12,200 BK company- and independently-owned franchised restaurants in seventy-three countries (seven thousand of which are in the United States), and they employ almost forty thousand people.SEC, *10K SEC Filings*, Burger King Corporation, August 2010, http://services.corporate-ir.net/SEC.Enhanced/SecCapsule.aspx?c=87140&fid=7105569 (accessed November 3, 2011). More than eleven million customers visit BK each day."Press Room," Burger King, http://www.bk.com/en/us/company-info/press/index.html (accessed November 2, 2011).

Operations Planning

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

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

Let's see how service firms like BK answer questions such as these.Information on Burger King was obtained from an interview with David Sell, former vice president of Central, Eastern, and Northern Europe divisions and president of Burger King France and Germany.

Operations Processes

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

Service providers that produce goods can, like manufacturers, adopt either a *make-to-order* or a *make-to-stock* approach to manufacturing them. BK, which encourages patrons to customize burgers and other menu items, uses a make-to-order approach. BK can customize products because it builds sandwiches one at a time rather than batch-process them. Meat patties, for example,

go from the grill to a steamer for holding until an order comes in. Then the patty is pulled from the steamer and requested condiments are added. Finally, the completed sandwich chutes to a counter worker, who gives it to the customer. In contrast, many of BK's competitors, including McDonald's, rely on a make-to-stock approach in which a number of sandwiches are made at the same time with the same condiments. If a customer wants, say, a hamburger without onions, he or she has to wait for a new batch of patties to be grilled. The procedure could take up to five minutes, whereas BK can process a special order in thirty seconds.

Like manufacturers, service providers must continuously look for ways to improve operational efficiency. Throughout its sixty-year history, BK has introduced a number of innovations that have helped make the company (as well as the fast-food industry itself) more efficient. BK, for example, was the first to offer drive-through service (which now accounts for 70 percent of its salesBob Krummert, "Burger King: Headed For A Fast-Casual Flameout?," *Restaurant Hospitality*, http://restaurant-hospitality.com/news/burger-king-headed-flameout-1019/ (accessed November 3, 2011).).

It was also a BK vice president, David Sell, who came up with the idea of moving the drink station from behind the counter so that customers could take over the time-consuming task of filling cups with ice and beverages. BK was able to cut back one employee per day at every one of its more than eleven thousand restaurants. Material costs also went down because customers usually fill cups with more ice, which is cheaper than a beverage. Moreover, there were savings on supply costs because most customers don't bother with lids, and many don't use straws. On top of everything else, most customers liked the system (for one thing, it allowed them to customize their own drinks by mixing beverages), and as a result, customer satisfaction went up, as well. Overall, the new process was a major success and quickly became the industry standard.

Facilities

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

Site Selection

People in the real estate industry often say that the three most important factors to consider when you're buying a home are location, location, location. The same principle applies when you're trying to locate a service business. To be successful in a service industry, you need to be accessible to your customers. Some service businesses, such as cable-TV providers, package-delivery services, and e-retailers, go to their customers. Many others, however—hotels, restaurants, stores, hospitals, and airports—have to attract customers to their facilities. These businesses must locate where there's a high volume of available customers. Let's see how BK decides where to place a restaurant.

"Through the light and to the right." This is a favorite catchphrase among BK planners who are looking for a promising spot for a new restaurant (at least in the United States). In picking a location, BK planners perform a detailed analysis of demographics and traffic patterns, yet the most important factor is usually *traffic count*—the number of cars or people that pass by a specific location in the course of a day. In the United States, where we travel almost everywhere by car, BK looks for busy intersections, interstate interchanges with easy off and on ramps, or such "primary destinations" as shopping malls, tourist attractions, downtown business areas, or movie theaters. In Europe, where public transportation is much more common, planners focus on subway, train, bus, and trolley stops.

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

Size and Layout

Because manufacturers do business out of plants rarely visited by customers, they base the size and layout of their facilities solely on production needs. In the service sector, however, most businesses must design their facilities with the customer in mind: they must accommodate the needs of their customers while keeping costs as low as possible. Performing this twofold task isn't easy. Let's see how BK has met the challenge.

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

To continue growing, BK needed to change the way it found and developed its locations. Planners decided that they had to find ways to reduce the size of a typical BK restaurant. For one thing, they could reduce the number of seats, because the business at a typical outlet had shifted over time from 90 percent inside dining and 10 percent drive-through to a 50-50 split. BK customers tended to be in a hurry, and more customers preferred the convenience of drive-through “dining.”

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

Ideas like these helped BK trim the size of a restaurant from four thousand square feet to as little as one thousand. In turn, smaller facilities enabled the company to enter markets that were once cost prohibitive. Now BK could locate profitably in airports, food courts, strip malls, center-city areas, and even schools. The company even designed 10-foot-by-10-foot kiosks that could be transported to special events, stadiums, and concerts.

Capacity Planning

Estimating capacity needs for a service business isn’t the same thing as estimating those of a manufacturer. A manufacturer can predict overall demand, produce the product, store it in inventory, and ship it to a customer when it’s ordered. Service providers, however, can’t store their products for later use: hairdressers can’t “inventory” haircuts, hospitals can’t “inventory” operations, and amusement parks can’t “inventory” roller-coaster rides. Service firms have to build sufficient capacity to satisfy customers’ needs on an “as-demanded” basis. Like manufacturers, service providers must consider many variables when estimating demand and capacity:

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



Figure 11.11: Retailers have to be prepared to accommodate much heavier traffic than normal during the holiday season. (Pexel License; Vladimir Srajber via Pexels)

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

Managing Operations

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

Scheduling

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

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

Inventory Control

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

Key Takeaways

- Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations.
- While manufacturers produce tangible, generally standardized products, service firms provide intangible products that are often customized to satisfy specific needs. Unlike manufactured goods, many services are bought and consumed at the same time.
- Operational efficiency is just as important in service industries as it is in manufacturing.
- Operations managers in the service sector make many decisions that are similar to those made by manufacturers: they decide which services to offer, how to provide these services, where to locate their businesses, what their facilities will look like, and what the demand will be for their services.
- Service providers that produce goods can, like manufacturers, adopt either a make-to-order approach (in which products are made to customer satisfaction) or make-to-stock approach (in which products are made for inventory) to manufacturing them.
- Estimating **capacity** needs for a service business is more difficult than for a manufacturer. Service providers can't store their services for later use: services must be delivered on an as-needed basis.
- Overseeing a service organization puts special demands on managers, especially services requiring a high degree of contact with customers.

- Given the importance of personalized service, scheduling workers is more complex in the service industry than in manufacturing. In manufacturing, operations managers focus on scheduling the *activities* needed to produce goods; in service organizations, they focus on scheduling *workers* to ensure that enough people are available to handle fluctuating customer demand.

Exercise

(AACSB) Analysis

Starting a new business can be an exciting adventure. Here's your chance to start a "pretend" business. Select a service business that you'd like to open, and answer these questions. Provide an explanation for each answer:

1. What services (and perhaps goods) will I provide?
2. How will I provide these services?
3. Where will I locate my business?
4. What will the facilities look like (how large will the facilities be and what will the layout look like)?
5. How many customers will I serve each day?
6. When will my customers want my services (which days of the week, which times of the day)?
7. How long will it take to serve each customer?
8. Why will my business succeed? Why will my customers return?

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6.7: Producing for Quality

Learning Objective

- Explain how manufacturing and service companies alike use total quality management and outsourcing to provide value to customers.

What do you do if you get it home and your brand-new DVD player doesn't work? What if you were late for class because it took you twenty minutes to get a burger and order of fries at the drive-through window of a fast-food restaurant? Like most people, you'd probably be more or less disgruntled. As a customer, you're constantly assured that when products make it to market, they're of the highest possible quality, and you tend to avoid brands that have failed to live up to your expectations or to producers' claims. You're told that workers in such businesses as restaurants are there to serve you, and you probably don't go back to establishments where you've received poor-quality service.

But what is *quality*? According to the American Society for Quality, quality refers to "the characteristics of a product or service that bear on its ability to satisfy stated or implied needs" (American Society of Quality, 2011). When you buy a DVD player, you expect it to play DVDs. When it doesn't, you question its quality. When you go to a drive-through window, you expect to be served in a reasonable amount of time. If you're forced to wait, you conclude that you're the victim of poor-quality service.

Quality Management

To compete today, companies must deliver quality goods and services that satisfy customers' needs. This is the objective of quality management. Total quality management (TQM), or quality assurance, includes all the steps that a company takes to ensure that its goods or services are of sufficiently high quality to meet customers' needs. Generally speaking, a company adheres to TQM principles by focusing on three tasks:

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

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

Customer Satisfaction

Companies that are committed to TQM understand that the purpose of a business is to generate a profit by satisfying customer needs. Thus, they let their customers define *quality* by identifying and offering those product features that satisfy customer needs. They encourage customers to tell them how to make the right products, both goods and services, that work the right way.

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

Employee Involvement

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

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

Continuous Improvement

An integral part of TQM is continuous improvement: the commitment to making constant improvements in the design, production, and delivery of goods and services. Improvements can almost always be made to increase efficiency, reduce costs, and improve customer service and satisfaction. Everyone in the organization is constantly on the lookout for ways to do things better.

Statistical Process Control

Companies can use a variety of tools to identify areas for improvement. A common approach in manufacturing is called statistical process control. This technique monitors production quality by testing a sample of output to see whether goods in process are being made according to predetermined specifications.

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

Benchmarking

Sometimes it also helps to look outside the organization for ideas on how to improve operations and to learn how your company compares with others. Companies routinely use benchmarking to compare their performance on a number of dimensions with the performance of other companies that excel in particular areas. Frequent benchmark targets include L.L. Bean, for its superior performance in filling orders; 3M, for its record of introducing innovative products; Motorola, for its success in maintaining consistent quality standards; and Mary Kay Cosmetics, for its skills in inventory control (Nuese, 1995).

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6.8: Cases and Problems

Learning on the Web (AACSB)

How to Build a BMW

How'd you like to own a Series 3 BMW? How about a convertible priced at $48,000 for those warm summer days? Or maybe a less expensive coupe for $39,000? Or, if you need more space for hauling camping equipment, dogs, or kids, maybe you would prefer a wagon at $37,000? We can't help you finance a BMW, but we can show you how they're made. Go to http://www.bmw-plant-munich.com/ to link to the BMW Web site for a virtual tour of the company's Munich, Germany, plant.

First, click on "Location" and then on "The Plant in Figures." Before going any further, answer the following questions:

- How many associates (employees) work in the plant?
- How many apprentices (trainees) work there? Why does the plant have trainees?
- How many cars are made in the plant each day? How many engines?

Next, click on "Production" to open a drop-down list that looks like this:

Fascination Production
Press Shop
Body Shop
Paint Shop
Engine Assembly
Assembly

Click on "Fascination Production," and watch a video that zips you through the production steps needed to make a BMW. Continue your tour by clicking on each progressive step taken to build a quality car: press shop, body shop, paint shop, engine assembly and final assembly. After reading about and watching the brief video describing the work done in a particular area of the plant, pause and answer the following questions (you will answer this set of questions five times—once for each of these areas of the factory: press shop, body shop, paint shop, engine assembly, and final assembly):

1. What production steps occurred in this area of the plant?
2. What technology does BMW use in the production process?
3. Approximately what percentage of the work was done by people?
4. What procedures were followed to ensure the production of high-quality vehicles?

Career Opportunities

Wanted: Problem Solvers and Creative Thinkers

If you had a time machine plus a craving for a great hamburger, you could return to the early 1950s and swing by Dick and Mac McDonald's burger stand in San Bernardino, California. Take a break from eating and watch the people in the kitchen. You'll see an early application of operations management in the burger industry. Dick and Mac, in an effort to sell more burgers in less time, redesigned their kitchen to use assembly-line procedures. As the number of happy customers grew, word spread about their speedy system, and their business thrived. Curiously, it wasn't Dick and Mac who made McDonald's what it is today, but rather a traveling milkshake-mixer salesman named Ray Kroc. He visited the hamburger stand to learn how they could sell twenty thousand shakes a year. When he saw their operations and the lines of people walking away with bags filled with burgers, fries, and shakes, he knew he had a winner. In cooperation with the McDonald brothers, he started selling franchises around the country, and the rest is history.

So, what does this story have to do with a career in operations management? If you're a problem solver like Dick and Mac (who discovered a way to make burgers faster and cheaper) or a creative thinker like Ray Kroc (who recognized the value in an assembly-line burger production system), then a career in operations management might be for you. The field is broad and offers a variety of opportunities. To get a flavor of the choices available, go to www.wetfeet.com/Careers-and-I...perations.aspx to link to the WetFeet Web site and review the dozen or so operations management positions listed. Provide a brief description of each position. Indicate how interesting you find each position by rating it using a five-point scale (with 1 being uninteresting and 5 being very interesting). Based on your assessment, pick the position you find most interesting and the one you find least interesting. Explain why you made your selections.

Ethics Angle (AACSB)

In many ways, Eastman Kodak (a multinational manufacturer and distributor of photographic equipment and supplies) is a model corporate citizen. *Fortune* magazine has ranked it as one of the country's most admired companies, applauding it in particular for its treatment of minorities and women. Its community-affairs programs and contributions have also received praise, but Eastman Kodak remains weak in one important aspect of corporate responsibility: it has consistently received low scores on environmental practices. For example, the watchdog group Scorecard rated Eastman Kodak's Rochester, New York, facility as the third-worst emitter of airborne carcinogens in the United States. Other reports have criticized the company for dumping cancer-causing chemicals into the nation's waters.

Go to www.kodak.com/US/en/corp/HSE/homepage.jhtml?pd-path=2879/7196 to link to the Eastman Kodak Web site and read its own assessment of its environmental practices. Then answer the following questions:

1. Based on the information provided on its Web site, how favorable do you feel about Eastman Kodak's environmental practices?
2. In what ways is the company responding to criticisms of its environmental practices and improving them?
3. Do the statements on the Web site mesh with the criticism that the company has received? If not, what accounts for the differences?

Team-Building Skills (AACSB)

Growing Accustomed to Your Fit

Instead of going to the store to try on several pairs of jeans that may or may not fit, wouldn't it be easier to go online and order a pair of perfect-fitting jeans? Lands' End has made this kind of shopping possible through mass-customization techniques and some sophisticated technology.

To gain some firsthand experience at shopping for mass-customized goods, have each member of your team go to Nike's iD site at http://nikeid.nike.com. Each team member should go through the process of customizing a different Nike product but stop right before placing an order. After everyone has gone through the process, get together and write a report in which the team explains exactly what's entailed by online mass customization and details the process at Nike. Be sure to say which things impressed you and which didn't. Explain why Nike developed this means of marketing products and, finally, offer some suggestions on how the process could be improved.

The Global View (AACSB)

What's the State of Homeland Job Security?

Over the past several decades, more and more U.S. manufacturers began outsourcing production to such low-wage countries as Mexico and China. The number of U.S. manufacturing jobs dwindled, and the United States became more of a service economy. People who were directly affected were understandably unhappy about this turn of events, but most people in this country didn't feel threatened. At least, not until service jobs also started going to countries that, like India, have large populations of well-educated, English-speaking professionals. Today, more technology-oriented jobs, including those in programming and Internet communications, are being outsourced to countries with lower wage rates. And tech workers aren't alone: the jobs of accountants, analysts, bankers, medical technicians, paralegals, insurance adjusters, and even customer-service representatives have become candidates for overseas outsourcing.

Many U.S. workers are concerned about job security (though the likelihood of a particular individual's losing a job to an overseas worker is still fairly low). The issues are more complex than merely deciding where U.S. employers should be mailing paychecks, and politicians, economists, business executives, and the general public differ about the causes and consequences of foreign outsourcing. Some people think it's a threat to American quality of life, while others actually think that it's a good thing.

Spend some time researching trends in outsourcing. Formulate some opinions, and then answer the following questions:

1. About what percentage of U.S. jobs have left the country in the last five years? What percentage will probably leave in the next five years?
2. What kinds of jobs are being outsourced, and where are they going? What kinds of jobs can't be outsourced?
3. How does global outsourcing help U.S. businesses? How does it hinder them?
4. How has the trend in outsourcing manufacturing and service operations to foreign countries helped average Americans? How has it harmed them?
5. Does overseas outsourcing help or hurt the U.S. economy? In what ways?

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7: DESIGNING ORGANIZATIONAL STRUCTURES

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7.1: Introduction



Exhibit 7.1: (Credit: CDC/ Dawn Arlotta / US Government Works)

EXPLORING BUSINESS CAREERS

Elise Eberwein (EVP of People and Communications, American Airlines)

As executive vice president of people and communications at American Airlines, Elise Eberwein's role within the structure of the organization might not be readily apparent. After all, you might ask, doesn't corporate communications typically involve marketing? And what does that have to do with organizational structure? As it turns out, quite a bit at the world's largest airline.

When American Airlines and US Airways finally got the U.S. government's approval to merge in late 2013, it was no longer business as usual for Eberwein and her colleagues at the "new" airline. Until the merger, which basically produced the world's largest airline with more than 6,000 daily flights and 102,900 employees, Eberwein was head of communications at US Airways—a position she held for nine years after various other jobs in the airline industry.



Exhibit 7.2: American Airlines jet. (Credit: Joao Carlos Medau/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Communications and aviation are in Eberwein's DNA. She worked as a flight attendant at TWA before moving on to manage communications at Denver-based Frontier Airlines. Her next communications experience was at America West, which then merged with US Airways, where Eberwein served as executive vice president of people, communications, and public affairs before she took over the chief communications job at American Airlines.

Corporation communications is no longer just about marketing. The importance of an effective communications strategy cannot be understated in today's 24/7 business environment. Corporate communication executives have taken on an expanded role in many organizations, according to a recent survey by the Korn Ferry Institute. Of the senior communications executives from Fortune 500 companies who responded to the survey, nearly 40 percent said chief communications officers report directly to the CEO. In addition, more than two-thirds of respondents believe the most important leadership characteristic for communications professionals is having a strategic mindset that goes beyond day-to-day communications activities and looks ahead to future possibilities that can be translated into achievable corporate strategies at all levels of the organization.

In a company as large as American Airlines, even after the initial two-year integration plan, there are many departments, unions, and other employees to communicate with on a daily basis, not to mention the millions of customers they serve every day. For example, American's social media hub consists of 30 or so team members, divided into three groups: social customer service, social engagement, and social insights. The customer service group, the largest of the three, operates around the clock to address customers' issues, including missed flight connections and lost luggage, as well as quirky questions like why American airplanes have a specific number of stripes on their tails. Reporting to Eberwein, the social media group is empowered to reach out to any company department directly to get answers for any customer.

Eberwein believes her role includes working closely with the CEO and other managers across the globe to provide consistent, detailed information to all of its stakeholders. To accomplish this feat, Eberwein and other senior managers hold a weekly Monday morning meeting to review the previous week's operations data, revenue results, and people engagement activities. Eberwein believes establishing this regular contact with colleagues across the organization helps reinforce American's commitment to engagement and transparent communications, which ultimately shapes the customer's experience as well as the entire company.

Sources: "Leadership Bios: Elise Eberwein," https://www.aa.com, accessed July 24, 2017; "By the Numbers: Snapshot of the Airline," http://news.aa.com, accessed July 24, 2017; Richard Marshall, Beth Fowler, and Nels Olson, "The Chief Communications Officer: Survey and Findings among the Fortune 500," https://www.kornferry.com, accessed July 24, 2017; Elise Eberwein, "Why the Chief Communications Officer Is Pivotal to the CEO, Especially a New One," *Chief Executive*, http://chiefexecutive.net, September 11, 2016; Michael Slattery, "A Visit to American Airlines Social Media Hub," *Airways* magazine, https://airwaysmag.com, June 10, 2016; Diana Bradley, "American Airlines CEO Discusses Comms Strategy behind US Airways Merger," *PR Week,* http://www.prweek.com, May 27, 2015.

This module focuses on the different types of organizational structure, the reasons an organization might prefer one structure over another, and how the choice of an organizational structure ultimately can impact that organization's success.

In today's dynamic business environment, organizational structures need to be designed so that the organization can quickly respond to new competitive threats and changing customer needs. Future success for companies will depend on their ability to be flexible and respond to the needs of customers. In this chapter, we'll look first at how companies build organizational structures by implementing traditional, contemporary, and team-based models. Then, we'll explore how managers establish the relationships within the structures they have designed, including determining lines of communication, authority, and power. Finally, we'll examine what managers need to consider when designing organizational structures and the trends that are changing the choices companies make about organizational design.

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7.2: Building Organizational Structures

What are the traditional forms of organizational structure?

The key functions that managers perform include planning, organizing, leading, and controlling. This module focuses specifically on the organizing function. *Organizing* involves coordinating and allocating a firm's resources so that the firm can carry out its plans and achieve its goals. This organizing, or structuring, process is accomplished by:

- Determining work activities and dividing up tasks *(division of labor)*
- Grouping jobs and employees *(departmentalization)*
- Assigning authority and responsibilities *(delegation)*

The result of the organizing process is a formal structure within an organization. An **organization** is the order and design of relationships within a company or firm. It consists of two or more people working together with a common objective and clarity of purpose. Formal organizations also have well-defined lines of authority, channels for information flow, and means of control. Human, material, financial, and information resources are deliberately connected to form the business organization. Some connections are long-lasting, such as the links among people in the finance or marketing department. Others can be changed at almost any time—for example, when a committee is formed to study a problem.

Every organization has some kind of underlying structure. Typically, organizations base their frameworks on traditional, contemporary, or team-based approaches. Traditional structures are more rigid and group employees by function, products, processes, customers, or regions. Contemporary and team-based structures are more flexible and assemble employees to respond quickly to dynamic business environments. Regardless of the structural framework a company chooses to implement, all managers must first consider what kind of work needs to be done within the firm.



Figure 7.2.1: Founded in 1943, Sweden retailer IKEA has grown from a small mail-order operation to a global force in home furnishings with more than 390 stores throughout Europe, North America, Africa, Australia, and Asia. Best known for its contemporary furniture designs, highly trafficked store openings, and quirky advertising, the IKEA Group consists of multiple divisions corresponding to the company's retail, supply chain, sales, and design and manufacturing functions. *What factors likely influenced the development of IKEA's organizational structure as the company expanded over the years?* (Credit: JJBers/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Division of Labor

The process of dividing work into separate jobs and assigning tasks to workers is called **division of labor**. In a fast-food restaurant, for example, some employees take or fill orders, others prepare food, a few clean and maintain equipment, and at least one supervises all the others. In an auto assembly plant, some workers install rearview mirrors, while others mount bumpers on

bumper brackets. The degree to which the tasks are subdivided into smaller jobs is called **specialization**. Employees who work at highly specialized jobs, such as assembly-line workers, perform a limited number and variety of tasks. Employees who become specialists at one task, or a small number of tasks, develop greater skill in doing that particular job. This can lead to greater efficiency and consistency in production and other work activities. However, a high degree of specialization can also result in employees who are disinterested or bored due to the lack of variety and challenge.

Traditional Structures

After a company divides the work it needs to do into specific jobs, managers then group the jobs together so that similar or associated tasks and activities can be coordinated. This grouping of people, tasks, and resources into organizational units is called **departmentalization**. It facilitates the planning, leading, and control processes.

An **organization chart** is a visual representation of the structured relationships among tasks and the people given the authority to do those tasks. In the organization chart in Figure 7.2.2, each figure represents a job, and each job includes several tasks. The sales manager, for instance, must hire salespeople, establish sales territories, motivate and train the salespeople, and control sales operations. The chart also indicates the general type of work done in each position. As Figure 7.2.3 shows, five basic types of departmentalization are commonly used in organizations:

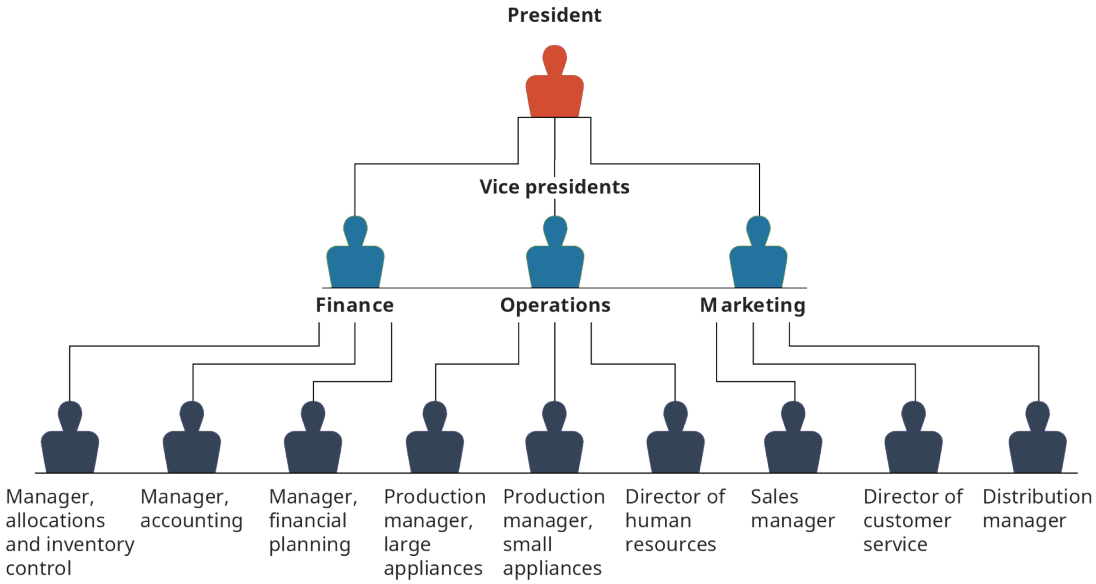


Figure 7.2.2: **Organization Chart for a Typical Appliance Manufacturer** Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license

1. ***Functional departmentalization***, which is based on the primary functions performed within an organizational unit (marketing, finance, production, sales, and so on). Ethan Allen Interiors, a vertically integrated home furnishings manufacturer, continues its successful departmentalization by function, including retail, manufacturing and sourcing, product design, logistics, and operations, which includes tight financial controls.[1]

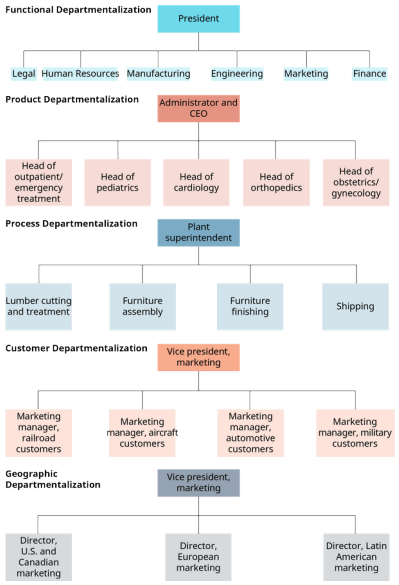


Figure 7.2.3: **Exhibit** 7.5: **Five Traditional Ways to Organize** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

2. ***Product departmentalization***, which is based on the goods or services produced or sold by the organizational unit (such as outpatient/emergency services, pediatrics, cardiology, and orthopedics). For example, ITT is a diversified leading manufacturer of highly engineered components and customized technology solutions for the transportation, industrial, and oil and gas markets. The company is organized into four product divisions: Industrial Process (pumps, valves, and wastewater treatment equipment), Control Technologies (motion control and vibration isolation products), Motion Technologies (shock absorbers, brake pads, and friction materials), and Interconnect Solutions (connectors for a variety of markets).[2]
3. ***Process departmentalization***, which is based on the production process used by the organizational unit (such as lumber cutting and treatment, furniture finishing, and shipping). For example, the organization of Gazprom Neft, a Russian oil company, reflects the activities the company needs to perform to extract oil from the ground and turn it into a final product: exploration and research, production (drilling), refining, and marketing and distribution.[3] Pixar, the animated-movie company now part of Disney, is divided into three parallel yet interactive process-based groups: technology development, which delivers computer-graphics tools; creative development, which creates stories and characters and animates them; and production, which coordinates the film-making process.[4]
4. ***Customer departmentalization***, which is based on the primary type of customer served by the organizational unit (such as wholesale or retail purchasers). The PNC Financial Services Group offers a wide range of services for all of its customers and is structured by the type of consumer it serves: retail banking for consumers; the asset management group, with specific focus on individuals as well as corporations, unions, municipalities, and others; and corporate and institutional banking for middle-market companies nationwide.[5]

ETHICS IN PRACTICE

Ethics in Practice

Panera's Menu Comes Clean Making a strategic change to a company's overall philosophy and the way it does business affects every part of the organizational structure. And when that change pertains to sustainability and "clean food," Panera Bread Company took on the challenge more than a decade ago and now has a menu free of man-made preservatives, sweeteners, colors, and flavors.

In 2015, Ron Shaich, company founder and CEO, announced Panera's "no-no" list of nearly 100 ingredients, which he vowed would be eliminated or never used again in menu items. Two years later, the company announced that its menu was "100 percent clean," but the process was not an easy one.

Panera used thousands of labor hours to review the 450 ingredients used in menu items, eventually reformulating more than 120 of them to eliminate artificial ingredients. Once the team identified the ingredients that were not "clean," they worked with the company's 300 vendors—and in some instances, a vendor's supplier—to reformulate an ingredient to make it preservative-

free. For example, the recipe for the company's popular broccoli cheddar soup had to be revised 60 times to remove artificial ingredients without losing the soup's taste and texture. According to Shaich, the trial-and-error approach was about finding the right balance of milk, cream, and emulsifiers, like Dijon mustard, to replace sodium phosphate (a no-no item) while keeping the soup's texture creamy. Panera also created a new cheddar cheese to use in the soup and used a Dijon mustard that contained unpreserved vinegar as a substitute for the banned sodium phosphate.

Sara Burnett, Panera's director of wellness and food policy, believes that the company's responsibility goes beyond just serving its customers. She believes that Panera can make a difference by using its voice and purchasing power to have a positive impact on the overall food system. In addition, the company's Herculean effort to remove artificial ingredients from its menu items also helped it take a close look at its supply chain and other processes that Panera could simplify by using better ingredients.

Panera is not yet satisfied with its commitment to clean food. The food chain recently announced its goal of sourcing 100 percent cage-free eggs for all of its U.S. Panera bakery-cafés by 2020.

Critical Thinking Questions

1. How does Panera's approach to clean eating provide the company with a competitive advantage?
2. What kind of impact does this commitment to preservative-free food have on the company's organizational structure?
3. Does "clean food" put additional pressure on Panera and its vendors? Explain your reasoning.

Sources: "Our Food Policy," www.panerabread.com, accessed July 24, 2017; Emily Payne, "Panera Bread's Sara Burnett on Shifting Demand for a Better Food System," *Food Tank,* http://foodtank.com, accessed July 18, 2017; Julie Jargon, "What Panera Had to Change to Make Its Menu 'Clean,'" *The Wall Street Journal,* https://www.wsj.com, February 20, 2017; John Kell, "Panera Says Its Food Menu Is Now 100% 'Clean Eating,'" *Fortune,* http://fortune.com, January 13, 2017; Lani Furbank, "Seven Questions with Sara Burnett, Director of Wellness and Food Policy at Panera Bread," *Food Tank,* https://foodtank.com, April 12, 2016.

5. ***Geographic departmentalization***, which is based on the geographic segmentation of organizational units (such as U.S. and Canadian marketing, European marketing, and Latin American marketing).

People are assigned to a particular organizational unit because they perform similar or related tasks, or because they are jointly responsible for a product, client, or market. Decisions about how to departmentalize affect the way management assigns authority, distributes resources, rewards performance, and sets up lines of communication. Many large organizations use several types of departmentalization. For example, Procter & Gamble (P&G), the multibillion-dollar consumer-products company, integrates four different types of departmentalization, which the company refers to as "four pillars." First, the Global Business Units (GBU) divide the company according to products (baby, feminine, and family care; beauty; fabric and home care; and health and grooming). Then, P&G uses a geographical approach, creating business units to market its products around the world. There are Selling and Market Operations (SMO) groups for North America; Latin America; Europe; Asia Pacific; Greater China; and India, the Middle East, and Africa. P&G's third pillar is Global Business Services division (GBS), which also uses geographic departmentalization. GBS provides technology processes and standard data tools to enable the GBUs and SMOs to better understand the business and to serve consumers and customers better. It supports P&G business units in areas such as accounting and financial reporting, information technology, purchases, payroll and benefits administration, and facilities management. Finally, the divisions of the Corporate Functions pillar provide a safety net to all the other pillars. These divisions are comprised of functional specialties such as customer business development; external relations; human resources; legal, marketing, consumer, and market knowledge; research and development; and workplace services.[6]

Line-and-Staff Organization

The **line organization** is designed with direct, clear lines of authority and communication flowing from the top managers downward. Managers have direct control over all activities, including administrative duties. An organization chart for this type of structure would show that all positions in the firm are directly connected via an imaginary line extending from the highest position in the organization to the lowest (where production of goods and services takes place). This structure, with its simple design and broad managerial control, is often well-suited to small, entrepreneurial firms.

As an organization grows and becomes more complex, the line organization can be enhanced by adding staff positions to the design. Staff positions provide specialized advisory and support services to line managers in the **line-and-staff organization**, shown in Figure 7.2.4. In daily operations, individuals in **line positions** are directly involved in the processes used to create goods and services. Individuals in **staff positions** provide the administrative and support services that line employees need to achieve the firm's goals. Line positions in organizations are typically in areas such as production, marketing, and finance. Staff positions

are found in areas such as legal counseling, managerial consulting, public relations, and human resource management.

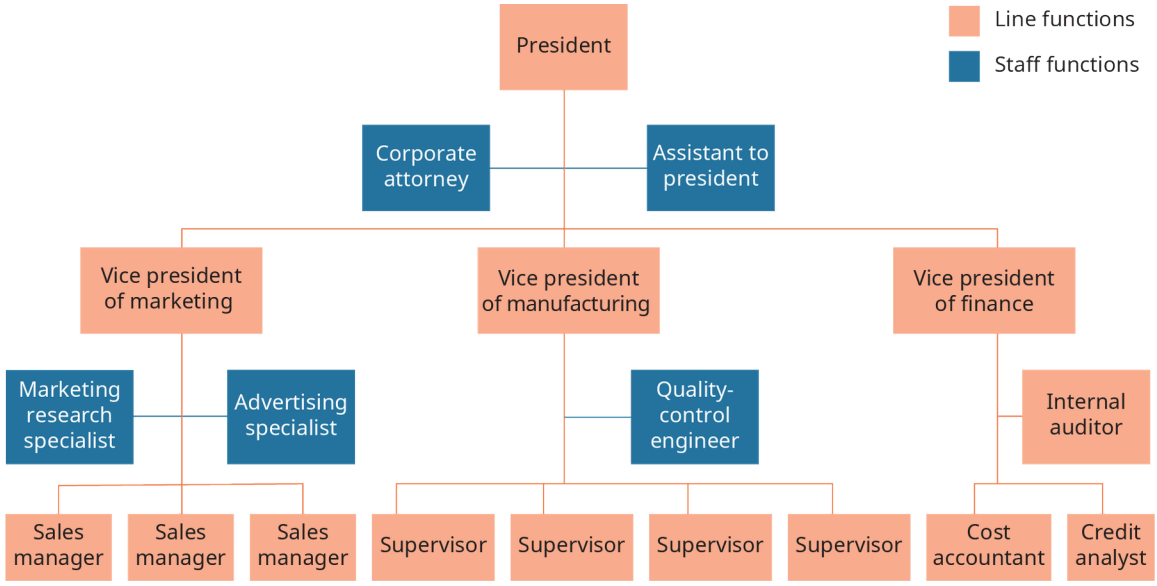


Figure 7.2.4: **Line-and-Staff Organization** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

CONCEPT CHECK

1. How does specialization lead to greater efficiency and consistency in production?
2. What are the five types of departmentalization?

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7.3: Contemporary Structures

What contemporary organizational structures are companies using?

Although traditional forms of departmentalization still represent how many companies organize their work, newer, more flexible organizational structures are in use at many firms. Let's look at matrix and committee structures and how those two types of organizations are helping companies better leverage the diverse skills of their employees.

Matrix Structure

The **matrix structure** (also called the *project management* approach) is sometimes used in conjunction with the traditional line-and-staff structure in an organization. Essentially, this structure combines two different forms of departmentalization, functional and product, that have complementary strengths and weaknesses. The matrix structure brings together people from different functional areas of the organization (such as manufacturing, finance, and marketing) to work on a special project. Each employee has two direct supervisors: the line manager from her or his specific functional area and the project manager. **Exhibit 7.7** shows a matrix organization with four special project groups (A, B, C, D), each with its own project manager. Because of the dual chain of command, the matrix structure presents some unique challenges for both managers and subordinates.

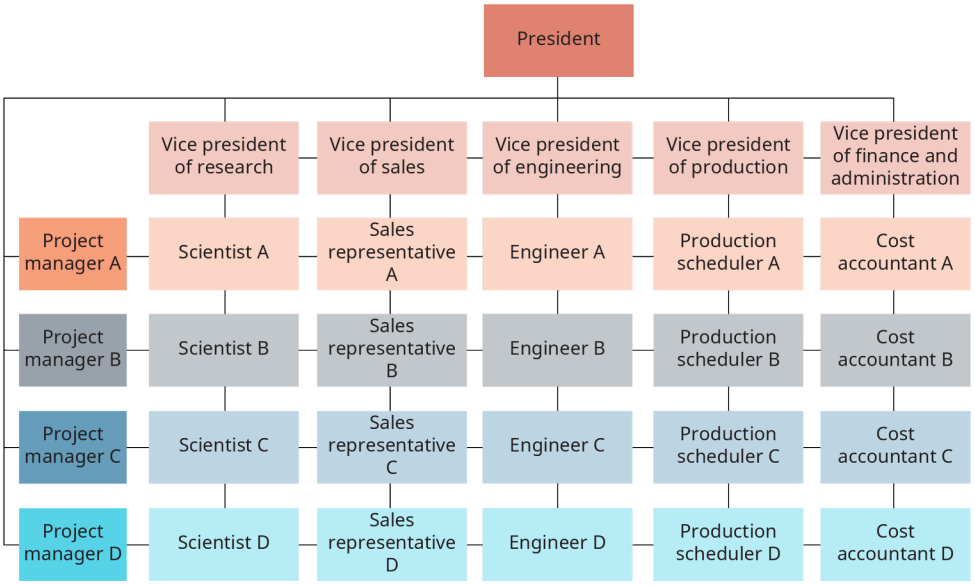


Exhibit 7.7: Matrix Organization (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Advantages of the matrix structure include:

- *Teamwork.* By pooling the skills and abilities of various specialists, the company can increase creativity and innovation and tackle more complex tasks.
- *Efficient use of resources.* Project managers use only the specialized staff they need to get the job done, instead of building large groups of underused personnel.
- *Flexibility.* The project structure is flexible and can adapt quickly to changes in the environment; the group can be disbanded quickly when it is no longer needed.
- *Ability to balance conflicting objectives.* The customer wants a quality product and predictable costs. The organization wants high profits and the development of technical capability for the future. These competing goals serve as a focal point for directing activities and overcoming conflict. The marketing representative can represent the customer, the finance representative can advocate high profits, and the engineers can push for technical capabilities.
- *Higher performance.* Employees working on special project teams may experience increased feelings of ownership, commitment, and motivation.
- *Opportunities for personal and professional development.* The project structure gives individuals the opportunity to develop

and strengthen technical and interpersonal skills.

Disadvantages of the matrix structure include:

- *Power struggles*. Functional and product managers may have different goals and management styles.
- *Confusion among team members*. Reporting relationships and job responsibilities may be unclear.
- *Lack of cohesiveness*. Team members from different functional areas may have difficulty communicating effectively and working together as a team.

Although project-based matrix organizations can improve a company's flexibility and teamwork, some companies are trying to unravel complex matrix structures that create limited accountability and complicate day-to-day operations. Some CEOs and other top managers suggest that matrix structures make it easier to blame others when things don't go as planned.[7]

Committee Structure

In **committee structure**, authority and responsibility are held by a group rather than an individual. Committees are typically part of a larger line-and-staff organization. Often the committee's role is only advisory, but in some situations the committee has the power to make and implement decisions. Committees can make the coordination of tasks in the organization much easier. For example, Novartis, the huge Swiss pharmaceutical company, has a committee structure, which reports to its board of directors. The company's executive committee is responsible for overseeing the business operations of group companies within the global organization and consists of the CEO, CFO, head of HR, general counsel, president of operations, head of biomedical research, global head of drug development, CEOs of the pharmaceutical and oncology units, and CEOs of Sandoz and Alcon, other Novartiscompanies. Members of the executive committee are selected by the company's board of directors.[8]

Committees bring diverse viewpoints to a problem and expand the range of possible solutions, but there are some drawbacks. Committees can be slow to reach a decision and are sometimes dominated by a single individual. It is also more difficult to hold any one individual accountable for a decision made by a group. Committee meetings can sometimes go on for long periods of time with seemingly little being accomplished.

CONCEPT CHECK

1. Why does the matrix structure have a dual chain of command?
2. How does a matrix structure increase power struggles or reduce accountability?
3. What are advantages of a committee structure? Disadvantages?

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7.4: Using Teams to Enhance Motivation and Performance

Why are companies using team-based organizational structures?

One of the most apparent trends in business today is the use of teams to accomplish organizational goals. Using a team-based structure can increase individual and group motivation and performance. This section gives a brief overview of group behavior, defines work teams as specific types of groups, and provides suggestions for creating high-performing teams.

Understanding Group Behavior

Teams are a specific type of organizational group. Every organization contains *groups,* social units of two or more people who share the same goals and cooperate to achieve those goals. Understanding some fundamental concepts related to group behavior and group processes provides a good foundation for understanding concepts about work teams. Groups can be formal or informal in nature. Formal groups are designated and sanctioned by the organization; their behavior is directed toward accomplishing organizational goals. Informal groups are based on social relationships and are not determined or sanctioned by the organization.

Formal organizational groups, like the sales department at Apple, must operate within the larger Apple organizational system. To some degree, elements of the larger Apple system, such as organizational strategy, company policies and procedures, available resources, and the highly motivated employee corporate culture, determine the behavior of smaller groups, such as the sales department, within the company. Other factors that affect the behavior of organizational groups are individual member characteristics (e.g., ability, training, personality), the roles and norms of group members, and the size and cohesiveness of the group. Norms are the implicit behavioral guidelines of the group, or the standards for acceptable and nonacceptable behavior. For example, an Apple sales manager may be expected to work at least two Saturdays per month without extra pay. Although this isn't written anywhere, it is the expected norm.

Group cohesiveness refers to the degree to which group members want to stay in the group and tend to resist outside influences (such as a change in company policies). When group performance norms are high, group cohesiveness will have a positive impact on productivity. Cohesiveness tends to increase when the size of the group is small, individual and group goals are similar, the group has high status in the organization, rewards are group-based rather than individual-based, and the group competes with other groups within the organization. Work group cohesiveness can benefit the organization in several ways, including increased productivity, enhanced worker self-image because of group success, increased company loyalty, reduced employee turnover, and reduced absenteeism. Southwest Airlines is known for its work group cohesiveness. On the other hand, cohesiveness can also lead to restricted output, resistance to change, and conflict with other work groups in the organization.

The opportunity to turn the decision-making process over to a group with diverse skills and abilities is one of the arguments for using work groups (and teams) in organizational settings. For group decision-making to be most effective, however, both managers and group members must understand its strengths and weaknesses (see **Table 7.1**).

Work Groups versus Work Teams

We have already noted that teams are a special type of organizational group, but we also need to differentiate between work groups and work teams. **Work groups** share resources and coordinate efforts to help members better perform their individual duties and responsibilities. The performance of the group can be evaluated by adding up the contributions of the individual group members. **Work teams** require not only coordination but also *collaboration,* the pooling of knowledge, skills, abilities, and resources in a collective effort to attain a common goal. A work team creates s*ynergy,* causing the performance of the team as a whole to be greater than the sum of team members' individual contributions. Simply assigning employees to groups and labeling them a team does not guarantee a positive outcome. Managers and team members must be committed to creating, developing, and maintaining high-performance work teams. Factors that contribute to their success are discussed later in this section.

Table 7.1: Strengths and Weaknesses of Group Decision Making

Strengths	Weaknesses
• Groups bring more information and knowledge to the decision-making process. • Groups offer a diversity of perspectives and, therefore, generate a greater number of disagreements. • Group decision-making results in a higher-quality decision than does individual decision-making. • Participation of group members increases the likelihood that a decision will be accepted.	• Groups typically take a longer time to reach a solution than an individual takes. • Group members may pressure others to conform, reducing the likelihood of alternatives. • The process may be dominated by one or a small number of participants. • Groups lack accountability, because it is difficult to assign responsibility for outcomes to any one individual.

Types of Teams

The evolution of the team concept in organizations can be seen in three basic types of work teams: problem-solving, self-managed, and cross-functional. **Problem-solving teams** are typically made up of employees from the same department or area of expertise and from the same level of the organizational hierarchy. They meet on a regular basis to share information and discuss ways to improve processes and procedures in specific functional areas. Problem-solving teams generate ideas and alternatives and may recommend a specific course of action, but they typically do not make final decisions, allocate resources, or implement change.

Many organizations that experienced success using problem-solving teams were willing to expand the team concept to allow team members greater responsibility in making decisions, implementing solutions, and monitoring outcomes. These highly autonomous groups are called **self-managed work teams**. They manage themselves without any formal supervision, taking responsibility for setting goals, planning and scheduling work activities, selecting team members, and evaluating team performance.

Today, approximately 80 percent of Fortune 1000 companies use some sort of self-managed teams.[9] One example is Zappos's shift to self-managed work teams in 2013, where the traditional organizational structure and bosses were eliminated, according to a system called holacracy.[10] Another version of self-managing teams can be found at W. L. Gore, the company that invented Gore-Tex fabric and Glide dental floss. The three employees who invented Elixir guitar strings contributed their spare time to the effort and persuaded a handful of colleagues to help them improve the design. After working three years *entirely* on their own—without asking for any supervisory or top management permission or being subjected to any kind of oversight—the team finally sought the support of the larger company, which they needed to take the strings to market. Today, W. L. Gore's Elixir is the number one selling string brand for acoustic guitar players.[11]

An adaptation of the team concept is called a **cross-functional team**. These teams are made up of employees from about the same hierarchical level but different functional areas of the organization. Many task forces, organizational committees, and project teams are cross-functional. Often the team members work together only until they solve a given problem or complete a specific project. Cross-functional teams allow people with various levels and areas of expertise to pool their resources, develop new ideas, solve problems, and coordinate complex projects. Both problem-solving teams and self-managed teams may also be cross-functional teams.

CUSTOMER SATISFACTION AND QUALITY

Team Approach Flies High at GE Aviation

"Teaming" is the term used at GE Aviation manufacturing plants to describe how self-managed groups of employees are working together to make decisions to help them do their work efficiently, maintain quality, and meet critical deadlines in the global aviation supply chain.

This management concept is not new to GE Aviation; its manufacturing plants in Durham, North Carolina, and Bromont, Quebec, Canada, have been using self-managed teams for more than 30 years. This approach to business operations continues to be

successful and is now used at most of its 77 manufacturing facilities worldwide.

The goal of teaming is to move decision-making and authority as close to the end-product as possible, which means front-line employees are accountable for meeting performance goals on a daily basis. For example, if there is some sort of delay in the manufacturing process, it is up to the team to figure out how to keep things moving—even if that means skipping breaks or changing their work schedules to overcome obstacles.

At the Bromont plant, workers do not have supervisors who give them direction. Rather, they have coaches who give them specific goals. The typical functions performed by supervisors, such as planning, developing manufacturing processes, and monitoring vacation and overtime, are managed by the teams themselves. In addition, members from each team sit on a joint council with management and HR representatives to make decisions that will affect overall plant operations, such as when to eliminate overtime and who gets promoted or fired.

This hands-on approach helps workers gain confidence and motivation to fix problems directly rather than sending a question up the chain of command and waiting for a directive. In addition, teaming allows the people who do the work on a daily basis to come up with the best ideas to resolve issues and perform various jobs tasks in the most efficient way possible.

For GE Aviation, implementing the teaming approach has been a successful venture, and the company finds the strategy easiest to implement when starting up a new manufacturing facility. The company recently opened several new plants, and the teaming concept has had an interesting effect on the hiring process. A new plant in Welland, Ontario, Canada, opens soon, and the hiring process, which may seem more rigorous than most job hiring experiences, is well under way. With the team concept in mind, job candidates need to demonstrate not only required technical skills but also soft skills—for example, the ability to communicate clearly, accept feedback, and participate in discussions in a respectful manner.

Critical Thinking Questions

1. What challenges do you think HR recruiters face when hiring job candidates who need to have both technical and soft skills?
2. How can experienced team members help new employees be successful in the teaming structure? Provide some examples.

Sources: GE Reports Canada, “The Meaning of Teaming: Empowering New Hires at GE’s Welland Brilliant Factory,” gereports.ca, July 17, 2017; Sarah Kessler, “GE Has a Version of Self-Management That Is Much Like Zappos’ Holacracy—and It Works,” *Quartz,* https://qz.com, June 6, 2017; Gareth Phillips, “Look No Managers! Self-Managed Teams,” *LinkedIn,* https://www.linkedin.com, June 9, 2016; Amy Alexander, “Step by Step: Train Employees to Take Charge,” *Investor’s Business Daily,* www.investors.com, June 18, 2014; Rasheedah Jones, “Teaming at GE Aviation,” *Management Innovation eXchange,* http://www.managementexchange.com, July 14, 2013.

Building High-Performance Teams

A great team must possess certain characteristics, so selecting the appropriate employees for the team is vital. Employees who are more willing to work together to accomplish a common goal should be selected, rather than employees who are more interested in their own personal achievement. Team members should also possess a variety of skills. Diverse skills strengthen the overall effectiveness of the team, so teams should consciously recruit members to fill gaps in the collective skill set. To be effective, teams must also have clearly defined goals. Vague or unclear goals will not provide the necessary direction or allow employees to measure their performance against expectations.

Next, high-performing teams need to practice good communication. Team members need to communicate messages and give appropriate feedback that seeks to correct any misunderstandings. Feedback should also be detached; that is, team members should be careful to critique ideas rather than criticize the person who suggests them. Nothing can degrade the effectiveness of a team like personal attacks. Lastly, great teams have great leaders. Skilled team leaders divide work so that tasks are not repeated, help members set and track goals, monitor their team’s performance, communicate openly, and remain flexible to adapt to changing goals or management demands.

CONCEPT CHECK

1. What is the difference between a work team and a work group?
2. Identify and describe three types of work teams.
3. What are some ways to build a high-performance team?

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7.5: Authority—Establishing Organizational Relationships

What tools do companies use to establish relationships within their organizations?

Once companies choose a method of departmentalization, they must then establish the relationships within that structure. In other words, the company must decide how many layers of management it needs and who will report to whom. The company must also decide how much control to invest in each of its managers and where in the organization decisions will be made and implemented.

Managerial Hierarchy

Managerial hierarchy (also called the *management pyramid*) is defined by the levels of management within an organization. Generally, the management structure has three levels: top, middle, and supervisory management. In a managerial hierarchy, each organizational unit is controlled and supervised by a manager in a higher unit. The person with the most formal authority is at the top of the hierarchy. The higher a manager, the more power he or she has. Thus, the amount of power decreases as you move down the management pyramid. At the same time, the number of employees increases as you move down the hierarchy.

Not all companies today are using this traditional configuration. One company that has eliminated hierarchy altogether is The Morning Star Company, the largest tomato processor in the world. Based in Woodland, California, the company employs 600 permanent "colleagues" and an additional 4,000 workers during harvest season. Founder and sole owner Chris Rufer started the company and based its vision on the philosophy of self-management, in which professionals initiate communication and coordination of their activities with colleagues, customers, suppliers, and others, and take personal responsibility for helping the company achieve its corporate goals.[12]

An organization with a well-defined hierarchy has a clear **chain of command**, which is the line of authority that extends from one level of the organization to the next, from top to bottom, and makes clear who reports to whom. The chain of command is shown in the organization chart and can be traced from the CEO all the way down to the employees producing goods and services. Under the *unity of command* principle, everyone reports to and gets instructions from only one boss. Unity of command guarantees that everyone will have a direct supervisor and will not be taking orders from a number of different supervisors. Unity of command and chain of command give everyone in the organization clear directions and help coordinate people doing different jobs.

Matrix organizations automatically violate the unity of command principle because employees report to more than one boss, if only for the duration of a project. For example, Unilever, the consumer-products company that makes Dove soap, Ben & Jerry's ice cream, and Hellmann's mayonnaise, used to have a matrix structure with one CEO for North America and another for Europe. But employees in divisions that operated in both locations were unsure about which CEO's decisions took precedence. Today, the company uses a product departmentalization structure.[13] Companies like Unilever tend to abandon matrix structures because of problems associated with unclear or duplicate reporting relationships, in other words, with a lack of unity of command.

Individuals who are part of the chain of command have authority over other persons in the organization. **Authority** is legitimate power, granted by the organization and acknowledged by employees, that allows an individual to request action and expect compliance. Exercising authority means making decisions and seeing that they are carried out. Most managers *delegate*, or assign, some degree of authority and responsibility to others below them in the chain of command. The **delegation of authority** makes the employees accountable to their supervisor. *Accountability* means responsibility for outcomes. Typically, authority and responsibility move downward through the organization as managers assign activities to, and share decision-making with, their subordinates. Accountability moves upward in the organization as managers in each successively higher level are held accountable for the actions of their subordinates.

Span of Control

Each firm must decide how many managers are needed at each level of the management hierarchy to effectively supervise the work performed within organizational units. A manager's **span of control** (sometimes called *span of management*) is the number

of employees the manager directly supervises. It can be as narrow as two or three employees or as wide as 50 or more. In general, the larger the span of control, the more efficient the organization. As Table 7.5.1 shows, however, both narrow and wide spans of control have benefits and drawbacks.

Table 7.5.1: Narrow and Wide Spans of Control

	Advantages	Disadvantages
Narrow span of control	• This approach allows a high degree of control. • Fewer subordinates may mean the manager is more familiar with each individual. • Close supervision can provide immediate feedback.	• More levels of management mean that it is more expensive. • Decision-making is slower due to vertical layers. • Top management are isolated. • This approach discourages employee autonomy.
Wide span of control	• Fewer levels of management means increased efficiency and reduced costs. • Increased subordinate autonomy leads to quicker decision-making. • This approach allows for greater organizational flexibility. • This approach creates higher levels of job satisfaction due to employee empowerment.	• This approach allows for less control. • Managers may lack familiarity with their subordinates due to the large number. • Managers can be spread so thin that they can't provide necessary leadership or support. • There may be a lack of coordination or synchronization.

If hundreds of employees perform the same job, one supervisor may be able to manage a very large number of employees. Such might be the case at a clothing plant, where hundreds of sewing machine operators work from identical patterns. But if employees perform complex and dissimilar tasks, a manager can effectively supervise only a much smaller number. For instance, a supervisor in the research and development area of a pharmaceutical company might oversee just a few research chemists due to the highly complex nature of their jobs.

CONCEPT CHECK

1. How does the chain of command clarify reporting relationships?
2. What is the role of a staff position in a line-and-staff organization?
3. What factors determine the optimal span of control?

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7.6: Degree of Centralization

How can the degree of centralization/decentralization be altered to make an organization more successful?

The optimal span of control is determined by the following five factors:

1. *Nature of the task*. The more complex the task, the narrower the span of control.
2. *Location of the workers*. The more locations, the narrower the span of control.
3. *Ability of the manager to delegate responsibility*. The greater the ability to delegate, the wider the span of control.
4. *Amount of interaction and feedback between the workers and the manager*. The more feedback and interaction required, the narrower the span of control.
5. *Level of skill and motivation of the workers*. The higher the skill level and motivation, the wider the span of control.

The final component in building an effective organizational structure is deciding at what level in the organization decisions should be made. **Centralization** is the degree to which formal authority is concentrated in one area or level of the organization. In a highly centralized structure, top management makes most of the key decisions in the organization, with very little input from lower-level employees. Centralization lets top managers develop a broad view of operations and exercise tight financial controls. It can also help to reduce costs by eliminating redundancy in the organization. But centralization may also mean that lower-level personnel don't get a chance to develop their decision-making and leadership skills and that the organization is less able to respond quickly to customer demands.

Decentralization is the process of pushing decision-making authority down the organizational hierarchy, giving lower-level personnel more responsibility and power to make and implement decisions. Benefits of decentralization can include quicker decision-making, increased levels of innovation and creativity, greater organizational flexibility, faster development of lower-level managers, and increased levels of job satisfaction and employee commitment. But decentralization can also be risky. If lower-level personnel don't have the necessary skills and training to perform effectively, they may make costly mistakes. Additionally, decentralization may increase the likelihood of inefficient lines of communication, competing objectives, and duplication of effort.

Several factors must be considered when deciding how much decision-making authority to delegate throughout the organization. These factors include the size of the organization, the speed of change in its environment, managers' willingness to give up authority, employees' willingness to accept more authority, and the organization's geographic dispersion.

Decentralization is usually desirable when the following conditions are met:

- The organization is very large, like ExxonMobil, Ford, or General Electric.
- The firm is in a dynamic environment where quick, local decisions must be made, as in many high-tech industries.
- Managers are willing to share power with their subordinates.
- Employees are willing and able to take more responsibility.
- The company is spread out geographically, such as Nordstrom, Caterpillar, or Ford.

As organizations grow and change, they continually reevaluate their structure to determine whether it is helping the company to achieve its goals.

CONCEPT CHECK

1. What are the characteristics of a centralized organization?
2. What are the benefits of a decentralized organization?
3. What factors should be considered when choosing the degree of centralization?

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7.7: Organizational Design Considerations

How do mechanistic and organic organizations differ?

You are now familiar with the different ways to structure an organization, but as a manager, how do you decide which design will work the best for your business? What works for one company may not work for another. In this section, we'll look at two generic models of organizational design and briefly examine a set of contingency factors that favors each.



Exhibit 7.8: The Walt Disney Company expanded its entertainment empire more than a decade ago by acquiring Pixar Studios, the animation powerhouse behind such blockbusters as *Toy Story, Finding Dory, Cars,* and *Up*. The $7.4 billion purchase absorbed Pixar into the Disney Studio Entertainment division, one of the company's four operating units, alongside Parks and Resorts, Media Networks, and Consumer Products and Interactive Media. *Why do some analysts believe that Disney's gigantic organizational structure could engulf the smaller Pixar operation and stifle its creative output?* (Credit: Poi Beltran/ Flicker/ Attribution 2.0 Generic (CC BY 2.0))

Mechanistic versus Organic Structures

Structural design generally follows one of the two basic models described in **Table 7.3**: mechanistic or organic. A **mechanistic organization** is characterized by a relatively high degree of job specialization, rigid departmentalization, many layers of management (particularly middle management), narrow spans of control, centralized decision-making, and a long chain of command. This combination of elements results in what is called a tall organizational structure. The U.S. Army and the United Nations are typical mechanistic organizations.

In contrast, an **organic organization** is characterized by a relatively low degree of job specialization, loose departmentalization, few levels of management, wide spans of control, decentralized decision-making, and a short chain of command. This combination of elements results in what is called a flat organizational structure. Colleges and universities tend to have flat organizational structures, with only two or three levels of administration between the faculty and the president. **Exhibit 7.9** shows examples of flat and tall organizational structures.

Factors Influencing the Choice between Mechanistic and Organic Structures

Although few organizations are purely mechanistic or purely organic, most organizations tend more toward one type or the other. The decision to create a more mechanistic or a more organic structural design is based on factors such as the firm's overall strategy, the size of the organization, and the stability of its external environment, among others.

A company's organizational structure should enable it to achieve its goals, and because setting corporate goals is part of a firm's overall strategy-making process, it follows that a company's structure depends on its *strategy*. That alignment can be challenging for struggling companies trying to accomplish multiple goals. For example, a company with an innovation strategy will need the flexibility and fluid movement of information that an organic organization provides. But a company using a cost-control strategy will require the efficiency and tight control of a mechanistic organization. Often, struggling companies try to simultaneously increase innovation and rein in costs, which can be organizational challenges for managers. Such is the case at Microsoft, where CEO Satya Nadella cut more than 18,000 jobs in 2014 after taking the helm at the technology giant. Most of the cuts were the result of the company's failed acquisition of Nokia's mobile phone business. More recently, the company eliminated additional jobs in sales and marketing (mostly overseas) as Microsoft shifts from a software developer to a cloud computing software delivery service. At the same time, Nadella is also trying to encourage employees and managers to break down barriers between divisions and increase the pace of innovation across the organization.[14]

Table 7.3: Mechanistic versus Organic Structure

Structural Characteristic	Mechanistic	Organic
Job specialization	High	Low
Departmentalization	Rigid	Loose
Managerial hierarchy (levels of management)	Tall (many levels)	Flat (few levels)
Span of control	Narrow	Wide
Decision-making authority	Centralized	Decentralization
Chain of command	Long	Short

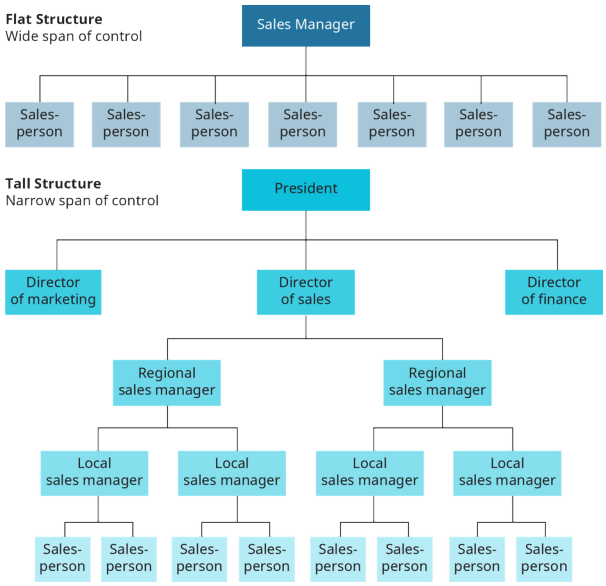


Exhibit 7.9: **Flat versus Tall Organizational Structures** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Size is another factor that affects how mechanistic or organic a company's organizational structure is. Much research has been conducted that shows a company's size has a significant impact on its organizational structure. Smaller companies tend to follow the more organic model, in part because they can. It's much easier to be successful with decentralized decision-making, for example, if you have only 50 employees. A company with that few employees is also more likely, by virtue of its size, to have a lesser degree of employee specialization. That's because, when there are fewer people to do the work, those people tend to know more about the entire process. As a company grows, it becomes more mechanistic, as systems are put in place to manage the greater number of employees. Procedures, rules, and regulations replace flexibility, innovation, and independence. That isn't always the case, however. W. L. Gore has nearly 10,000 employees and more than $3 billion in annual revenues, but, as noted earlier, uses an extremely organic organizational structure. Employees have no bosses, participate on teams, and often create roles for themselves to fill functional gaps within the company.[15]

Lastly, the business in which a company operates has a significant impact on its organizational structure. In complex, dynamic,

and unstable environments, companies need to organize for flexibility and agility. That is, their organizational structures need to respond to rapid and unexpected changes in the business environment. For companies operating in stable environments, however, the demands for flexibility and agility are not so great. The environment is predictable. In a simple, stable environment, therefore, companies benefit from the efficiencies created by a mechanistic organizational structure.

MANAGING CHANGE

Google Learns the Alphabet

A little less than 20 years ago, Larry Page and Sergey Brin built a search engine that used links to determine the importance of individual pages on the web. Today, Google has grown from two founders to more than 60,000 employees in 50 different countries. While the company is routinely high on the lists of best places to work and companies with the best employee perks, its meteoric growth has not been without challenges.

Much has been written about Google's informal organizational structure, which has fueled a creative environment second to none. At one point, the founders shared an office that looked like a college dorm room, complete with skateboards, beanbag chairs, and remote-controlled airplanes. The company's offices around the world are designed to be the most productive workspaces imaginable, sometimes with meeting rooms designed as camping vans (Amsterdam) or hallways decorated with subway grates and fire hydrants (New York City).

As this creative environment expanded, Google relied on its innovative and competitive culture to produce some of the most-used products around the world, including YouTube, the Android operating system, Gmail, and, of course, Google Search. As Google grew, so did the strain on its informal structure. In the early days, while adding employees on a daily basis, the company needed to find the right balance between maintaining creativity and running a rapidly growing organization.

In 2001, Brin and Page hired an outside CEO, Eric Schmidt, who hired an HR manager and then divided employees into teams based on product or function. This structure seemed to work well until Google started to acquire companies or develop new products to add to its portfolio of business ventures, including Double Click and Nest. At the same time, Page and Brin never lost sight of their "moonshot" projects, potentially game-changing innovations that could change the world, such as a self-driving car, which may or may not become a profitable venture.

Fast-forward to 2015, when the founders decided Google was getting too big to contain in one company. They created Alphabet, which is now a holding company that includes Google as well as several other business ventures. Their decision to refocus Google and pull out other activities under the Alphabet umbrella has provided transparency and an organizational structure that has been simplified. Sundar Pichai, who was quite successful managing Google Search, became the new Google CEO, while Page became the Alphabet CEO and Brin the Alphabet President. (Former Google CEO Schmidt is Alphabet's executive chairman.)

This reorganization allows both Brin and Page to focus on projects they are passionate about, such as Project Loon, a network of balloons flying high above commercial airspace that provides web connectivity to remote areas, while leaving Google and its many successful endeavors to be managed independently by Pichai and his team. Alphabet's recent CFO hire, Ruth Porat, former CFO at Morgan Stanley, has received praise for her guidance in helping company executives take a closer look at costs while still encouraging the innovation and creativity the Google founders seemingly invented. Although not as simple as *A-B-C*, the new organizational structure seems to streamline processes while allowing the various businesses room to grow on their own.

Critical Thinking Questions

1. If you were a long-time "Googler," how would feel about the change in organizational structure at the company?
2. Do you think the creative work environment fostered by company founders has taken a hit with the new Alphabet organizational structure? Why or why not?
3. What are some advantages and disadvantages of creating separate businesses for the company's moonshot projects?

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CONCEPT CHECK

1. Compare and contrast mechanistic and organic organizations.
2. What factors determine whether an organization should be mechanistic or organic?

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7.8: The Informal Organization

How does the informal organization affect the performance of the company?

Up to this point, we have focused on formal organizational structures that can be seen in the boxes and lines of the organization chart. Yet many important relationships within an organization do not show up on an organization chart. Nevertheless, these relationships can affect the decisions and performance of employees at all levels of the organization.

The network of connections and channels of communication based on the informal relationships of individuals inside the organization is known as the **informal organization**. Informal relationships can be between people at the same hierarchical level or between people at different levels and in different departments. Some connections are work-related, such as those formed among people who carpool or ride the same train to work. Others are based on nonwork commonalties such as belonging to the same church or health club or having children who attend the same school.

Functions of the Informal Organization

The informal organization has several important functions. First, it provides a source of friendships and social contact for organization members. Second, the interpersonal relationships and informal groups help employees feel better-informed about and connected with what is going on in their firm, thus giving them some sense of control over their work environment. Third, the informal organization can provide status and recognition that the formal organization cannot or will not provide employees. Fourth, the network of relationships can aid the socialization of new employees by informally passing along rules, responsibilities, basic objectives, and job expectations. Finally, the organizational grapevine helps employees to be more aware of what is happening in their workplace by transmitting information quickly and conveying it to places that the formal system does not reach.

Informal Communication Channels

The informal channels of communication used by the informal organization are often referred to as the *grapevine* or the *rumor mill*.Managers need to pay attention to the grapevines in their organization, because their employees increasingly put a great deal of stock in the information that travels along it, especially in this era of social media. A recent survey found that many business leaders have their work cut out for them in the speeches and presentations they give employees. Survey participants were asked if they would believe a message delivered in a speech by a company leader or one that they heard over the grapevine. Forty-seven percent of those responding said they would put more credibility in the grapevine. Only 42 percent said they would believe senior leadership, and another 11 percent indicated they would believe a blend of elements from both messages. Perhaps even more interesting is how accurate employees perceive their company grapevine to be: 57 percent gave it favorable ratings. “The grapevine may not be wholly accurate, but it is a very reliable indicator that something is going on,” said one survey respondent.[16]

With this in mind, managers need to learn to use the existing informal organization as a tool that can potentially benefit the **formal organization**. An excellent way of putting the informal organization to work for the good of the company is to bring informal leaders into the decision-making process. That way, at least the people who use and nurture the grapevine will have more accurate information to send it.



Exhibit 7.10: Smart managers understand that not all of a company's influential relationships appear as part of the organization chart. A web of informal, personal connections exists between workers, and vital information and knowledge pass through this web constantly. Using social media analysis software and other tracking tools, managers can map and quantify the normally invisible relationships that form between employees at all levels of an organization. *How might identifying a company's informal organization help managers foster teamwork, motivate employees, and boost productivity?* (Credit: University of Exeter /flickr / Attribution 2.0 Generic (CC BY 2.0))

CONCEPT CHECK

1. What is the informal organization?
2. How can informal channels of communication be used to improve operational efficiency?

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7.9: Trends in Organizational Structure

What trends are influencing the way businesses organize?

To improve organizational performance and achieve long-term objectives, some organizations seek to reengineer their business processes or adopt new technologies that open up a variety of organizational design options, such as virtual corporations and virtual teams. Other trends that have strong footholds in today's organizations include outsourcing and managing global businesses.

Reengineering Organizational Structure

Periodically, all businesses must reevaluate the way they do business. This includes assessing the effectiveness of the organizational structure. To meet the formidable challenges of the future, companies are increasingly turning to **reengineering**—the complete redesign of business structures and processes in order to improve operations. An even simpler definition of reengineering is "starting over." In effect, top management asks, "If we were a new company, how would we run this place?" The purpose of reengineering is to identify and abandon the outdated rules and fundamental assumptions that guide current business operations. Every company has many formal and informal rules, based on assumptions about technology, people, and organizational goals, that no longer hold. Thus, the goal of reengineering is to redesign business processes to achieve improvements in cost control, product quality, customer service, and speed. The reengineering process should result in a more efficient and effective organizational structure that is better suited to the current (and future) competitive climate of the industry.

The Virtual Corporation

One of the biggest challenges for companies today is adapting to the technological changes that are affecting all industries. Organizations are struggling to find new organizational structures that will help them transform information technology into a competitive advantage. One alternative that is becoming increasingly prevalent is the **virtual corporation**, which is a network of independent companies (suppliers, customers, even competitors) linked by information technology to share skills, costs, and access to one another's markets. This network structure allows companies to come together quickly to exploit rapidly changing opportunities. The key attributes of a virtual corporation are:

- *Technology.* Information technology helps geographically distant companies form alliances and work together.
- *Opportunism.* Alliances are less permanent, less formal, and more opportunistic than in traditional partnerships.
- *Excellence.* Each partner brings its core competencies to the alliance, so it is possible to create an organization with higher quality in every functional area and increase competitive advantage.
- *Trust.* The network structure makes companies more reliant on each other and forces them to strengthen relationships with partners.
- *No borders.* This structure expands the traditional boundaries of an organization.

In the concept's purest form, each company that links up with others to create a virtual corporation is stripped to its essence. Ideally, the virtual corporation has neither a central office nor an organization chart, no hierarchy, and no vertical integration. It contributes to an alliance only its core competencies, or key capabilities. It mixes and matches what it does best with the core competencies of other companies and entrepreneurs. For example, a manufacturer would only manufacture, while relying on a product design firm to decide what to make and a marketing company to sell the end result.

Although firms that are purely virtual organizations are still relatively scarce, many companies are embracing several characteristics of the virtual structure. One example is Cisco Systems. Cisco uses many manufacturing plants to produce its products, but the company owns none of them. In fact, Cisco now relies on contract manufacturers for all of its manufacturing needs. Human hands probably touch fewer than 10 percent of all customer orders, with fewer than half of all orders processed by a Cisco employee. To the average customer, the interdependency of Cisco's suppliers and inventory systems makes it look like one huge, seamless company.

Virtual Teams

Technology is also enabling corporations to create virtual work teams. Geography is no longer a limitation when employees are considered for a work team. Virtual teams mean reduced travel time and costs, reduced relocation expenses, and utilization of specialized talent regardless of an employee's location.

When managers need to staff a project, all they need to do is make a list of required skills and a general list of employees who possess those skills. When the pool of employees is known, the manager simply chooses the best mix of people and creates the virtual team. Special challenges of virtual teams include keeping team members focused, motivated, and communicating positively despite their locations. If feasible, at least one face-to-face meeting during the early stages of team formation will help with these potential problems.



Exhibit 7.11: In today's high-tech world, teams can exist any place where there is access to the internet. With globalization and outsourcing being common strategies in business operations today, companies of all shapes and sizes utilize virtual teams to coordinate people and projects halfway around the world. Unlike coworkers in traditional teams, virtual team members rarely meet in person, working from different locations and continents. *What practical benefits do virtual teams offer to businesses, employees, and other members?*(Credit: ThoroughlyReviewed/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Outsourcing

Another organizational trend that continues to influence today's managers is outsourcing. For decades, companies have outsourced various functions. For example, payroll functions such as recording hours, managing benefits and wage rates, and issuing paychecks have been handled for years by third-party providers. Today, however, outsourcing includes a much wider array of business functions: customer service, production, engineering, information technology, sales and marketing, and more.

Historically, companies have outsourced for two main reasons: cost reduction and labor needs. Often, to satisfy both requirements, companies outsource work to firms in foreign countries. In 2017, outsourcing remains a key component of many businesses' operations but is not strictly limited to low-level jobs. Some of the insights highlighted in Deloitte's recent Global Outsourcing Survey bear this out. According to survey respondents from 280 global organizations, outsourcing continues to be successful because it is adapting to changing business environments. According to the survey, outsourcing continues to grow across mature functions such as HR and IT, but it has successfully moved to nontraditional business functions such as facilities management, purchasing, and real estate. In addition, some businesses view outsourcing as a way of infusing their operations with innovation and using it to maintain a competitive advantage—not just as a way to cut costs. As companies increasingly view outsourcing as more than a cost-cutting strategy, they will be expecting more of their vendors in terms of supplying innovation and other benefits.[17]

Another form of outsourcing has become prevalent over the last several years, in part as the result of the slow economic recovery from the global recession of 2007–2009. As many U.S. businesses hesitated to hire full-time workers even as they began to

experience gradual growth, some companies began to offer contract work to freelancers, who were not considered full-time employees eligible for company benefits. Known as the *gig economy,* this work approach has advantages and disadvantages. Some gig workers like the independence of being self-employed, while others acknowledge that they are taking on multiple small projects because they can't find full-time work as company employees. Another group of individuals work as full-time employees but may sign up for gigs such as driving for Uber or Lyft to supplement their income. Recent estimates suggest that the gig economy may impact more than one-third of the U.S. workforce over the next few years.[18]

Despite the challenges, outsourcing programs can be effective. To be successful in outsourcing efforts, managers must do the following:

- Identify a specific business problem.
- Consider all possible solutions.
- Decide whether outsourcing the work is the appropriate answer to the problem.
- Develop a strategic outsourcing partnership with vendors and a solid framework that promotes seamless collaboration and communication.
- Engage with outsourcing partners on a regular basis to instill trust between the two entities.
- Remain flexible when it comes to working with outsourcing providers in terms of accommodating requests or adjusting needs when necessary in an effort to build a long-term strategic partnership beneficial to both parties.[19]

Structuring for Global Mergers

Recent mergers creating mega-firms (such as Microsoft and LinkedIn, Amazon and Whole Foods, and Verizon and Yahoo) raise some important questions regarding corporate structure. How can managers hope to organize the global pieces of these huge, complex new firms into a cohesive, successful whole? Should decision-making be centralized or decentralized? Should the firm be organized around geographic markets or product lines? And how can managers consolidate distinctly different corporate cultures? These issues and many more must be resolved if mergers of global companies are to succeed.

Beyond designing a new organizational structure, one of the most difficult challenges when merging two large companies is uniting the cultures and creating a single business. The merger between Pfizer and Pharmacia, makers of Dramamine and Rogaine, is no exception. Failure to effectively merge cultures can have serious effects on organizational efficiency.

As part of its strategic plan for the giant merger, Pfizer put together 14 groups that would make recommendations concerning finances, human resources, operation support, capital improvements, warehousing, logistics, quality control, and information technology. An outside consultant was hired to facilitate the process. One of the first tasks for the groups was to deal with the conqueror (Pfizer) versus conquered (Pharmacia) attitudes. Company executives wanted to make sure all employees knew that their ideas were valuable and that senior management was listening.

As more and more global mergers take place, sometimes between the most unlikely suitors, companies must ensure that the integration plan includes strategies for dealing with cultural differences, establishing a logical leadership structure, implementing a strong two-way communications channel at all levels of the organization, and redefining the "new" organization's vision, mission, values, and culture.[20]

CONCEPT CHECK

1. How does technology enable firms to organize as virtual corporations?
2. What effect could the gig economy have on a company's decision to outsource?
3. What are some organizational issues that must be addressed when two firms merge?

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8: MANAGEMENT

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8.1: Introduction



Exhibit 6.1: (Credit: Urs Rüegsegger / flickr / Public Domain Mark 1.0)

EXPLORING BUSINESS CAREERS

Jalem Getz (BuyCostumes.com/Wantable, Inc.)

You might ask, “How does one come to work in the world of online costume retail?” A passion for holiday make-believe and dress-up? A keen eye for business potential? The drive to capitalize on a competitive advantage? If you’re Jalem Getz, the answer is: all of these. Getz is the founder of BuyCostumes.com, an online costume and accessories retailer and, most recently, founder of Wantable, Inc.

As with most businesses, BuyCostumes.com and Wantable, Inc., are the result of careful planning. BuyCostumes.com was a response to what Getz saw as inherent flaws of resource allocation with the business model of brick-and-mortar costume retailers. “As a brick-and-mortar business, we were the gypsies of retail, which caused scale problems since we started over every year. Because we only were in a mall four or five months a year, locations we had one year often were rented the next. So we had to find new stores to rent each year. Then we had to find management to run the stores, and train employees to staff them. We also had to shuffle the inventory around each year to stock them. It’s almost impossible to grow a business like that.” By turning to the internet, however, Getz was able to bypass all of those issues. The virtual “space” was available year-round, and inventory and staff were centralized in a single warehouse location.

Getz grew BuyCostumes.com to a multimillion-dollar business before selling it, with a staff of about 600 employees during its peak season. Before Getz sold the business, it carried over 10,000 Halloween items and had upwards of 20 million visitors each holiday season. In one year, it shipped over 1 million costumes across the world, including 45 countries outside the United States. “We say that our goal is to ensure that anytime anyone buys a costume anywhere in the world, it will be from BuyCostumes.com. And, although to some extent we’re kidding, we’re also very serious.”

To keep track of all this action, Getz mixed ideals of a strong work ethic, a willingness to take risks, and an interest in having fun while making a profit. Given the size of the company, BuyCostumes.com organized its management to help keep the company focused on the corporate goal of continued growth. For Getz, his role in the management hierarchy was to “hire excellent people who have similar goals and who are motivated the same way I am and then put them in a position where they can succeed.” Beyond that? “Inspect what you expect.” This maxim is a concise way to say that, although he does not believe in constantly watching over his employees’ shoulders, he does believe in periodically checking in with them to ensure that both he and they are on the same page. By considering the process of management a conversation between himself and his employees, he exhibits a strong participative leadership style.

Getz will joke that he wishes he could say that he spent his childhood dreaming of the day he could work with costumes. The truth, though, is that he saw an opportunity, grabbed it, and hasn't let go since. And sometimes, especially during Halloween, truth can be even more satisfying than fiction.

After selling BuyCostumes.com, Getz experimented with other digital start-ups but quickly realized he worked best with retail. In 2012, he launched Wantable, Inc., an online personal shopping service. In its first four years, Getz led the company to exceed 28,000% annual revenue growth and to hire more than 100 employees. It became profitable in 2016 and looked to double its income the following year.

Sources: "About Wantable," http://blog.wantable.com, accessed October 27, 2017; "Wantable Surpasses 100 Employees," http://www.prweb.com, April 3, 2017; Jeff Engel, "Jalem Getz's Latest Retail Startup Wantable Targets Women, Fast Growth," https://www.xconomy.com, April 21, 2014.

Today's companies rely on managers to guide daily operations using human, technological, financial, and other resources to create a competitive advantage. For many beginning business students, being in "management" is an attractive but somewhat vague future goal. This vagueness is due in part to an incomplete understanding of what managers do and how they contribute to organizational success or failure. This chapter introduces the basic functions of management and the skills managers need to drive an organization toward its goals. We will also discuss how leadership styles influence a corporate culture and highlight the trends that are shaping the future role of managers.

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8.2: The Role of Management

What is the role of management?

Management is the process of guiding the development, maintenance, and allocation of resources to attain organizational goals. Managers are the people in the organization responsible for developing and carrying out this management process. Management is dynamic by nature and evolves to meet needs and constraints in the organization's internal and external environments. In a global marketplace where the rate of change is rapidly increasing, flexibility and adaptability are crucial to the managerial process. This process is based in four key functional areas of the organization: planning, organizing, leading, and controlling. Although these activities are discussed separately in the chapter, they actually form a tightly integrated cycle of thoughts and actions.

From this perspective, the managerial process can be described as (1) anticipating potential problems or opportunities and designing plans to deal with them, (2) coordinating and allocating the resources needed to implement plans, (3) guiding personnel through the implementation process, and (4) reviewing results and making any necessary changes. This last stage provides information to be used in ongoing planning efforts, and thus the cycle starts over again. The four functions are highly interdependent, with managers often performing more than one of them at a time and each of them many times over the course of a normal workday.



Exhibit 6.2: To encourage greater collaboration between employees, Apple is investing $5 billion in the construction of its new Cupertino, CA, headquarters, which is replacing several buildings the company had outgrown. Most headquarters-based employees of Apple now share not only the same office space, but also the same technology tools and corporate culture. *How do Apple's planning and organizing decisions increase organizational efficiency and effectiveness?* (Credit: Tom Pavel / flickr/ Attribution 2.0 Generic (CC BY 2.0))

The four management functions can help managers increase organizational efficiency and effectiveness. **Efficiency** is using the least possible amount of resources to get work done, whereas **effectiveness** is the ability to produce a desired result. Managers need to be both efficient and effective in order to achieve organizational goals. For example in 2016, Delta, one of the most efficient network U.S. airlines, operated at revenue of 12.15 cents per seat-mile, which is the revenue the company makes on one seat (occupied or not) the distance of one mile. No other airline came close to operating this efficiently except Southwest, which flew seats that produced 12.51 cents a mile, the best performance of all U.S. airlines.[1] There are many ways that airlines can manage to produce higher revenue per seat-mile. For instance, they can raise ticket prices, fill more of their seats, operate more efficient aircraft that utilize less fuel, or negotiate favorable salaries with their employees. While efficiency and effectiveness are sometimes lauded by investors, airlines also need to account for customer satisfaction, which can mean extra costs.[2]

To meet the demands of rapid growth, Skechers hired a new chief financial officer, John Vandemore, which allowed their existing CFO (David Weinberg) to concentrate on international expansion. Skechers CEO Robert Greenberg commented: "As international now represents more than 50 percent of our total business, we must continue to ramp up operations and infrastructure to meet

the demand. David (Weinberg) understands how to do it the right way at the right speed to maintain our forward momentum. With John (Vandemore) handling CFO responsibilities, David will now have the bandwidth to travel and find opportunities to maximize our efficiencies around the globe."[3]

As these examples and Table 6.1 show, good management uses the four management functions to increase a company's efficiency and effectiveness, which leads to the accomplishment of organizational goals and objectives. Let's look more closely at what each of the management functions entails.

Table 6.1

What Managers Do and Why					
Good management consists of these four activities:			**Which results in**		**And leads to**
Planning • Set objectives and state mission • Examine alternatives • Determine needed resources • Create strategies to reach objectives	**Leading** • Lead and motivate employees to accomplish organizational goals • Communicate with employees • Resolve conflicts • Manage change				
Organizing • Design jobs and specify tasks • Create organizational structure • Staff positions • Coordinate work activities • Set policies and procedures • Allocate resources	**Controlling** • Measure performance • Compare performance to standards • Take necessary action to improve performance	Leads to	Organizational efficiency and effectiveness	Leads to	Achievement of organizational mission and objectives

CONCEPT CHECK

1. Define the term *management*.
2. What are the four key functions of managers?
3. What is the difference between efficiency and effectiveness?

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8.3: Planning

What are the four types of planning?

Planning begins by anticipating potential problems or opportunities the organization may encounter. Managers then design strategies to solve current problems, prevent future problems, or take advantage of opportunities. These strategies serve as the foundation for goals, objectives, policies, and procedures. Put simply, planning is deciding what needs to be done to achieve organizational objectives, identifying when and how it will be done, and determining who should do it. Effective planning requires extensive information about the external business environment in which the firm competes, as well as its internal environment.

There are four basic types of planning: strategic, tactical, operational, and contingency. Most of us use these different types of planning in our own lives. Some plans are very broad and long term (more strategic in nature), such as planning to attend graduate school after earning a bachelor's degree. Some plans are much more specific and short term (more operational in nature), such as planning to spend a few hours in the library this weekend. Your short-term plans support your long-term plans. If you study now, you have a better chance of achieving some future goal, such as getting a job interview or attending graduate school. Like you, organizations tailor their plans to meet the requirements of future situations or events. A summary of the four types of planning appears in Table 6.2.

Strategic planning involves creating long-range (one to five years), broad goals for the organization and determining what resources will be needed to accomplish those goals. An evaluation of external environmental factors such as economic, technological, and social issues is critical to successful strategic planning. Strategic plans, such as the organization's long-term mission, are formulated by top-level managers and put into action at lower levels in the organization. For example, when Mickey Drexler took over as CEO of J.Crew, the company was floundering and had been recently purchased by a private equity group. One of Drexler's first moves was to change the strategic direction of the company by moving it out of the crowded trend-following retail segment, where it was competing with stores such as Gap, American Eagle, and Abercrombie and back into the preppie, luxury segment where it began. Rather than trying to sell abundant inventory to a mass market, J.Crew cultivated scarcity, making sure items sold out early rather than hit the sale rack later in the season. The company also limited the number of new stores it opened during a two-year span but planned to double the number of stores in the next five to six years. Drexler led the company through public offerings and back to private ownership before bringing on a new CEO in 2017. He remained chairman with ownership in the company.[4]

Table 6.2: Types of Planning

Type of Planning	Time Frame	Level of Management	Extent of coverage	Purpose and Goal	Breadth of Content	Accuracy and Predictability
Strategic	1–5 years	Top management (CEO, vice presidents, directors, division heads)	External environment and entire organization	Establish mission and long-term goals	Broad and general	High degree of uncertainty
Tactical	Less than 1 year	Middle management	Strategic business units	Establish mid-range goals for implementation	More specific	Moderate degree of certainty
Operational	Current	Supervisory management	Geographic and functional divisions	Implement and activate specific objectives	Specific and concrete	Reasonable degree of certainty
Contingency	When an event occurs or a situation demands	Top and middle management	External environment and entire organization	Meet unforeseen challenges and opportunities	Both broad and detailed	Reasonable degree of certainty once event or situation occurs

CATCHING THE ENTREPRENEURIAL SPIRIT

Changing Strategy Can Change Your Opportunities

Since 1949, Gordon Bernard, a printing company in Milford, Ohio, focused exclusively on printing fundraising calendars for a variety of clients, such as cities, schools, scout troops, and fire departments. The company's approximately 4,000 clients nationwide, 10 percent of which have been with the company for over 50 years, generated $4 million in revenue in 2006. In order to better serve customers, company president Bob Sherman invested $650,000 in the purchase of a Xerox iGEN3 digital color press so that the company could produce in-house a part of its calendar product that had been outsourced. The high-tech press did more for the company than simply reduce costs, however.

The new press gave the company four-color printing capability for the first time in its history, and that led the management of Gordon Bernard to rethink the company's strategy. The machine excels at short runs, which means that small batches of an item can be printed at a much lower cost than on a traditional press. The press also has the capability to customize every piece that rolls off the machine. For example, if a pet store wants to print 3,000 direct mail pieces, every single postcard can have a personalized greeting and text. Pieces targeted to bird owners can feature pictures of birds, whereas the dog owners' brochure will contain dog pictures. Text and pictures can be personalized for owners of show dogs or overweight cats or iguanas.

Bob Sherman created a new division to oversee the implementation, training, marketing, and creative aspects of the new production process. The company even changed how it thinks of itself. No longer does Gordon Bernard consider itself a printing firm, but as a marketing services company with printing capabilities. That change in strategy prompted the company to seek more commercial work. For example, Gordon Bernard will help clients of its new services develop customer databases from their existing information and identify additional customer information they might want to collect. Even though calendar sales accounted for 97 percent of the firm's revenues, that business is seasonal and leaves large amounts of unused capacity in the off-peak periods. Managers' goals for the new division were to contribute 10 percent of total revenue within a couple years of purchase.

Critical Thinking Questions

1. What type of planning do you think Gordon Bernard is doing?
2. Because Gordon Bernard's strategy changed only after it purchased the iGEN3, does the shift constitute strategic planning? Why or why not?

Sources: GBC Fundraising Calendars, http://www.gordonbernard.com/, accessed September 15, 2017; Gordon Bernard Co Inc., www.manta.com, accessed September 15, 2017; Karen Bells, "Hot Off the Press; Milford Printer Spends Big to Fill New Niche," *Cincinnati Business Courier,* July 15, 2005, pp. 17–18.

An organization's **mission** is formalized in its **mission statement**, a document that states the purpose of the organization and its reason for existing. For example, Twitter's mission statement formalizes both concepts while staying within its self-imposed character limit; see **Table 6.3**.

Table 6.3 Sources: "About" and "Our Values," https://about.twitter.com, accessed October 30, 2017; Justin Fox, "Why Twitter's Mission Statement Matters," Harvard Business Review, https://hbr.org, accessed October 30, 2017; Jeff Bercovici, "Mission Critical: Twitter's New 'Strategy Statement' Reflects Shifting Priorities," Inc., https://www.inc.com, accessed October 30, 2017.

Twitter's Mission, Values, and Strategy
Mission: Give everyone the power to create and share ideas and information instantly, without barriers.
Values: We believe in free expression and think every voice has the power to impact the world.
Strategy: Reach the largest daily audience in the world by connecting everyone to their world via our information sharing and distribution platform products and be one of the top revenue generating Internet companies in the world.
Twitter combines its mission and values to bring together a diverse workforce worldwide to fulfill its strategy.

Twitter's Mission, Values, and Strategy

The 3 Parts of a Company Mission Statement:

- Purpose
- Value
- Action

In all organizations, plans and goals at the tactical and operational levels should clearly support the organization's mission statement.

Tactical planning begins the implementation of strategic plans. Tactical plans have a shorter (less than one year) time frame than strategic plans and more specific objectives designed to support the broader strategic goals. Tactical plans begin to address issues of coordinating and allocating resources to different parts of the organization.

Under Mickey Drexler, many new tactical plans were implemented to support J.Crew's new strategic direction. For example, he severely limited the number of stores opened each year, with only nine new openings in the first two years of his tenure (he closed seven). Instead, he invested the company's resources in developing a product line that communicated J.Crew's new strategic direction. Drexler dumped trend-driven apparel because it did not meet the company's new image. He even cut some million-dollar volume items. In their place, he created limited editions of a handful of garments that he thought would be popular, many of which fell into his new luxury strategy. For example, J.Crew now buys shoes directly from the same shoe manufacturers that produce footwear for designers such as Prada and Gucci. In general, J.Crew drastically tightened inventories, a move designed to keep reams of clothes from ending up on sale racks and to break its shoppers' habit of waiting for discounts.

This part of the plan generated great results. Prior to Drexler's change in strategy, half of J.Crew's clothing sold at a discount. After implementing tactical plans aimed to change that situation, only a small percentage does. The shift to limited editions and tighter inventory controls has not reduced the amount of new merchandise, however. On the contrary, Drexler created a J.Crew bridal collection, a jewelry line, and Crew Cuts, a line of kids' clothing. The results of Drexler's tactical plans were impressive. J.Crew saw same-store sales rise 17 percent in one year.[5]

Operational planning creates specific standards, methods, policies, and procedures that are used in specific functional areas of the organization. Operational objectives are current, narrow, and resource focused. They are designed to help guide and control the implementation of tactical plans. In an industry where new versions of software have widely varying development cycles, Autodesk, maker of software tools for designers and engineers, implemented new operational plans that dramatically increased profits. Former CEO Carol Bartz shifted the company away from the erratic release schedule it had been keeping to regular, annual software releases. By releasing upgrades on a defined and predictable schedule, the company is able to use annual subscription pricing, which is more affordable for small and midsize companies. The new schedule keeps Autodesk customers on the most recent versions of popular software and has resulted in an overall increase in profitability.[6]

The key to effective planning is anticipating future situations and events. Yet even the best-prepared organization must sometimes cope with unforeseen circumstances, such as a natural disaster, an act of terrorism, or a radical new technology. Therefore, many companies have developed **contingency plans** that identify alternative courses of action for very unusual or crisis situations. The contingency plan typically stipulates the chain of command, standard operating procedures, and communication channels the organization will use during an emergency.

An effective contingency plan can make or break a company. Consider the example of Marriott Hotels in Puerto Rico. Anticipating Hurricane Maria in 2017, workers at the San Juan Marriott had to shift from their regular duties to handling the needs of not only customers, but everyone who needed assistance in the wake of the hurricane that devastated the island. A contingency plan and training for events such as this were a key part of managing this crisis.[7] The company achieved its goal of being able to cater to guest and general needs due to planning and training while having a contingency plan in place. One guest commented on TripAdvisor, "Could not believe how friendly, helpful & responsive staff were even during height of hurricane. Special thanks to Eydie, Juan, Jock, Ashley and security Luis. They kept us safe & were exemplary. Will always stay at Marriott from now on."[8] Within one month after Hurricane Maria hit, operations were back to normal at the San Juan Marriott.[9]

MANAGING CHANGE

Boeing Takes Off in New Direction

Boeing and Airbus have been locked in fierce competition for the world's airplane business for decades. What characterized most of that time period was a focus on designing larger and larger airplanes. Since its development in the 1970s, Boeing revamped its pioneering B747 numerous times and at one time boasted over 1,300 of the jumbo jets in operation around the world. As part of this head-to-head competition for bragging rights to the largest jet in the air, Boeingwas working on a 747X, a super-jumbo jet designed to hold 525 passengers. In what seemed to be an abrupt change of strategy, Boeing conceded the super-jumbo segment of the market to its rival and killed plans for the 747X. Instead of trying to create a plane with more seats, Boeing engineers began developing planes to fly fewer people at higher speeds. Then, as the rising price of jet fuel surpassed the airlines' ability to easily absorb its increasing cost, Boeing again changed its strategy, this time focusing on developing jets that use less fuel. In the end, Boeing's strategy changed from plane capacity to jet efficiency.

The new strategy required new plans. Boeing managers identified gaps in Airbus's product line and immediately set out to develop planes to fill them. Boeing announced a new 787 "Dreamliner," which boasted better fuel efficiency thanks to lightweight composite materials and next-generation engine design. Even though the 787 has less than half the seating of the Airbus A380, Boeing's Dreamliner is a hit in the market. Orders for the new plane have been stronger than anticipated, forcing Boeing to change its production plans to meet demand. The company decided to accelerate its planned 787 production rate buildup, rolling out a new jet every two days or so.

Airbus was not so lucky. The company spent so much time and energy on its super-jumbo that its A350 (the plane designed to compete with Boeing's 787) suffered. The 787 uses 15 percent less fuel than the A350, can fly nonstop from Beijing to New York, and is one of the fastest-selling commercial planes ever.

The battle for airline supremacy continues to switch between the two global giants. In 2017, Boeing beat Airbus on commercial jet orders at the Paris Air Show and continues to push forward. A spokesperson has hinted at a hybrid fuselage for midrange planes, which could carry passengers farther at lower costs. If successful, Boeing will regain market share lost to the Airbus A321.

Critical Thinking Questions

1. What seems to be the difference in how Boeing and Airbus have approached planning?
2. Do you think Airbus should change its strategic plans to meet Boeing's or stick with its current plans? Explain.

Sources: Gillian Rich, "Why Boeing's Paris Air Show Orders Are 'Staggering'," www.investors.com, June 22, 2017; Jon Ostrower, "Boeing vs. Airbus: A New Winner Emerges at the Paris Air Show," *CNN,* money.cnn.com, June 22, 2017; Gillian Rich, "'Hybrid' Design for New Boeing Midrange Jet Could Hit This Sweet Spot," www.investors.com, June 20, 2017; Alex Taylor, III, "Boeing Finally Has a Flight Plan," *Fortune*, June 13, 2005, pp. 27–28; J. Lynn Lunsford and Rod Stone, "Boeing Net Falls, but Outlook Is Rosy," *The Wall Street Journal*, July 28, 2005, p. A3; Carol Matlack and Stanley Holmes, "Why Airbus Is Losing Altitude," *Business Week*, June 20, 2005, p. 20; J. Lynn Lunsford, "UPS to Buy 8 Boeing 747s, Lifting Jet's Prospects," *The Wall Street Journal*, September 18, 2005, p. A2; "Airbus to Launch A350 Jet in October," *Xinhua News Agency*, September 14, 2005, online; "Boeing Plans Major Change," *Performance Materials*, April 30, 2001, p. 5.

CONCEPT CHECK

1. What is the purpose of planning, and what is needed to do it effectively?
2. Identify the unique characteristics of each type of planning.

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8.4: Organizing

What are the primary functions of managers in organizing activities?

A second key function of managers is **organizing**, which is the process of coordinating and allocating a firm's resources in order to carry out its plans. Organizing includes developing a structure for the people, positions, departments, and activities within the firm. Managers can arrange the structural elements of the firm to maximize the flow of information and the efficiency of work processes. They accomplish this by doing the following:

- Dividing up tasks *(division of labor)*
- Grouping jobs and employees *(departmentalization)*
- Assigning authority and responsibilities *(delegation)*

These and other elements of organizational structure are discussed in detail elsewhere. In this chapter, however, you should understand the three levels of a managerial hierarchy. This hierarchy is often depicted as a pyramid, as in **Exhibit 6.3**. The fewest managers are found at the highest level of the pyramid. Called **top management**, they are the small group of people at the head of the organization (such as the CEO, president, and vice president). Top-level managers develop *strategic plans* and address long-range issues such as which industries to compete in, how to capture market share, and what to do with profits. These managers design and approve the firm's basic policies and represent the firm to other organizations. They also define the company's values and ethics and thus set the tone for employee standards of behavior. For example, Jack Welch, the former CEO of General Electric, was a role model for his managers and executives. Admirers say that he had an extraordinary capacity to inspire hundreds of thousands of people in many countries and he could change the direction of a huge organization like General Electric as if it were a small firm. Following his leadership, General Electric's executives turned in impressive results. During his tenure, General Electric's average annual shareholder return was 25 percent.[10]

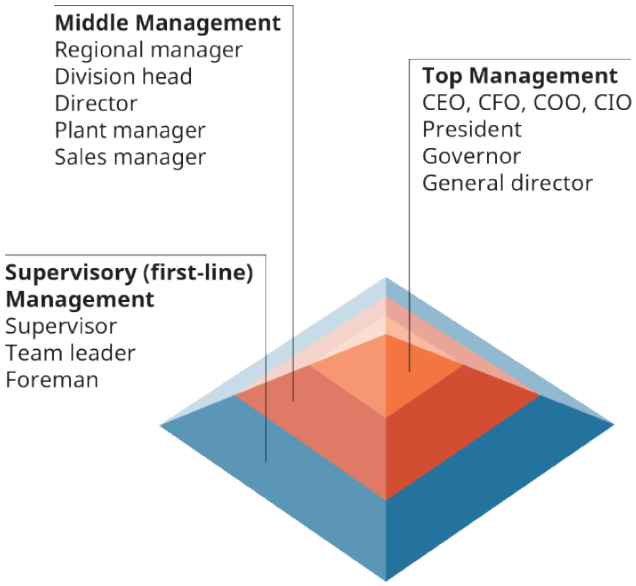


Figure 6.3: The Managerial Pyramid (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

The second and third tiers of the hierarchy are called **middle management** and **supervisory (first-line) management**, respectively. Middle managers (such as division heads, departmental managers, and regional sales managers) are responsible for beginning the implementation of strategic plans. They design and carry out *tactical plans* in specific areas of the company. They begin the process of allocating resources to meet organizational goals, and they oversee supervisory managers throughout the firm. Supervisors, the most numerous of the managers, are at the bottom of the managerial pyramid. These managers design and carry out *operational plans* for the ongoing daily activities of the firm. They spend a great deal of their time guiding and motivating the employees who actually produce the goods and services.

CONCEPT CHECK

1. Explain the managerial function of organizing.
2. What is the managerial pyramid?

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8.5: Leading, Guiding, and Motivating Others

How do leadership styles influence a corporate culture?

Leadership, the third key management function, is the process of guiding and motivating others toward the achievement of organizational goals. A leader can be anyone in an organization, regardless of position, able to influence others to act or follow, often by their own choice. Managers are designated leaders according to the organizational structure but may need to use negative consequences or coercion to achieve change. In the organization structure, top managers use leadership skills to set, share, and gain support for the company's direction and strategy—mission, vision, and values, such as Jeff Bezos does at Amazon. Middle and supervisory management use leadership skills in the process of directing employees on a daily basis as the employees carry out the plans and work within the structure created by management. Top-level leadership demonstrated by Bezos was also exhibited by Jack Welch while leading General Electric and led to many studies of his approach to leadership. Organizations, however, need strong effective leadership at all levels in order to meet goals and remain competitive.

To be effective leaders, managers must be able to influence others' behaviors. This ability to influence others to behave in a particular way is called **power**. Researchers have identified five primary sources, or bases, of power:

- **Legitimate power**, which is derived from an individual's position in an organization
- **Reward power**, which is derived from an individual's control over rewards
- **Coercive power**, which is derived from an individual's ability to threaten negative outcomes
- **Expert power**, which is derived from an individual's extensive knowledge in one or more areas
- **Referent power**, which is derived from an individual's personal charisma and the respect and/or admiration the individual inspires

Many leaders use a combination of all of these sources of power to influence individuals toward goal achievement. While CEO of Procter & Gamble, A. G. Lafley got his legitimate power from his position. His reward power came from reviving the company and making the stock more valuable. Also, raises and bonus for managers who met their goals was another form of reward power. Lafley also was not hesitant to use his coercive power. He eliminated thousands of jobs, sold underperforming brands, and killed weak product lines. With nearly 40 years of service to the company, Lafley had a unique authority when it came to P&G's products, markets, innovations, and customers. The company's sales doubled during his nine years as CEO, and its portfolio of brands increased from 10 to 23. He captained the purchase of Clairol, Wella AG, and IAMS, as well as the multibillion-dollar merger with Gillette. As a result, Lafley had a substantial amount of referent power. Lafley is also widely respected, not only by people at P&G, but by the general business community as well. Ann Gillin Lefever, a managing director at Lehman Brothers, said, "Lafley is a leader who is liked. His directives are very simple. He sets a strategy that everybody understands, and that is more difficult than he gets credit for."[11]

Leadership Styles

Individuals in leadership positions tend to be relatively consistent in the way they attempt to influence the behavior of others, meaning that each individual has a tendency to react to people and situations in a particular way. This pattern of behavior is referred to as **leadership style**. As Table 6.4 shows, leadership styles can be placed on a continuum that encompasses three distinct styles: autocratic, participative, and free rein.

Autocratic leaders are directive leaders, allowing for very little input from subordinates. These leaders prefer to make decisions and solve problems on their own and expect subordinates to implement solutions according to very specific and detailed instructions. In this leadership style, information typically flows in one direction, from manager to subordinate. The military, by necessity, is generally autocratic. When autocratic leaders treat employees with fairness and respect, they may be considered knowledgeable and decisive. But often autocrats are perceived as narrow-minded and heavy-handed in their unwillingness to share power, information, and decision-making in the organization. The trend in organizations today is away from the directive, controlling style of the autocratic leader.



Exhibit 6.4: Recently ranking near the top of the *Forbes* list of the world's most powerful women was Sheryl Sandberg, the COO at Facebook. As Facebook's chief operating officer since 2008, Sandberg has helped dramatically boost revenues at the social network. Sandberg also founded Lean In, a nonprofit named after her bestselling book, to support women's empowerment. *What are Sheryl Sandberg's primary sources of power?* (Credit: JD Lasica/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

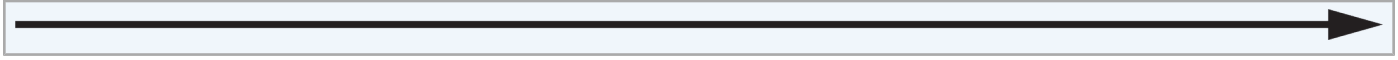
Instead, U.S. businesses are looking more and more for **participative leaders**, meaning leaders who share decision-making with group members and encourage discussion of issues and alternatives. Participative leaders use a democratic, consensual, consultative style. One CEO known for her participative leadership style is Meg Whitman, former CEO at Hewlett Packard. When Whitman worked at eBay, a team in the German-based operation began a promotional "treasure hunt," launching registration pages, clues, and an hourly countdown clock. Trouble was, the launch violated eBay's well-established corporate project-development processes. When the treasure hunt began, 10 million contestants logged on, crashing the local servers. Rather than shut the project down, the VP in charge of the German operation allowed the promotion to be fixed and fly under the radar of corporate headquarters. Successful innovations emerged, such as an Easy Lister feature and separate registration processes for private and business sellers. When the VP shared this experience with Meg Whitman, she fostered the idea of rapid prototyping throughout the organization, which "breaks rules to get something done," and modeled such behavior for the entire organization.[12]

Table 6.4

Leadership Styles of Managers		
←		
Amount of authority held by the leader		
Autocratic Style	**Participative Style (Democratic, Consensual, Consultative)**	**Free-Rein (Laissez-Faire) Style**
• Manager makes most decisions and acts in authoritative manner. • Manager is usually unconcerned about subordinates' attitudes toward decisions. • Emphasis is on getting task accomplished. • Approach is used mostly by military officers and some production line supervisors.	• Manager shares decision-making with group members and encourages teamwork. • Manager encourages discussion of issues and alternatives. • Manager is concerned about subordinates' ideas and attitudes. • Manager coaches subordinates and helps coordinate efforts. • Approach is found in many successful organizations.	• Manager turns over virtually all authority and control to group. • Members of group are presented with task and given freedom to accomplish it. • Approach works well with highly motivated, experienced, educated personnel. • Approach is found in high-tech firms, labs, and colleges.

Leadership Styles of Managers

Amount of authority held by group members



ETHICS IN PRACTICE

Scott Stephenson: Balancing the Duality of Ethics

Whether it's Bernie Madoff defrauding investors, Wells Fargo having to respond to creating fake accounts in the names of real customers, or Mylan N.V. imposing huge price increases on its life-saving EpiPen, it seems like there is never a shortage of ethical issues being an important aspect of business. As shown by these examples, unethical decisions permeate different parts of the business and occur for different reasons.

In the case of Bernie Madoff, it was the greed of one person using a Ponzi scheme to defraud thousands of customers. In the case of Wells Fargo, the culprits were managers putting excessive pressure on workers to meet new account quotas. The case of Mylan included the dramatic rise in the price of the EpiPen in a short time span and reports that CEO Heather Bresch and other executives received compensation that increased over 700 percent during the same time frame. Adding to the Mylan case was the fact that Bresch is the daughter of West Virginia Senator Joseph Manchin, and prior to being appointed CEO at Mylan, Bresch served as Mylan's chief lobbyist and helped craft the Generic Drug User Fee Amendments and the School Access to Emergency Epinephrine Act.

Where does the responsibility of managing ethical behavior in organizations reside? The answer is *everyone* in the organization is responsible to act in an ethical manner. The primary responsibility resides, however, with the CEO and also with the chief financial officer, who has the responsibility to oversee financial compliance with laws and regulations. Scott Stephenson, the CEO of Verisk Analytics, recently commented on how he approaches the duality of what he terms a "loose–tight" approach to leadership where he provides his employees with the discretion and responsibility to make critical decisions in crisis situations where ethics might be involved. That's the loose part. He also works on communicating and building trust in his employees so that he has the confidence they will act responsibly and make the correct decisions in crisis situations. That's the tight part of his leadership duality.

Critical Thinking Questions

1. Do you think Verisk Analytics, a technology company that needs innovation breakthroughs, benefits from Stephenson's "loose–tight" approach? What if Stephesnon had been an autocratic leader? Explain your reasoning.
2. What kind of participative leader (described below) does Stephenson seem to be? Explain your choice.

Sources: Scott Stephenson, "The Duality of Balanced Leadership," *Forbes*, https://www.forbes.com, November 29, 2017; Matt Egan, "Wells Fargo Uncovers Up to 1.4 Million More Fake Accounts," *CNN Money,* money.cnn.com, August 31, 2017; Jesse Heitz, "The EpiPen Scandal and the Perception of the Washington Establishment," *The Hill,*http://thehill.com, September 1, 2016; "Decade's Top 10 Ethics Scandals," *The Wall Street Journal*, https://www.wsj.com, August 9, 2010.

Participative leadership has three types: democratic, consensual, and consultative. **Democratic leaders** solicit input from all members of the group and then allow the group members to make the final decision through a voting process. This approach works well with highly trained professionals. The president of a physicians' clinic might use the democratic approach. **Consensual leaders**encourage discussion about issues and then require that all parties involved agree to the final decision. This is the general style used by labor mediators. **Consultative leaders** confer with subordinates before making a decision but retain the final decision-making authority. This technique has been used to dramatically increase the productivity of assembly-line workers.

The third leadership style, at the opposite end of the continuum from the autocratic style, is **free-rein** or **laissez-faire** (French for "leave it alone") **leadership**. Managers who use this style turn over all authority and control to subordinates. Employees are assigned a task and then given free rein to figure out the best way to accomplish it. The manager doesn't get involved unless asked. Under this approach, subordinates have unlimited freedom as long as they do not violate existing company policies. This approach is also sometimes used with highly trained professionals as in a research laboratory.

Although one might at first assume that subordinates would prefer the free-rein style, this approach can have several drawbacks. If free-rein leadership is accompanied by unclear expectations and lack of feedback from the manager, the experience can be

frustrating for an employee. Employees may perceive the manager as being uninvolved and indifferent to what is happening or as unwilling or unable to provide the necessary structure, information, and expertise.

No leadership style is effective all the time. Effective leaders recognize employee growth and use **situational leadership**, selecting a leadership style that matches the maturity and competency levels of those completing the tasks. Newly hired employees may respond well to authoritative leadership until they understand the job requirements and show the ability to handle routine decisions. Once established, however, those same employees may start to feel undervalued and perform better under a participative or free-rein leadership style. Using situational leadership empowers employees as discussed next.

Employee Empowerment

Participative and free-rein leaders use a technique called empowerment to share decision-making authority with subordinates. **Empowerment** means giving employees increased autonomy and discretion to make their own decisions, as well as control over the resources needed to implement those decisions. When decision-making power is shared at all levels of the organization, employees feel a greater sense of ownership in, and responsibility for, organizational outcomes.

Management use of employee empowerment is on the rise. This increased level of involvement comes from the realization that people at all levels in the organization possess unique knowledge, skills, and abilities that can be of great value to the company. For example, when Hurricane Katrina hit the Gulf Coast, five miles of railroad tracks were ripped off a bridge connecting New Orleans to Slidell, Louisiana. Without the tracks, which fell into Lake Pontchartrain, Norfolk Southern Railroad couldn't transport products between the East and West Coasts. Before the storm hit, however, Jeff McCracken, a chief engineer at the company, traveled to Birmingham with equipment he thought he might need and then to Slidell with 100 employees. After conferring with dozens of company engineers and three bridge companies, McCracken decided to try to rescue the miles of track from the lake. (Building new tracks would have taken several weeks at the least.) To do so, he gathered 365 engineers, machine operators, and other workers, who lined up eight huge cranes and, over the course of several hours, lifted the five miles of sunken tracks in one piece out of the lake and bolted it back on the bridge.[13] By giving employees the autonomy to make decisions and access to required resources, Norfolk Southern was able to avoid serious interruptions in its nationwide service.

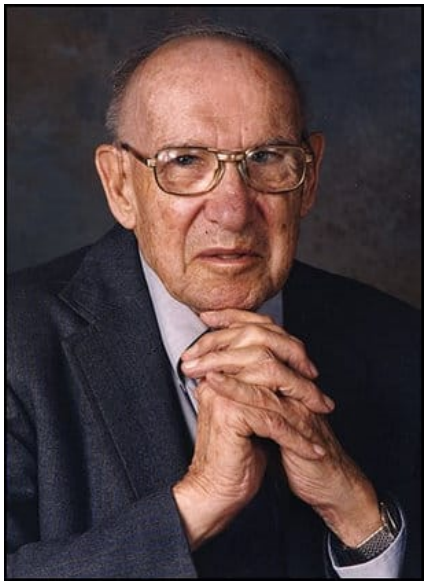


Exhibit 6.5 Management thought leader Peter Drucker (1909–2005) was the author of more than three dozen books, translated into almost as many languages. Most management scholars have remarked that although he was firmly associated with the human relations school of management—along with Douglas McGregor and Warren Bennis, for example—the thought leader Drucker most admired was Frederick Winslow Taylor, the father of "scientific" management. *Should any one "school" of management predominate thinking, or should all approaches be considered?* (Credit: IsaacMao/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Corporate Culture

The leadership style of managers in an organization is usually indicative of the underlying philosophy, or values, of the organization. The set of *attitudes, values,* and *standards of behavior* that distinguishes one organization from another is called

corporate culture. A corporate culture evolves over time and is based on the accumulated history of the organization, including the vision of the founders. It is also influenced by the dominant leadership style within the organization. Evidence of a company's culture is seen in its heroes (e.g., the late Andy Grove of Intel[14], myths (stories about the company passed from employee to employee), symbols (e.g., the Nike swoosh), and ceremonies. The culture at Google, working in teams and fostering innovation, sometimes is overlooked while its employee perks are drooled over. But both are important to the company's corporate culture. Since 2007 Google has been at or near the top of *Fortune*'s list of the "100 Best Companies to Work For," an annual list based on employee survey results tabulated by an independent company: Great Place to Work®. [15] "We have never forgotten since our startup days that great things happen more frequently within the right culture and environment," a company spokesperson said in response to the company first taking over the top spot.[16]

Culture may be intangible, but it has a tremendous impact on employee morale and a company's success. Google approaches morale analytically. When it found that mothers were leaving the company in higher rates than other employee groups, the company improved its parental-leave policies. The result was a 50 percent reduction in attrition for working moms. An analytical approach along with culture-building activities such as town halls led by black employees and allies, support for transgender employees, and unconscious-bias workshops are why employees say Google is a safe and inclusive place to work.[17] Clearly Google leaders recognize culture is critical to the company's overall success.

CONCEPT CHECK

1. How do leaders influence other people's behavior?
2. How can managers empower employees?
3. What is corporate culture?

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8.6: Controlling

How do organizations control activities?

The fourth key function that managers perform is **controlling**. Controlling is the process of assessing the organization's progress toward accomplishing its goals. It includes monitoring the implementation of a plan and correcting deviations from that plan. As **Exhibit 6.6** shows, controlling can be visualized as a cyclical process made up of five stages:

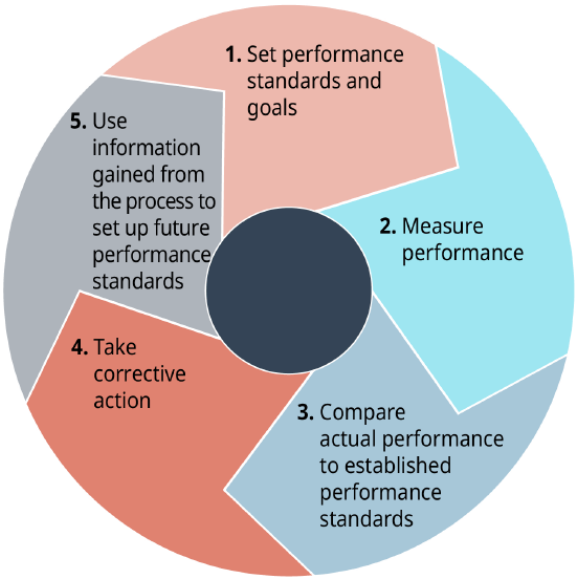


Exhibit 6.6: **The Control Process** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Performance standards are the levels of performance the company wants to attain. These goals are based on its strategic, tactical, and operational plans. The most effective performance standards state a measurable behavioral objective that can be achieved in a specified time frame. For example, the performance objective for the sales division of a company could be stated as "$200,000 in gross sales for the month of January." Each individual employee in that division would also have a specified performance goal. Actual firm, division, or individual performance can be measured against desired performance standards to see if a gap exists between the desired level of performance and the actual level of performance. If a performance gap does exist, the reason for it must be determined and corrective action taken.

Feedback is essential to the process of control. Most companies have a reporting system that identifies areas where performance standards are not being met. A feedback system helps managers detect problems before they get out of hand. If a problem exists, the managers take corrective action. Toyota uses a simple but effective control system on its automobile assembly lines. Each worker serves as the customer for the process just before his or hers. Each worker is empowered to act as a quality control inspector. If a part is defective or not installed properly, the next worker won't accept it. Any worker can alert the supervisor to a problem by tugging on a rope that turns on a warning light (i.e., feedback). If the problem isn't corrected, the worker can stop the entire assembly line.

Why is controlling such an important part of a manager's job? First, it helps managers to determine the success of the other three functions: planning, organizing, and leading. Second, control systems direct employee behavior toward achieving organizational goals. Third, control systems provide a means of coordinating employee activities and integrating resources throughout the organization.

CONCEPT CHECK

1. Describe the control process.
2. Why is the control process important to the success of the organization?

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8.7: Managerial Roles

What roles do managers take on in different organizational settings?

In carrying out the responsibilities of planning, organizing, leading, and controlling, managers take on many different roles. A role is a set of behavioral expectations, or a set of activities that a person is expected to perform. Managers' roles fall into three basic categories: *informational roles, interpersonal roles,* and *decisional role*s. These roles are summarized in Table 6.5. In an **informational role**, the manager may act as an information gatherer, an information distributor, or a spokesperson for the company. A manager's **interpersonal roles** are based on various interactions with other people. Depending on the situation, a manager may need to act as a figurehead, a company leader, or a liaison. When acting in a **decisional role**, a manager may have to think like an entrepreneur, make decisions about resource allocation, help resolve conflicts, or negotiate compromises.

Managerial Decision Making

In every function performed, role taken on, and set of skills applied, a manager is a decision maker. Decision-making means choosing among alternatives. Decision-making occurs in response to the identification of a problem or an opportunity. The decisions managers make fall into two basic categories: programmed and nonprogrammed. **Programmed decisions** are made in response to routine situations that occur frequently in a variety of settings throughout an organization. For example, the need to hire new personnel is a common situation for most organizations. Therefore, standard procedures for recruitment and selection are developed and followed in most companies.

Table 6.5: The Many Roles Managers Play in an Organization

Role	Description	Example
Information Roles		
Monitor	• Seeks out and gathers information relevant to the organization	• Finding out about legal restrictions on new product technology
Disseminator	• Provides information where it is needed in the organization	• Providing current production figures to workers on the assembly line
Spokesperson	• Transmits information to people outside the organization	• Representing the company at a shareholders' meeting
Interpersonal Roles		
Figurehead	• Represents the company in a symbolic way	• Cutting the ribbon at ceremony for the opening of a new building
Leader	• Guides and motivates employees to achieve organizational goals	• Helping subordinates to set monthly performance goals
Liaison	• Acts as a go-between among individuals inside and outside the organization	• Representing the retail sales division of the company at a regional sales meeting

Role	Description	Example
Decisional Roles		
Entrepreneur	• Searches out new opportunities and initiates change	• Implementing a new production process using new technology
Disturbance handler	• Handles unexpected events and crises	• Handling a crisis situation such as a fire
Resource allocator	• Designates the use of financial, human, and other organizational resources	• Approving the funds necessary to purchase computer equipment and hire personnel
Negotiator	• Represents the company at negotiating processes	• Participating in salary negotiations with union representatives

Infrequent, unforeseen, or very unusual problems and opportunities require **nonprogrammed decisions** by managers. Because these situations are unique and complex, the manager rarely has a precedent to follow. The earlier example of the Norfolk Southernemployee, who had to decide the best way to salvage a five-mile-long piece of railroad track from the bottom of Lake Pontchartrain, is an example of a nonprogrammed decision. Likewise, when Hurricane Katrina was forecast to make landfall, Thomas Oreck, then CEO of the vacuum manufacturer that bears his name, had to make a series of nonprogrammed decisions. Oreck's corporate headquarters were in New Orleans, and its primary manufacturing facility was in Long Beach, Mississippi. Before the storm hit, Oreck transferred its computer systems and call-center operations to backup locations in Colorado and planned to move headquarters to Long Beach. The storm, however, brutally hit both locations. Oreck executives began searching for lost employees, tracking down generators, assembling temporary housing for workers, and making deals with UPS to begin distributing its product (UPS brought food and water to Oreck from Atlanta and took vacuums back to the company's distribution center there). All of these decisions were made in the middle of a very challenging crisis environment.

Whether a decision is programmed or nonprogrammed, managers typically follow five steps in the decision-making process, as illustrated in **Exhibit 6.7**:

1. Recognize or define the problem or opportunity. Although it is more common to focus on problems because of their obvious negative effects, managers who do not take advantage of new opportunities may lose competitive advantage to other firms.
2. Gather information so as to identify alternative solutions or actions.
3. Select one or more alternatives after evaluating the strengths and weaknesses of each possibility.
4. Put the chosen alternative into action.
5. Gather information to obtain feedback on the effectiveness of the chosen plan.

It can be easy (and dangerous) for managers to get stuck at any stage of the decision-making process. For example, entrepreneurs can become paralyzed evaluating the options. For the Gabby Slome, the cofounder of natural pet food maker Ollie, the idea for starting the company came after her rescue dog began having trouble digesting store-bought pet food after living on scraps. Slome decided that the pet food industry, a $30 billion a year business, was ripe for a natural food alternative. She laments, however, that she let perfect be the enemy of the very good by indulging in "analysis paralysis."[18]

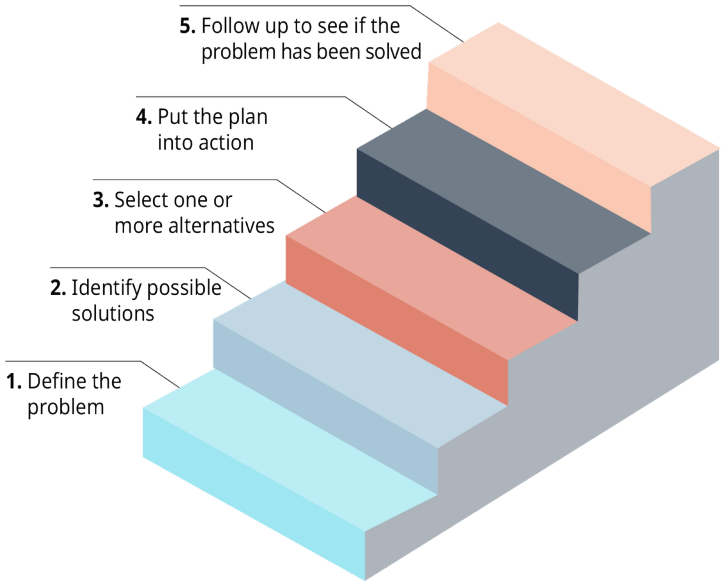


Exhibit 6.7: **The Decision-Making Process** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

CONCEPT CHECK

1. What are the three types of managerial roles?
2. Give examples of things managers might do when acting in each of the different types of roles.
3. List the five steps in the decision-making process.

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8.8: Managerial Skills

What set of managerial skills is necessary for managerial success?

In order to be successful in planning, organizing, leading, and controlling, managers must use a wide variety of skills. A *skill* is the ability to do something proficiently. Managerial skills fall into three basic categories: technical, human relations, and conceptual skills. The degree to which each type of skill is used depends upon the level of the manager's position as seen in **Exhibit 6.8**. Additionally, in an increasingly global marketplace, it pays for managers to develop a special set of skills to deal with global management issues.

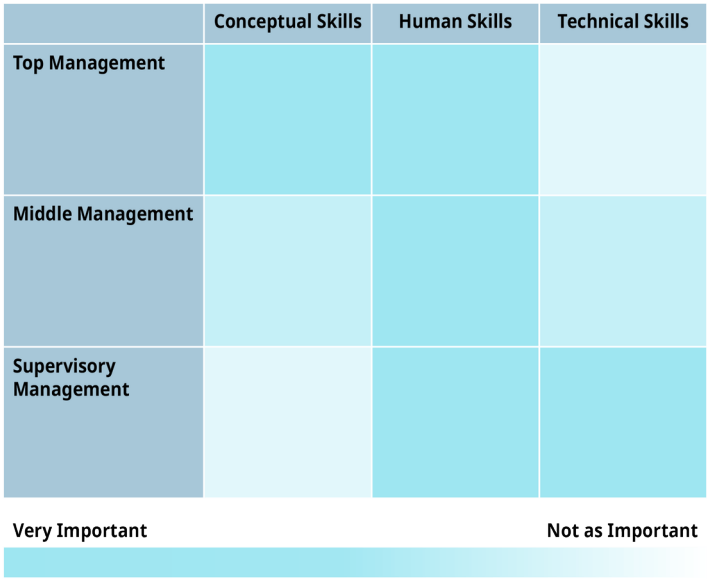


Exhibit 6.8: The Importance of Managerial Skills at Different Management Levels (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Technical Skills

Specialized areas of knowledge and expertise and the ability to apply that knowledge make up a manager's **technical skills**. Preparing a financial statement, programming a computer, designing an office building, and analyzing market research are all examples of technical skills. These types of skills are especially important for supervisory managers because they work closely with employees who are producing the goods and/or services of the firm.

Human Relations Skills

Human relations skills are the interpersonal skills managers use to accomplish goals through the use of human resources. This set of skills includes the ability to understand human behavior, to communicate effectively with others, and to motivate individuals to accomplish their objectives. Giving positive feedback to employees, being sensitive to their individual needs, and showing a willingness to empower subordinates are all examples of good human relations skills. Identifying and promoting managers with human relations skills are important for companies. A manager with little or no people skills can end up using an authoritarian leadership style and alienating employees.

Conceptual Skills

Conceptual skills include the ability to view the organization as a whole, understand how the various parts are interdependent, and assess how the organization relates to its external environment. These skills allow managers to evaluate situations and

develop alternative courses of action. Good conceptual skills are especially necessary for managers at the top of the management pyramid, where strategic planning takes place.

CONCEPT CHECK

1. Define the basic managerial skills.
2. How important is each of these skill sets at the different levels of the management pyramid?

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8.9: Trends in Management and Leadership

What trends will affect management in the future?

Four important trends in management today are crisis management, outside directors, the growing use of information technology, and the increasing need for global management skills.

Crisis Management

Crises, both internal and external, can hit even the best-managed organization. Sometimes organizations can anticipate crises, in which case managers develop contingency plans, and sometimes they can't. Take, for example, the sudden death of McDonald'sCEO Jim Cantalupo. The company had a solid succession plan in place and immediately named Charlie Bell as new CEO. Only a few months later, Bell announced that he had terminal cancer. Even though the company had prepared for the event of its leader's untimely death, surely it couldn't have anticipated that his successor would also be stricken by a terminal illness at almost the same time. Likewise, consider the devastation caused by Hurricanes Harvey, Irma, Maria, and Nate in 2017. Part of Marriott Hotels' crisis management plan included relaxing its "no pets" policy and allowing patrons fleeing the storm to check in with their pets because it was the right thing to do.[19]

Crises cannot be fully anticipated, but managers can develop contingency plans to help navigate through the aftermath of a disaster. For example, consider the challenges that faced Rajiv Joseph, the author of several plays including *Bengal Tiger at the Baghdad Zoo*, who was in Houston preparing to open his new play, *Describe the Night*, at the Alley Theater when Hurricane Harvey hit and flooded the theater a few weeks prior to opening night. The six New York–based actors, the director, the stage manager, and Joseph decided to help in the relief efforts and made their way to the George Brown Convention Center, which had become the central location for relief efforts. When they arrived and the staffers discovered they were theater artists, they were deployed to handle the writing and deployment of public address announcements and manage the incoming crowds. What made the relief efforts successful was planning—matching the skill sets of volunteers with tasks they are best able to perform.[20] Even though those in charge of the relief efforts had contingency plans, they still needed to make dozens of nonprogrammed decisions to effectively manage the ever-changing situation.[21]

No manager or executive can be completely prepared for these types of unexpected crises. However, how a manager handles the situation could mean the difference between disaster, survival, and even financial gain. No matter the crisis, there are some basic guidelines managers should follow to minimize negative outcomes. Managers should not become immobilized by the problem or ignore it. Managers should face the problem head on. Managers should always tell the truth about the situation and then put the best people on the job to correct the problem. Managers should ask for help if they need it, and finally, managers must learn from the experience to avoid the same problem in the future.[22] Table 6.6 describes what CEOs and other leaders learned about crisis management.

Managers and Information Technology

The second trend having a major impact on managers is the proliferation of data and analytics in information technology. An increasing number of organizations are selling technology, and an increasing number are looking for cutting-edge technology to make and market the products and services they sell. One particularly useful type of technology is dashboard software. Much like the dashboard in a car, dashboard software gives managers a quick look into the relevant information they need to manage their companies. Most large companies are organized in divisions, and often each division relies on a particular type of application or database software. Dashboard software allows employees to access information from software they don't routinely use, for example, from an application used by a different division from their own. More important, however, is the ability of a dashboard to show up-to-the-minute information and to allow employees to see all the information they need—such as financial and performance data—on a single screen.

Table 6.6 Sources: Danny Gavin, "Customer Service Lessons Learned in the Wake of Hurricane Harvey," Forbes, September 26, 2017; Jay Steinfeld, "5 Lessons Learned from Hurricane Harvey," Inc., September 21, 2017; Susan Burns and David Hackett, "Business Lessons from Hurricane Irma," 941CEO, November-December 2017; "New Lessons to Learn," Fortune, October 3, 2005, pp. 87–88; AZQuotes, Accessed February 25, 2018, http://www.azquotes.com/quote/863856.

Lessons Leaders Learned about Managing Crises	
Howard Schultz Chairman, Starbucks	Learn from one crisis at a time. After the Seattle earthquake of 2001, the company invested in a notification system that could handle text messaging. The night before Hurricane Katrina hit, Starbucks sent out 2,300 phone calls to associates in the region, telling them about available resources.
Gary Loveman CEO, Harrah's	Make life easier for your employees. Before the storm hit, management announced that in the event of total entertainment disaster, employees would be paid for at least 90 days. The decision was meant to provide employees with some certainty during a very uncertain time.
J. W. Marriott CEO, Marriott	Communicate for safety. Marriott moved its email system out of New Orleans before Katrina hit. As a result, employees were able to communicate with each other and vendors to get food and water to affected areas. A massive publicity campaign (Dial 1-800-Marriott) helped the company find 2,500 of its 2,800 people in the region.
Geno Auriemma University of Connecticut Basketball Coach	It's about doing it in a way that it can't be done any better. That is the goal every day.
Danny Gavin VP, Brian Gavin Diamonds	"Create an unforgettable customer experience" may sound like a cliché, but this is our golden rule. Despite waist-high water and treacherous conditions, we had several international orders that needed to be shipped the Wednesday after Hurricane Harvey hit. FedEx and UPS had ceased operations around the Houston area during the storm, but our CEO Brian Gavin was determined to deliver an outstanding customer service experience. That's why he drove with the packages in hand to the nearest FedEx store that was open: College Station. The standard three-hour round trip ended up taking five hours.
Bob Nardelli CEO, Home Depot	Prepare for the next big one. After each catastrophic event, Home Depot does a postmortem on its response efforts so that employees and managers can become more experienced and better prepared. Before Katrina hit, the company prestaged extra supplies and generators, sent 1,000 relief associates to work in the stores in the Gulf Region, and made sure that area stores were overstocked with first-response items such as insecticides, water, and home generators.
Scott Ford CEO, Alltel	Take care of everybody. When Katrina hit, Alltel was missing 35 employees. When the company had found all but one, managers used the company's network infrastructure to track her phone activity, contact the last person she had called, and work with the army to find her.
Paul Pressler CEO, Gap	Empower the workforce. Gap had 1,300 employees affected by Katrina, and one of the biggest problems the company faced was getting people their paychecks. The company, which had extended payroll by 30 days to affected employees, now encourages all employees to use direct deposit as a means to ensure access to their pay.
Jim Skinner CEO, McDonald's	Be flexible with company assets. McDonald's had 280 restaurants close in the immediate aftermath of the storm, but shortly afterward, 201 were already open. During the crisis, McDonald's converted its human resource service center into a crisis command center. The quickly formed help center fielded 3,800 calls.
Robert Baugh COO, Chiles Restaurants	With Hurricane Irma approaching, Baugh communicated with staff for several days before the storm to prepare and to find out which employees would be evacuating, which would be staying, and which had special needs. The Chiles Group used Hot Schedules, a platform all employees log into, to create a timeline to secure all three restaurants (since these restaurants have lots of outdoor seating and outdoor bars, it was a huge chore) and to broadcast when the restaurants would reopen. Team leaders were responsible for communicating with their members. Vendors and chefs were told earlier in the week to reduce food orders to minimize loss. Freezers and refrigerators were packed with hundreds of bags of ice.

Such integrated functionality made dashboards extremely popular. A Gartner commentary suggests that companies put data and

analytics at the heart of every company business decision.[23] Despite the increasing popularity of dashboard technology, the control tool has some drawbacks, such as focusing too intently on short-term results and ignoring the overall progress toward long-term goals. And some employees might bristle at being monitored as closely as dashboard tools allow.

Nonetheless, companies are seeing real results from implementing dashboard software. Robert Romanoff, a partner at the law firm of Levenfeld Romanoff in Chicago, uses dashboards that aggregate data from clients, strategic partners, and internal staff from the mailroom to the boardroom to improve what he calls the 3 *P*s. The 3 *P*s are process efficiency, project management, and strategic pricing.[24]



Exhibit 6.9: Marketing and sales professionals are increasingly turning to advanced software programs called “dashboards” to monitor business and evaluate performance. These computer tools use analytics and big data to help managers identify valuable customers, track sales, and align plans with company objectives—all in real time. A typical dashboard might include sales and bookings forecasts, monthly close data, customer satisfaction data, and employee training schedules. This example tracks customers attending the Consumer Electronics Show so that the buzz created by influencers can be measured. *How does information technology affect managerial decision-making?* (Credit: Intel Free Press/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Managing Multinational Cultures

The increasing globalization of the world market has created a need for managers who have **global management skills**, that is, the ability to operate in diverse cultural environments. With more and more companies choosing to do business in multiple locations around the world, employees are often required to learn the geography, language, and social customs of other cultures. It is expensive to train employees for foreign assignments and pay their relocation costs; therefore, choosing the right person for the job is especially important. Individuals who are open minded, flexible, willing to try new things, and comfortable in a multicultural setting are good candidates for international management positions.

As companies expand around the globe, managers will continue to face the challenges of directing the behavior of employees around the world. They must recognize that because of cultural differences, people respond to similar situations in very different ways. The burden, therefore, falls on the manager to produce results while adapting to the differences among the employees he or she manages.

How a manager gets results, wins respect, and leads employees varies greatly among countries, cultures, and individuals. For example, different cultures have different approaches to time. American, German, and Swiss cultures, among others, take a linear view of time, whereas southern European counties such as Italy take a multi-active time approach, and many Eastern cultures, such as China, take a cyclic approach. An American manager with a linear view of time will approach scheduling planning with a different approach than colleagues with a multi-active or cyclic approach.[25] Despite differences such as these (examples of which can be cited for every country in the world), managing within a different culture is only an extension of what managers do every day: working with differences in employees, processes, and projects.

CONCEPT CHECK

1. How can information technology aid in decision-making?
2. What are three principles of managing multinational cultures?
3. Describe several guidelines for crisis management.

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9: HUMAN RESOURCES

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9.4: Employee Selection

9.5: Employee Training and Development

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9.7: Employee Compensation and Benefits

9.8: Managing Grievances and Conflicts

9.9: Legal Environment of Human Resources and Labor Relations

9.10: Trends in Human Resource Management and Labor Relations

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9.1: Introduction



Exhibit 8.1: (Credit: Ludovic Bertron /flickr / Attribution 2.0 Generic (CC BY 2.0))

EXPLORING BUSINESS CAREERS

Andrea Herran, Human Resources Consultant

In college, Andrea Herran studied business administration and minored in psychology. Always interested in a business career, she initially took psychology simply because it was interesting. Little did she know how applicable that minor would become. As a human resources (HR) consultant, she often benefits from her psychology background. “Studying human behavior really gave me the background necessary to put myself in the position of others, to see things from their point of view, which has definitely been helpful in my career in human resources.”

Herran started out as an administrative assistant in the HR department of a hotel, and her career has run the gamut of human resources over the 25 years since she graduated from college. She has been an employment coordinator, focusing on employee recruitment and selection, and a personnel manager, where she learned the skills necessary to maintain and evaluate employees. As a training manager, she sharpened her talent for developing, coordinating, and even administering staff training. Eventually, she became the director of human resources for companies both in the United States and abroad. Indeed, beyond the United States, she has worked in Mexico, Argentina, and South Africa.

Andrea worked her way up in the corporate world, but entrepreneurship was more consistent with her desire for a fast-paced, changing environment, both in terms of what she does and who she works with, so she made the move to consulting. “Consulting allows me to draw upon all my human resources skills. I have opened five HR departments in my career, so I bring my full experience to bear on the challenges each company has.”

Today, Andrea’s passion is working with small businesses, entrepreneurs, managers, and owners as an advisor to “uncomplicate the people side of your business.” As the principal of Focus HR Consulting, she advises firms how to set up human resource programs and ensure legal compliance. She also provides leadership coaching and training and mentors employees. She has worked in several industries, including hospitality (hotels and restaurants), advertising, professional services, logistics, technology, and manufacturing.

When Andrea was hired by Aquion Water Treatment Products, she was tasked with updating the company’s HR policies and procedures. The company’s performance reviews were very task-oriented versus behavior-oriented. Instead of determining whether a task was completed, behavior-oriented reviews seek to evaluate not only whether the person completed the task but also how he or she did so, especially examining the interactions involved in the task. Is an employee punctual at returning

consumer request calls? How does he or she relate to customers? As a manager, does he or she express thoughts clearly? “By evaluating specific behaviors, you create an environment with clearly set qualifications for advancement and opportunities for targeted employee development. Without this, the *human* aspect of human resources can be overlooked.”

Andrea has never looked back on her choice to become an entrepreneur, and she believes her varied employment history was a key to her success. “Anyone interested in this field should experience as many possibilities within human resources as possible. You leave school with the theory, but only through experience do you really get to see what the potential of such a career is.”

Sources: “About Us,” http://focushr.biz, accessed February 8, 2018; “Member Spotlight: Andrea Herran,” http://www.centerforguiltfreesuccess.com, accessed February 8, 2018; Insureon blog, “5 HR Pros Reveal the Secret to Hiring the Right Employees the First Time,” http://www.insureon.com, June 3, 2016.

This chapter looks at the role of human resources within an organization, from the general processes of developing and planning to the more specific tasks of employee evaluation and compensation.

Human resource management and labor relations involve acquisition, development, use, and maintenance of a human resource mix (people and positions) to achieve strategic organizational goals and objectives. Successful human resource management is based on a company’s ability to attract and hire the best employees, equip them with the knowledge and skills they need to excel, compensate them fairly, and motivate them to reach their full potential and perform at high levels. Today’s business environment presents numerous challenges to effectively managing employees:

- Technology continues to advance, which places great importance on knowledge workers, especially when demand outstrips the supply of high-talent individuals.
- Global business operations involve rapid data transfer and necessitate accelerated decision-making by executive and technical employees.
- The workforce is increasingly more diversified and multicultural, which places increased emphasis on communication and cultural understanding.
- Work, life, and family priorities are more difficult to balance as dual-worker families populate the labor force.
- Employment and labor laws continue to greatly influence employee recruitment and hiring, compensation decisions, and employee retention and turnover in both union and nonunion organizations.

Each day, human resource experts and front-line supervisors deal with these challenges while sharing responsibility for attracting and retaining skilled, motivated employees. Whether faced with a large or small human resources problem, supervisors need some understanding of difficult employee-relations issues, especially if there are legal implications.

In this chapter, you will learn about the elements of the human resource management process, including human resource planning and job analysis and design, employee recruitment and selection, training and development of employees, performance planning and evaluation, and compensation of the workforce. The chapter also describes labor unions and their representation of millions of American workers in construction, manufacturing, transportation, and service-based industries.

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9.2: Achieving High Performance through Human Resources Management

What is the human resource management process, and how are human resource needs determined?

Human resource (HR) management is the process of hiring, developing, motivating, and evaluating employees to achieve organizational goals. The goals and strategies of the firm's business model form the basis for making human resource management decisions. HR practices and systems comprise the firm's human resource decision support system that is intended to make employees a key element for gaining competitive advantage. To this end, the HR management process contains the following sequenced activities:

- Job analysis and design
- Human resource planning and forecasting
- Employee recruitment
- Employee selection
- Training and development
- Performance planning and evaluation
- Compensation and benefits

The human resource management process shown in **Exhibit 8.3** encourages the development of high-performance employees. The process is sequential because employees can't be trained and paid until selected and placed in jobs, which follows recruitment, which is preceded by human resource planning and job analysis and design. Good HR practices used along this sequence foster performance improvement, knowledge and skill development, and loyal employees who desire to remain with the organization.

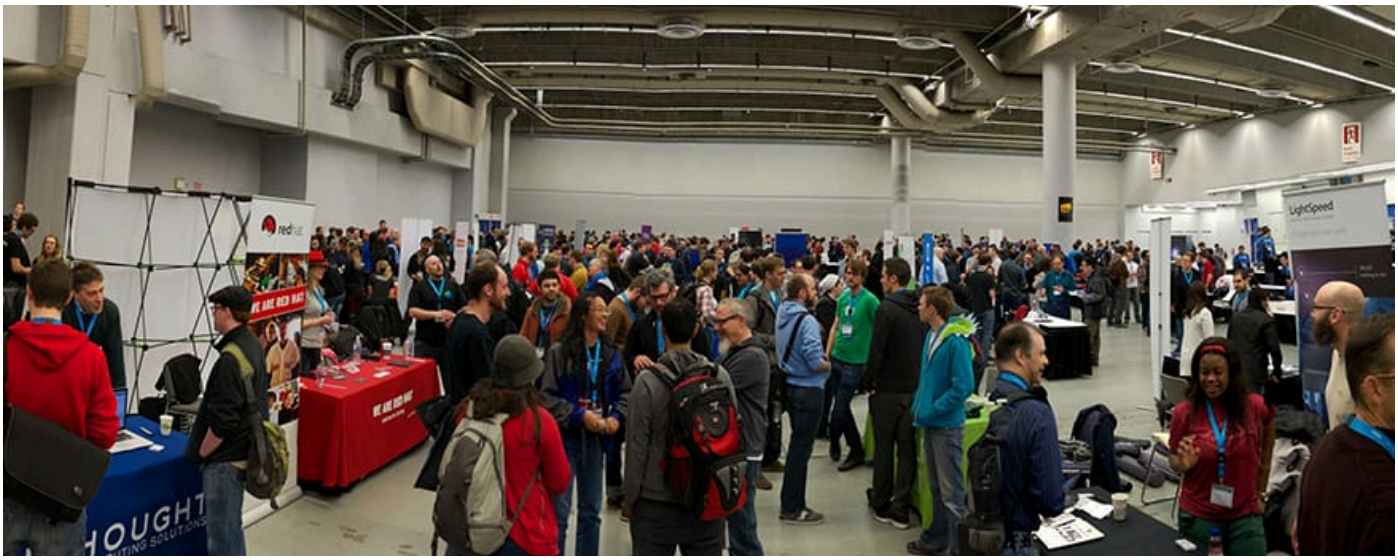


Exhibit 8.2: A job fair, career fair or career expo, are events in which employers, recruiters, and schools give information to potential employees and job seekers attend hoping to make a good impression to potential employers. They also interact with potential coworkers by speaking face-to-face, exchanging résumés, and asking questions in attempt to get a good feel on the work needed. Likewise, online job fairs are held, giving job seekers another way to get in contact with probable employers using the internet. *How do you plan on using events like this in seeking your job? How can utilize the courses that you are taking to illustrate your skills that you can discuss at job fairs*. (Credit: Taavi Burns/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

HR Planning and Job Analysis and Design

Two important, and somewhat parallel, aspects of the human resource management process are determining employee needs of the firm and the jobs to be filled. When Alcon Labs gained approval from the Food and Drug Administration for sales of a new contact lens disinfectant solution in its Opti-Free product line, it had to determine if additional sales representatives were needed and whether new sales positions with different knowledge and skill requirements should be established.[1] **Human resource planning** at Alcon means having the right number of people, with the right training, in the right jobs, to meet its sales goals for the new product. Once the need for sales representatives is determined, human resource specialists assess the skills of the firm's existing employees to see whether new people must be hired or current people can be trained. See **Exhibit 8.3** for a representation of the human resource management process.

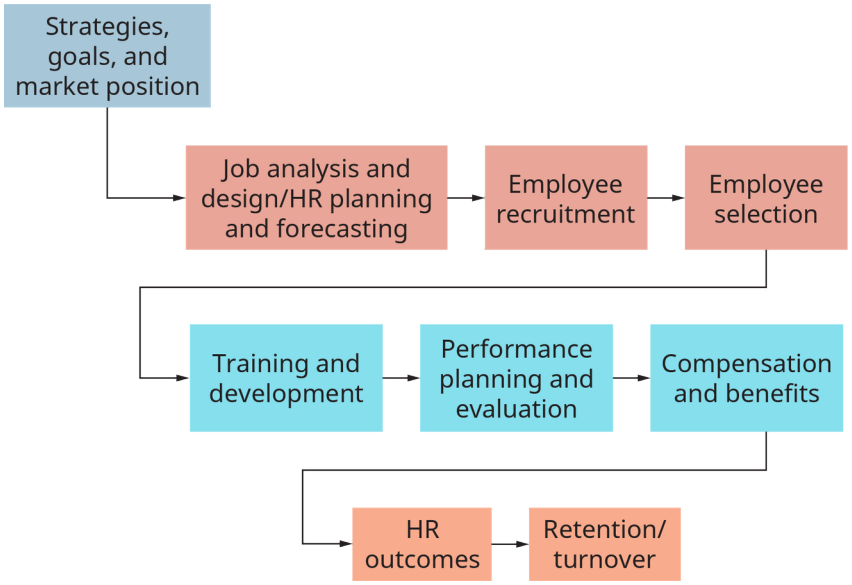


Exhibit 8.3: Human Resource Management Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Human resource planners must know what skills different jobs require. Information about a specific job typically begins with a **job analysis**, which is a study of the tasks required to do a job well. This information is used to specify the essential skills, knowledge, and abilities required for the job. When Hubert Joly started as the CEO at Best Buy, the retailer was facing serious financial pressures. The threat of online competition from Amazon was real. Joly was also facing a staffing issue with a lot of turnover. He and his team instituted a plan to keep and promote staff as a core competency that would differentiate Best Buy from online retailers.[2] Also, a key HR responsibility is that jobs are examined to make any changes in job duty and task responsibilities. The tasks and responsibilities of a job are listed in a **job description**. The skills, knowledge, and abilities a person must have to fill a job are spelled out in a **job specification**. These two documents help human resource planners find the right people for specific jobs. A sample job description and specification is shown in **Table 8.1**.

HR Planning and Forecasting

Forecasting an organization's human resource needs, known as an HR *demand forecast,* is an essential aspect of HR planning. This process involves two forecasts: (1) determining the number of people needed by some future time (in one year, for example) and (2) estimating the number of people currently employed by the organization who will be available to fill various jobs at some future time; this is an *internal supply forecast*.

Table 8.1: Job Description and Specification

Position: College Recruiter Reports to: Vice President of Human	**Location: Corporate Offices Resources Classification: Salaried/Exempt**
Job Summary:	

Position: College Recruiter Reports to: Vice President of Human	Location: Corporate Offices Resources Classification: Salaried/Exempt
Member of HR corporate team. Interacts with managers and department heads to determine hiring needs for college graduates. Visits 20 to 30 college and university campuses each year to conduct preliminary interviews of graduating students in all academic disciplines. Following initial interviews, works with corporate staffing specialists to determine persons who will be interviewed a second time. Makes recommendations to hiring managers concerning best-qualified applicants.	
Job Duties and Responsibilities:	
Estimated time spent and importance:	
15%	Working with managers and department heads, determines college recruiting needs.
10%	Determines colleges and universities with degree programs appropriate to hiring needs to be visited.
15%	Performs college relations activities with numerous colleges and universities.
25%	Visits campuses to conduct interviews of graduating seniors.
15%	Develops applicant files and performs initial applicant evaluations.
10%	Assists staffing specialists and line managers in determining who to schedule for second interviews.
5%	Prepares annual college recruiting report containing information and data about campuses, number interviewed, number hired, and related information.
5%	Participates in tracking college graduates who are hired to aid in determining campuses that provide the most outstanding employees.
Job Specification (Qualifications):	
Bachelor's degree in human resource management or a related field. Minimum of two years of work experience in HR or department that annually hires college graduates. Ability to perform in a team environment, especially with line managers and department heads. Very effective oral and written communication skills. Reasonably proficient in Excel, Word, and Windows computer environment and familiar with PeopleSoft software.	

The Advancement Planning process at Best Buy involved reducing the turnover that occurs in most retail environments. The company has achieved a second-place ranking, behind only Costco, and its general managers' tenure at a store averages five years. The performance of managers at Best Buy is reviewed to identify people who can fill vacancies and be promoted, a process known as **succession planning**.[3] If Best Buy has a temporary shortage of sales professionals, at the holiday shopping season, for example, they can hire an experienced contractor or interim executive as a temporary or **contingent worker**, someone who wants to work but not on a permanent, continuous basis. **Exhibit 8.4** summarizes the process of planning and forecasting an organization's personnel needs.

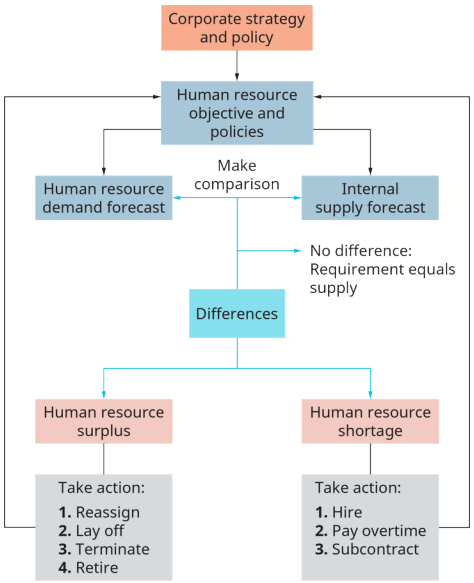


Exhibit 8.4: **Human Resource Planning Process** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

CONCEPT CHECK

1. Define human resource management.
2. Distinguish between job analysis, job description, and the job specification.
3. Describe the human resource management process.

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9.3: Employee Recruitment

How do firms recruit applicants?

When a firm creates a new position or an existing one becomes vacant, the firm starts looking for people with qualifications that meet the requirements of the job. Two sources of job applicants are the internal and external labor markets. The internal labor market consists of employees currently employed by the firm; the external labor market is the pool of potential applicants outside the firm.

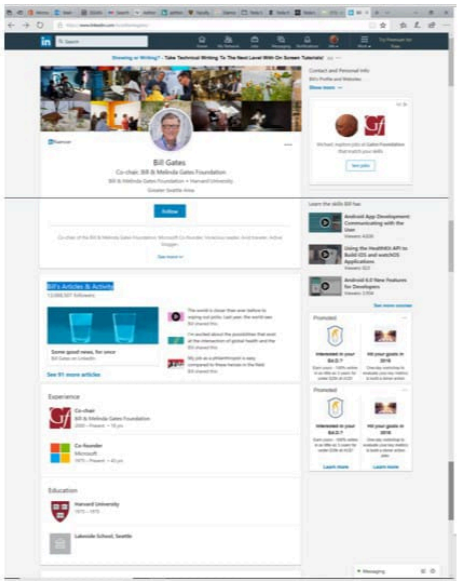


Exhibit 8.5: Online recruiting is among the top internet success stories of the past decade. LinkedIn, Monster, and CareerBuilder are hot spots for job hunters and recruiters seeking to establish a working relationship. *What are the advantages and disadvantages of online recruiting compared to traditional forms of recruitment?* (Credit: Bill Gates LinkedIn Profile screen capture, 3/23/2018)

Internal Labor Market

Internal recruitment can be greatly facilitated by using a human resource information system that contains an employee database with information about each employee's previous work experience, skills, education and certifications, job and career preferences, performance, and attendance. Promotions and job transfers are the most common results of internal recruiting. BNSF Railway, Walmart, Boeing, Ritz-Carlton Hotels, and most other firms, large and small, promote from within and manage the upward mobility of their employees.

External Labor Market

The external labor market consists of prospects to fill positions that cannot be filled from within the organization. **Recruitment** is the process of attracting qualified people to form an applicant pool. Numerous methods are used to attract applicants, including print, radio, web, and television advertising. Hospitality and entertainment firms, such as Ritz-Carlton Hotels and Six Flags, frequently use job fairs to attract applicants. A **job fair**, or *corporate open house*, is usually a one- or two-day event at which applicants are briefed about job opportunities, given tours, and encouraged to apply for jobs. For firms needing accountants, engineers, sales managers, and others for professional and scientific positions, college recruiting is very common. These firms (Deloitte, Cisco Systems, Salesforce.com, and thousands of others) schedule job fairs and on-campus interviews with graduating seniors.

Online Recruiting and Job Search

The internet, social media, and specialized software have completely changed the employee recruitment process. Dozens of companies such as Monster.com, Indeed, StartWire, and Glassdoor enable applicants to search for job openings, post their résumés, and apply for jobs that companies have posted. Most companies provide links to their company website and to the career page on their site so applicants can learn about the company culture, listen to or read testimonials from employees about what it is like to work for the company, and search for additional openings that may interest them.

Large firms may receive thousands of online applications per month. To review and evaluate thousands of online résumés and job applications, firms depend on software to scan and track applicant materials using key words to match skills or other requirements for a particular job. Social media has also changed how companies search for applicants and verify applicant information.

MANAGING CHANGE

Social Networking and Employee Recruitment

Referrals and professional networking are commonly used methods of identifying job prospects, particularity for managerial, professional, and technical positions. Several software applications and social networks facilitate employee referrals, reference checking, and hiring based on networks of personal relationships. ExecuNet and ExecRank are just two of the many career sites that allow members to search for contacts and network with other professionals in their fields.

LinkedIn is the most popular social network for professionals. It is a giant database of contacts with profiles that provide an overview of a person's past and present professional experience, skills, professional referrals, and affiliations with business and professional associations. A member can search through an extended network of contacts based on his or her professional acquaintances. The basis for a search can be job, job title, company, geography, zip code, or membership in a professional organization. LinkedIn uses the concept that there are no more than six degrees of separation between two people, or one person can be linked to any other individual through no more than six other people. With more than 530 million members worldwide, LinkedIn's extensive platform is an ideal network for both recruiters and those looking to make their next career move.

LinkedIn, like other social networks, is based on voluntary participation, and members consent to being networked. Nevertheless, important questions can be raised regarding privacy concerns and use of one's social network.

Critical Thinking Questions

1. Social networks can easily generate a name for an HR recruiting target, but how can the hiring firm convert the target into a candidate who is interested in the job?
2. A social network like LinkedIn is an excellent tool that can be used to build a personal brand and find a new job. In what ways could a job seeker potentially *harm* their career opportunities on a social networking site?

Sources: "About ExecuNet," https://www.execunet.com, accessed February 8, 2018; "LinkedIn Statistics," https://expandedramblings.com, accessed February 8, 2018; "Social Recruiting Tips," https://www.betterteam.com, January 24, 2018; Susan M. Heathfield, "Use LinkedIn for Recruiting Employees," *The Balance,*https://www.thebalance.com, April 7, 2017.

Recruitment Branding

Recruitment branding involves presenting an accurate and positive image of the firm to those being recruited. Carbone Smolan Agency (CSA) is a New York–based image consulting firm that assists in developing a recruitment branding strategy.[4] The materials developed by CSA comprise a *realistic job preview*, which informs job candidates about organizational realities of the job and the firm so they can more accurately evaluate jobs and firm expectations concerning work assignments, performance standards, promotional opportunities, company culture, and many other characteristics of the job.

CONCEPT CHECK

1. What are the two sources of job applicants?
2. What are some methods firms use to recruit applicants?

3. What is meant by recruitment branding?

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9.4: Employee Selection

How do firms select qualified applicants?

After a firm has attracted enough job applicants, employment specialists begin the selection process. **Selection** is the process of determining which people in the applicant pool possess the qualifications necessary to be successful on the job. The steps in the employee selection process are shown in **Exhibit 8.6**. An applicant who can jump over each step, or hurdle, will very likely receive a job offer; thus, this is known as the successive hurdles approach to applicant screening. Alternatively, an applicant can be rejected at any step or hurdle. Selection steps or hurdles are described below:

1. *Initial screening*. During initial screening, an applicant completes an application form and/or submits a résumé, and has a brief interview of 30 minutes or less. The job application includes information about educational background, previous work experience, and job duties performed.
2. HR Senior Vice President Martha LaCroix of the Yankee Candle Company uses personality assessments to make sure that prospective employees will fit the firm's culture. LaCroix was helped by Predictive Index (PI) Worldwide in determining Yankee Candle's best- and worst-performing store managers for developing a best practice behavioral profile of a top-performing store manager.[6] The profile was used for personality testing and to develop interview questions that reveal how an applicant may behave in certain work situations.

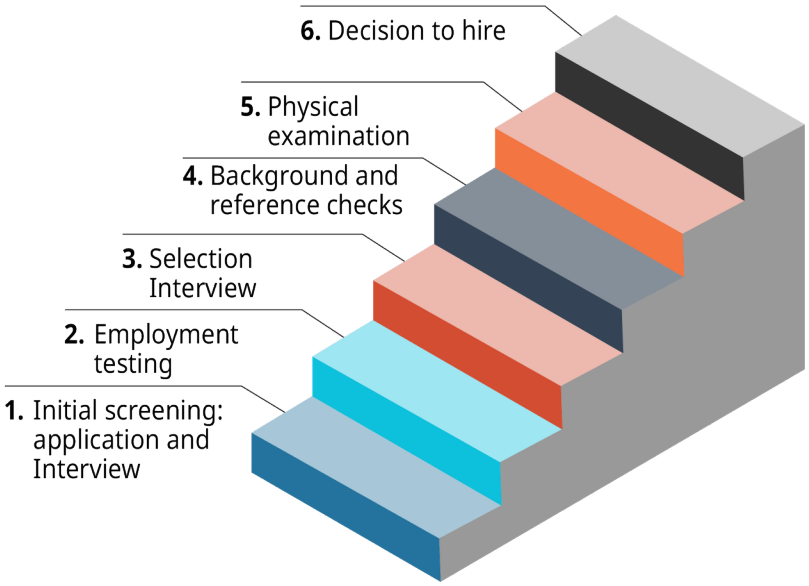


Exhibit 8.6 Steps of the Employee Selection Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

3. *Selection interview.* The tool most widely used in making hiring decisions is the **selection interview**, an in-depth discussion of an applicant's work experience, skills and abilities, education, and career interests. For managerial and professional positions, an applicant may be interviewed by several persons, including the line manager for the position to be filled. This interview is designed to determine a person's communication skills and motivation. During the interview, the applicant may be presented with realistic job situations, such as dealing with a disgruntled customer, and asked to describe how he or she would handle the problem. Carolyn Murray of W.L. Gore & Associates (maker of Gore-Tex, among other products) listens for casual remarks that may reveal the reality behind applicant answers to her questions. Using a baseball analogy, Murray gives examples of how three job candidates struck out with her questions. See **Table 8.2**.[7]

Table 8.2: Striking Out at the Interview Game

The Pitch (Question to Applicant)	The Swing (Applicant's Response)	The Miss (Interviewer's Reaction to Response)
"Give me an example of a time when you had a conflict with a team member."	"Our leader asked me to handle all of the FedExing for our team. I did it, but I thought that FedExing was a waste of my time."	"At Gore, we work from a team concept. Her answer shows that she won't exactly jump when one of her teammates needs help."
"Tell me how you solved a problem that was impeding your project."	"One of the engineers on my team wasn't pulling his weight, and we were closing in on a deadline. So I took on some of his work."	"The candidate may have resolved the issue for this particular deadline, but he did nothing to prevent the problem from happening again."
"What's the one thing that you would change about your current position?"	"My job as a salesman has become boring. Now I want the responsibility of managing people."	"He's probably not maximizing his current territory, and he is complaining. Will he find his next role 'boring' and complain about that role, too?"

4. *Background and reference check*. If applicants pass the selection interview, most firms examine their background and check their references. In recent years, an increasing number of employers, such as American Airlines, Disney, and Microsoft, are carefully researching applicants' backgrounds, particularly their legal history, reasons for leaving previous jobs, and even creditworthiness.
5. *Physical exams and drug testing*. A firm may require an applicant to have a medical checkup to ensure he or she is physically able to perform job tasks. Drug testing is common in the transportation and health care industries. Southwest Airlines, BNSF Railway, Texas Health Resources, and the U.S. Postal Service use drug testing for reasons of workplace safety, productivity, and employee health.
6. *Decision to hire*. If an applicant progresses satisfactorily through all the selection steps (or jumps all of the selection hurdles), a decision to hire the person is made; however, the job offer may be contingent on passing a physical exam and/or drug test. The decision to hire is nearly always made by the manager of the new employee.

An important aspect of employee recruitment and selection involves treating job applicants as valued customers; in fact, some applicants may be customers of the firm.

CUSTOMER SATISFACTION AND QUALITY

Puttin' on the Ritz—For Potential Employees

Your meeting with a human resource representative is often your first exposure to the company you are applying to work for, and firms must provide good customer service to applicants if they expect to hire the most qualified employees.

Companies have several opportunities to create a positive impression of their organization during these key points in the employee selection process. These include a variety of communication channels, such as:

- In-person greetings at a job fair or at the interview itself
- Phone calls to a prospective employee from a human resource professional to set up the interview and any follow-up conversations between human resources and the applicant
- E-mail correspondence to acknowledge receipt of an application and to thank applicants for submitting their job application
- A thank-you note from the employer following the second interview

A firm that is recognized for treating prospective employees especially well is Ritz-Carlton Hotels, a subsidiary of Marriott International. When the Washington D.C. Ritz-Carlton was recruiting employees to staff a new hotel, the goal was to provide applicants with a personal demonstration of the famous Ritz-Carlton service-oriented culture.

As applicants arrived, they experienced the Ritz-Carlton "warm welcome" from several employees who greeted them, wished them luck, and escorted them past a violinist and piano player to the waiting room, where beverages and snacks were available. Applicants went through a standardized screening questionnaire, and those who passed went on to a professionally developed structured interview. Individuals were then personally escorted to the "fond farewell," where they were thanked, given Ritz-Carlton chocolates, and escorted out of the hotel. The goal of Ritz-Carlton managers is to give applicants the same experience they would

expect to receive as a customer staying in the hotel. Every applicant receives a personal, formal thank-you note for coming to the job fair, and those who are considered for positions but later rejected receive another note. Ritz-Carlton wants to make a good impression because an applicant could be a future Ritz-Carlton hotel guest, or the son or daughter of a guest.

Ritz-Carlton continues to show exemplary service during the employee orientation process. Every employee must go through seven days of training before ever working in a Ritz-Carlton. Two full days of the orientation are indoctrination in the Ritz-Carlton values and philosophy. The goal is to create a significant emotional experience for new employees during their first few days. This happens the moment new employees arrive for training at 6:00 a.m. and see senior leaders lined up outside the doors of the hotel, clapping and cheering as they greet them. The message is clear: *You are important and we will treat you exactly as we want you to treat customers.*

The leadership team is involved in facilitating the program, sending a powerful message about the importance of consensual commitment. “For these next few days, we will orient you to who we are—our heart, our soul, our goals, our vision, our dreams—so you can join us, and not just work for us.”

Horst Schultz, former president and COO of the Ritz-Carlton, first implemented the motto “We Are Ladies and Gentlemen Serving Ladies and Gentlemen” in the mid-1980s, and the motto is still at the heart of the company’s values today. In an address to employees, Schultz said, “You are not servants. We are not servants. Our profession is service. We are Ladies and Gentlemen, just as the guests are, who we respect as Ladies and Gentlemen. We are Ladies and Gentlemen and should be respected as such.”

Critical Thinking Questions

1. What are the benefits of an employer treating a job applicant like a customer? Are there costs associated with treating applicants poorly?
2. What is the Ritz-Carlton motto? How does it teach both applicants and employees about the company’s values?

Sources: “Gold Standards,” http://www.ritzcarlton.com, accessed February 8, 2018; “Lifetime Learning Opportunities,” http://www.marriott.com, accessed February 8, 2018; Justin Hoffman, “Secrets of the Ritz-Carlton’s ‘Legendary’ Customer Service,” https://www.psafinancial.com, May 8, 2014; Sandra J. Sucher and Stacy McManus, “The Ritz-Carlton Hotel Company,” Harvard Business School Case #601-163, March 2001; revised September 2005.

CONCEPT CHECK

1. Describe the employee selection process.
2. What are some of the ways that prospective employees are tested?

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9.5: Employee Training and Development

What types of training and development do organizations offer their employees?

To ensure that both new and experienced employees have the knowledge and skills to perform their jobs successfully, organizations invest in training and development activities. **Training and development** involves learning situations in which the employee acquires additional knowledge or skills to increase job performance. Training objectives specify performance improvements, reductions in errors, job knowledge to be gained, and/or other positive organizational results. The process of creating and implementing training and development activities is shown in **Exhibit 8.8**. Training is done either on the job or off the job.



Exhibit 8.7: Here is the final assembly process on an Boeing 787-10 for Singapore Airlines. This plant is one of Boeing's largest and most technologically advanced manufacturing facilities. *How is technology helping companies develop skilled workers both on and off the job?* (Credit: airbus777/Flickr/ Attribution 2.0 Generic (CC BY 2.0))

On-the-Job Training

New-employee training is essential and usually begins with **orientation**, which entails getting the new employee ready to perform on the job. Formal orientation (often a half-day classroom program) provides information about the company history, company values and expectations, policies, and the customers the company serves, as well as an overview of products and services. More important, however, is the specific job orientation by the new employee's supervisor concerning work rules, equipment, and performance expectations. This second briefing tends to be more informal and may last for several days or even weeks.

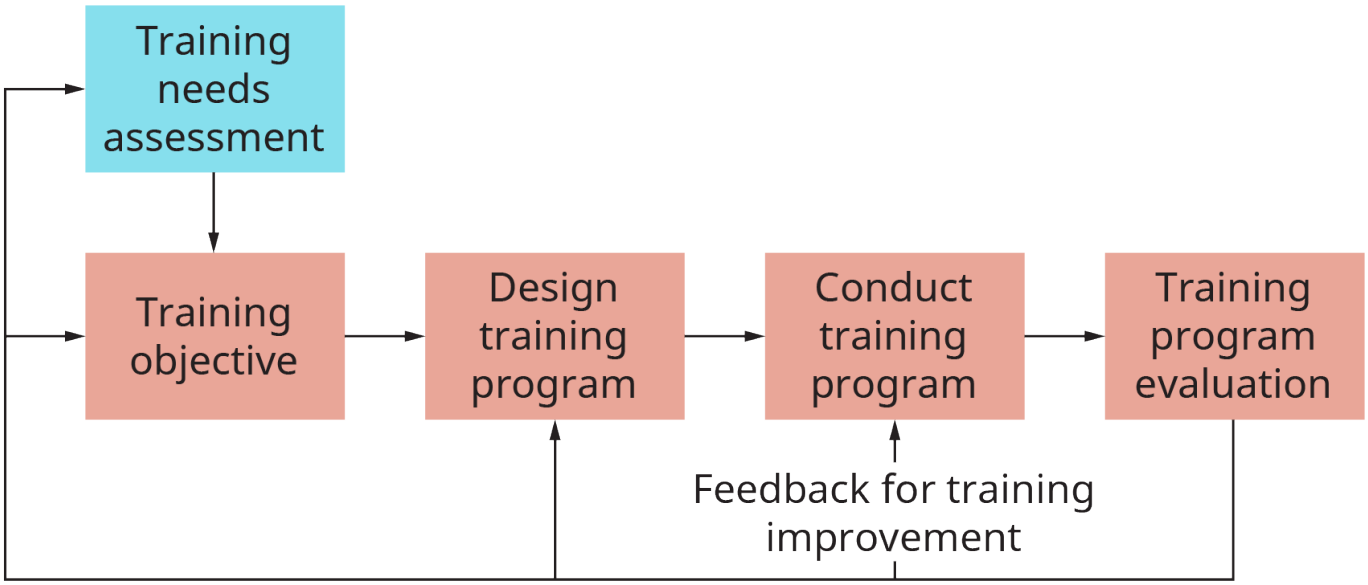


Exhibit 8.8: **Employee Training and Development Process** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Beyond employee orientation, job training takes place at the job site or workstation and is directly related to the job. This training involves specific job instruction, coaching (guidance given to new employees by experienced ones), special project assignments, or job rotation. **Job rotation** is the reassignment of workers to several different jobs over time. At Walmart, management trainees rotate through three or more merchandizing departments, customer service, credit, and even the human resource department during the first year or two on the job.

Two other forms of on-the-job training are apprenticeship and mentoring. An **apprenticeship** usually combines specific on-the-job instruction with classroom training. It may last as long as four years and can be found in the skilled trades of carpentry, plumbing, and electrical work. **Mentoring** involves a senior manager or other experienced employee providing job- and career-related information to a mentee. Inexpensive and providing instantaneous feedback, mentoring is becoming increasingly popular with many firms, including FedEx, Merrill Lynch, Dow Chemical, and Bank of America. Whereas mentoring is typically conducted through ongoing face-to-face interactions between mentor and mentee, technology now allows for a long-distance mentoring relationship. Dow Chemical uses e-mail and video conferencing to facilitate long-distance mentoring between persons who are working in different countries. For a mentee whose second language is English, writing e-mail messages in English helps the individual become fluent in English, which is a requirement of all Dow Chemical employees regardless of location and country of origin.[8]

EXPANDING AROUND THE GLOBE

Employees on the (International) Move

Working abroad at one of the thousands of American or foreign multinational firms can be exciting and look good on your résumé. But is an international job assignment a step up the ladder to a more rewarding career path or a potential minefield of professional and family risk? The answer depends as much on an employee's family situation as his or her ambition, as well as how well the company supports and handles a transfer to an international location.

International job experience is increasingly seen as an essential leadership competency; therefore, many companies have developed robust rotational programs designed to give individuals critical global experience. According to the BGRS 2016 Global Mobility Trends Survey, providing high levels of service to relocating employees and their families is a fundamental expectation.

Brookfield Global Relocation Services (BGRS) is a talent mobility and relocation services firm that manages more than 60,000 relocations in 140 countries each year for its corporate and government clients. With 15 offices around the world, the company's staff (that speaks 40 languages) can tap into their network of 1,900 trusted suppliers to help employees and families acclimate to their new work and home environments.

Increasing numbers of recent college graduates and experienced professionals are offered opportunities for overseas work

assignments ranging from a few days to 24 months or longer. But acclimating to a new country and culture, as well as a new work environment, can be daunting and involves some unique challenges.

Challenges face expatriates aside from the demands of work include:

- Choosing schools for children
- Securing housing
- Finding medical facilities
- Opening bank accounts
- Finding transportation and obtaining a driver's license
- Completing government forms
- Locating food stores
- Learning about community and entertainment offerings

With 189,000 worldwide staff and partners, KPMG International is one of the world's largest professional services and accounting firms, with a presence in 152 countries. Through programs like the KPMG Global Opportunities (GO) program, the professionals at KPMG can explore job rotation assignments, transfer to a new location, or change to a new job function or group. The company's Career Mobility Connection tool allows employees to evaluate opportunities based on their interests and to seek guidance from a transition advisor on potential career opportunities.

KPMG has developed several programs and standards to guide employees and establish consistency, whether they work in the United States or abroad. One of the most important is the KPMG Code of Conduct, which defines the values and standards by which KPMG conducts business and is intended to help guide actions and behaviors of its global workforce.

Every year, all KPMG employees and partners are required to affirm their agreement to comply with the Code of Conduct. In addition, all partners and employees are required to complete mandatory training that reinforces the principles of the Code and further builds understanding of the firm's expectations.

Critical Thinking Questions

1. How is KPMG's Global Code of Conduct intended to influence and guide the personal values and behaviors of its employees and partners?
2. Why must the Code of Conduct be affirmed by employees and partners every year? Why does KPMG include their partners in this program?
3. What are the top four or five job qualifications an employee should have to be considered for an overseas assignment?

Sources: Corrine Purtill, "Expat Couples Do Best When They've Moved for the Woman's Job," *Quartz at Work*, December 6, 2017; https://work.qz.com/1134685/expat-co...he-womans-job/; Donald Murray, "The 7 Greatest Challenges of Moving Overseas and How to Resolve Them," *International Living*, March 15, 2018, internationalliving.com/the-...-resolve-them/; "KPMG's Code of Conduct," Accessed March 15, 2018, home.kpmg.com/us/en/home/abo...f-conduct.html.

Off-the-Job Training

Even with the advantages of on-the-job training, many firms recognize that it is often necessary to train employees away from the workplace. With off-the-job training, employees learn the job away from the job. There are numerous popular methods of off-the-job training. It frequently takes place in a classroom, where cases, role-play exercises, films, videos, lectures, and computer demonstrations are used to develop workplace skills.

Web-based technology is increasingly being used along with more traditional off-the-job training methods. E-learning and e-training involve online computer presentation of information for learning new job tasks. Union Pacific Railroad has tens of thousands of its employees widely dispersed across much of the United States, so it delivers training materials online to save time and travel costs. Technical and safety training at Union Pacific are made available as **programmed instruction**, an online, self-paced, and highly structured training method that presents trainees with concepts and problems using a modular format. Software provided can make sure that employees receive, undergo, and complete, as well as sign off on, various training modules.[9]

Web-based training can also be done using a **simulation**, for example, a scaled-down version of a manufacturing process or even a mock cockpit of a jet airplane. American Airlines uses a training simulator for pilots to practice hazardous flight maneuvers or learn the controls of a new aircraft in a safe, controlled environment with no passengers. The simulator allows for more direct

transfer of learning to the job.

CONCEPT CHECK

1. Describe several types of on-the-job training.
2. What are the advantages of simulation training?
3. How is technology impacting off-the-job training?

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9.6: Performance Planning and Evaluation

How are performance appraisals used to evaluate employee performance?

Along with employee orientation and training, new employees learn about performance expectations through performance planning and evaluation. Managers provide employees with expectations about the job. These are communicated as job objectives, schedules, deadlines, and product and/or service quality requirements. As an employee performs job tasks, the supervisor periodically evaluates the employee's efforts. A **performance appraisal** is a comparison of actual performance with expected performance to determine an employee's contributions to the organization and to make decisions about training, compensation, promotion, and other job changes. The performance planning and appraisal process is shown in **Exhibit 8.9** and described below.

1. The manager establishes performance standards.
2. The employee works to meet the standards and expectations.
3. The employee's supervisor evaluates the employee's work in terms of quality and quantity of output and various characteristics such as job knowledge, initiative, relationships with others, and attendance and punctuality.
4. Following the performance evaluation, reward (pay raise) and job change (promotion) decisions can be made. If work is unsatisfactory, the employee may be put on a performance improvement plan, which outlines the behaviors or performance that must be improved, the milestones and time periods to improve performance, and what will occur if performance is not improved.
5. Rewards are positive feedback and provide reinforcement, or encouragement, for the employee to continue improving their performance.

It was once common practice for performance appraisals to be conducted on an annual basis, but most companies have moved away from that standard. Instead, managers are encouraged to provide employees with continuous real-time feedback so that skill development and job performance can be improved more rapidly.

Information for performance appraisals can be assembled using rating scales, supervisor logs of employee job incidents, and reports of sales and production statistics. Regardless of the source, performance information should be accurate and a record of the employee's job behavior and efforts. **Table 8.3** illustrates a rating scale for one aspect of a college recruiter's job. A rating of "9" is considered outstanding job behavior and performance; a rating of "1" is viewed as very poor to unacceptable.

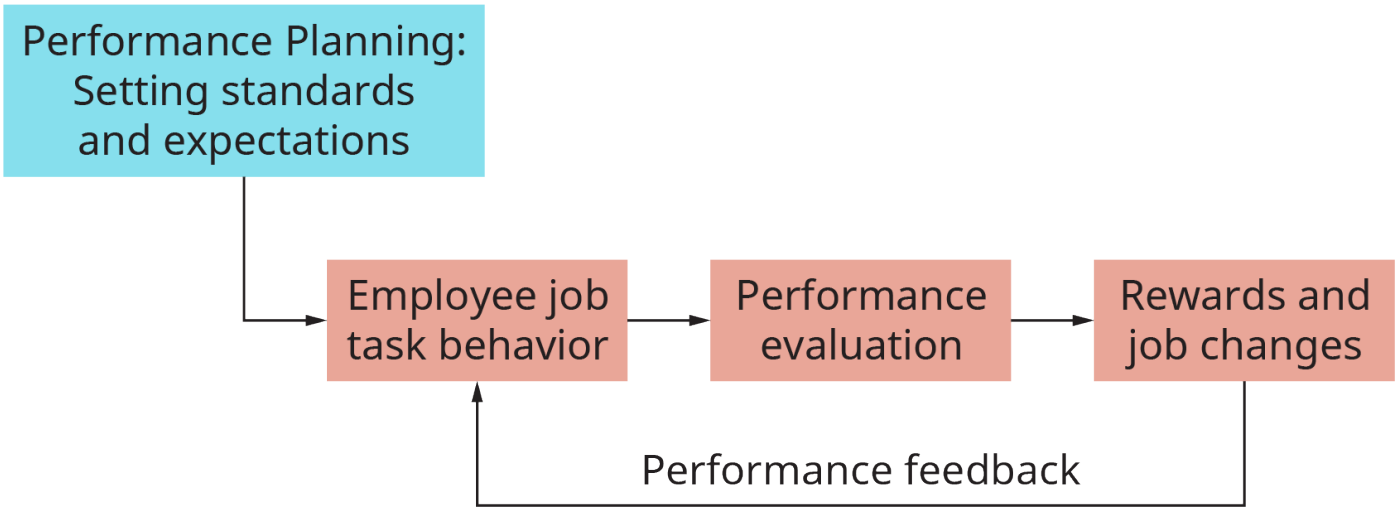


Exhibit 8.9: Performance Planning and Evaluation

Table 8.3:
Example of Behavior-Based Rating Scale for Performance Appraisal

Position: College Recruiter **Job Description: Visits campuses and conducts interviews of graduating seniors** **Explanation of Rating**	**Performance Rating**	**Explanation of Rating**
This recruiter plans and organizes spring-semester college-recruiting schedule to minimize travel expenses and maximize the number of colleges visited and students interviewed.	9	
	8	Even with tight travel schedules between campuses, this recruiter completes each campus report before arrival at next campus.
	7	In making plans to visit a new campus, this recruiter might not have identified two or three faculty
	6	members for obtaining pre-visit information about degree programs.
This recruiter occasionally does not check with college placement office to request student résumés two days before arrival.	5	
	4	Sometimes this recruiter's notes are incomplete concerning a student's response to interview questions.
	3	This recruiter is often several minutes late in starting interviews.
This recruiter is frequently late in sending thank-you letters to students interviewed.	2	
	1	This recruiter is always late completing campus-recruiting reports.

CONCEPT CHECK

1. What are the steps in the performance planning and appraisal process?
2. What purposes do performance appraisals serve?
3. Describe some sources of information for the performance appraisal.

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9.7: Employee Compensation and Benefits

What are the types of compensation and methods for paying workers?

Compensation, which includes both pay and benefits, is closely connected to performance appraisals. Employees who perform better tend to get bigger pay raises. Several factors affect an employee's pay:

1. *Pay structure and internal influences.* Wages, salaries, and benefits are based on skills, experience, and the level of the job. The most important high-level positions, such as president, chief information officer, and chief financial officer, are compensated at the highest rates. Likewise, different jobs of equal importance to the firm are compensated at similar rates. As the level of management responsibility increases, so does pay. For instance, if a drill-press operator and a lathe operator are considered of equal importance, they may both be paid $21 per hour.
2. *Pay level and external influences.* In deciding how much to pay workers, the firm must also be concerned with the salaries paid by competitors. If competitors are paying higher wages, a firm may lose its best employees. HR professionals regularly evaluate salaries by geography, job position, and competitor and market wages. Wage and salary surveys conducted by the U.S. Chamber of Commerce and the U.S. Department of Labor can also be useful. There are also several websites such as Glassdoor that post salaries for jobs by company.

An employer can decide to pay at, above, or below the going rate. Most firms try to offer competitive wages and salaries within a geographic area or an industry. If a company pays below-market wages, it may not be able to hire skilled people. The level of a firm's compensation is determined by the firm's financial condition (or profitability), efficiency, and employee productivity, as well as the going rates paid by competitors. For example, MillerCoors Brewing Co. is considered a high-paying firm ($29–$33 per hour for production employees).[10]

Types of Compensation or Pay

There are two basic types of compensation: direct and indirect. Direct pay is the wage or salary received by the employee; indirect pay consists of various employee benefits and services. Employees are usually paid directly on the basis of the amount of time they work, the amount they produce, the type of work performed, or some combination of skill, time, and output. An hourly rate of pay or a monthly salary is considered base pay, or an amount of pay received by the employee regardless of output level. In many jobs, such as sales and manufacturing, an employee can earn additional pay as a result of a commission or an **incentive pay**arrangement. The accelerated commission schedule for a salesperson shown below indicates that as sales increase the incentive becomes increasingly more attractive and rewarding; therefore, pay can function as a powerful motivator. In this example, a salesperson receives a base monthly salary of $1,000, then earns 3 percent on the first $50,000 of product sold, 4 percent on the next $30,000, and 5 percent on any sales beyond $80,000.

Base pay	$1,000 per month
3% of 50,000	1,500
4% of 30,000	1,200
5% of 20,000	1,000
	$4,700

Two other incentive pay arrangements are bonuses and profit-sharing. Employees may be paid bonuses for reaching certain monthly or annual performance goals or achieving a specific cost-saving objective. In this instance, employees are rewarded based on achieving certain goals.

In a profit-sharing plan, employees may receive some portion of the firm's profit. Employee profit shares are usually based on annual company financial performance and therefore are paid once a year. With either a bonus or a profit share, an important incentive pay consideration is whether the bonus or profit share is the same for all employees or whether it is differentiated by level in the organization, base pay, or some other criterion. Choice Homes, a large-scale builder of starter homes, pays an annual incentive share that is the same for everyone; the president receives the same profit share or bonus as the lowest-paid employee.

Indirect pay includes pensions, health insurance, vacation time, and many others. Some forms of indirect pay are required by law: unemployment compensation, worker's compensation, and Social Security, which are all paid in part by employers. **Unemployment compensation** provides former employees with money for a certain period while they are unemployed. To be eligible, the employee must have worked a minimum number of weeks, be without a job, and be willing to accept a suitable position offered by the state Unemployment Compensation Commission. Some state laws permit payments to strikers. **Worker's compensation** pays employees for lost work time caused by work-related injuries and may also cover rehabilitation after a serious injury. Social Security is mainly a government pension plan, but it also provides disability and survivor benefits and benefits for people undergoing kidney dialysis and transplants. Medicare (health care for seniors) and Medicaid (health care for the poor) are also part of Social Security.

Many employers also offer benefits not required by law. Among these are paid time off (vacations, holidays, sick days, even pay for jury duty), health insurance (including dental and vision), supplemental benefits (disability, life, pet insurance, legal benefits), 401K contributions, pensions and retirement savings accounts, and stock purchase options.

Some firms with numerous benefits allow employees to mix and match benefit items or select items based on individual needs. A younger employee with a family may desire to purchase medical, disability, and life insurance, whereas an older employee may want to put more benefit dollars into a retirement savings plan. Pay and benefits are obviously important elements of human resource management and are frequently studied as aspects of employee job satisfaction. Pay can be perceived as very satisfactory, or it can be a point of job dissatisfaction. In a study of job satisfaction conducted by SAP, direct compensation was the most important element of job satisfaction by employees from various companies.[11] As the cost of health insurance and other benefits has risen sharply over the past few years, benefits have become increasingly important to workers.

CATCHING THE ENTREPRENEURIAL SPIRIT

Starbucks Perks More Than Coffee

At Starbucks, CEO Howard Schultz understood that the single most important aspect of creating an enduring brand is its people. Schultz wanted to set Starbucks apart from other coffee shops and service businesses, and he did this by offering health benefits and stock ownership for people who work part-time. It had never been done before, and it came with a cost.

In addition to employee benefits, funding to build the brand was funneled into operations to create an experience that would enable the brand to endure and be sold profitably for many years to come. So instead of expensive marketing and advertising campaigns, the company focused on experiential marketing.

Scott Bedbury, the president of marketing of Starbucks at the time, explains. "The stores were once four white walls. There was no comfortable furniture or fireplaces or music. So we set out to create an experience in the stores and a level of brand equity that most traditionally marketed brands couldn't touch. That meant constant creative development of products, and the look and feel in the stores. It wasn't cheap. The first year, we spent $100 million building out stores, which is a significant marketing budget for anyone."

But the defining moment for the brand was the stock option and employee benefit plan. This laid the foundation for the company's internal brand, and was Schultz's mission from the very beginning, explains Bedbury. "When Howard took over the company, he was not a rich man and he didn't own a house or even a car. Howard grew up poor in Brooklyn and was influenced strongly by his dad, who never got health benefits from any of his employers. This fueled Howard's drive to create a company that put employees first. He is passionate that when it comes to customers versus employees, employees will always come first."

But it wasn't easy, and it took a lot of courage to present this idea to investors. Bedbury said, "When Howard tried to raise $2.8 million to buy the company from the three founders, he made 220 presentations and he got shut down in all but 12 of them. He was seen as an idealist who was going to put an unnecessary burden on the bottom line by offering benefits to part-time employees who viewed this as a temporary job. But Howard convinced them that turnover would drop, which it did. Store manager attrition was 15 percent, part-time hourly employees was 65 percent, compared to McDonalds and Taco Bell, which were about 200–300 percent a year. That's turning over your work force every four months, and when you do that, your service suffers and there are all kinds of problems. I don't know why more people don't do it. If you give up some equity to employees, they'll reward you for that."

Critical Thinking Questions

1. How can a company like Starbucks sustain its strong employee culture while continuing to grow rapidly?
2. Can a firm give its employees too much in terms of benefits and services? Explain.

Sources: Blog, MarketSmarter, http://www.marketsmarter.com/blog, accessed March 12, 2018; Carmine Gallo, "How Starbucks CEO Howard Schultz Inspired Us to Dream Bigger," *Forbes,* https://www.forbes.com, December 2, 2016; Tanza Loudenback, "The Story Behind the Rise of Starbucks' Howard Shultz, Who Just Gave a Raise to Every US Employee of His $82 Billion Coffee Company," *Business Insider,* http://www.businessinsider.com, July 11, 2016; Monique Reece, *Real-Time Marketing for Business Growth* (Upper Saddle River, NJ: FT Press/Pearson, 2010).

CONCEPT CHECK

1. How does a firm establish a pay scale for its employees?
2. What is the difference between direct and indirect pay?
3. Why are health insurance and benefits so important to employees?

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9.8: Managing Grievances and Conflicts

How are grievances between management and labor resolved, and what tactics are used to force a contract settlement?

In a unionized work environment, employees follow a step-by-step process for handling grievances or disputes between management and labor. Conflicts over contracts, however, are far more challenging to resolve and may result in the union or employer imposing economic pressure, as described in this section.

Grievance Handling and Arbitration

The union's main way of policing the contract is the grievance procedure. A **grievance** is a formal complaint by an employee or the union that management has violated some part of the contract. Under a typical contract, the employee starts by presenting the grievance to the supervisor, either in person or in writing. The typical grievance procedure is illustrated in **Exhibit 8.13**. An example grievance is a situation in which an employee is disciplined with a one-day suspension (and loss of pay) for being late for work several times in one month.



Exhibit 8.12: Ezekiel Elliott is a star running back for the Dallas Cowboys who was suspended by NFL commissioner Roger Goodell for six games in the 2017 season. The controversial NFL running back, with the support of the NFL Players Association (NFLPA), appealed the decision several times and was able to delay the suspension, but eventually lost a highly publicized case in federal court. U.S. District Judge Katherine Polk Failla ruled that the NFL's decision to suspend Elliott did not violate the labor agreement. *What options did Elliott and the NFLPA have after losing this court case?* (Credit: grantlairdjr/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

If the problem isn't solved, the grievance is put in writing. The employee, one or more union officials, the supervisor, and perhaps the plant manager then discuss the grievance. If the matter still can't be resolved, another meeting takes place with higher-level representatives of both parties present. If top management and the local union president can't resolve the grievance, it goes to arbitration.

Arbitration is the process of settling a labor-management dispute by having a third party—a single arbitrator or a panel—make a decision. The decision is final and binding on the union and employer. The arbitrator reviews the grievance at a hearing and then makes the decision, which is presented in a document called the award. In the one-day suspension mentioned above, the arbitrator might rule that the discipline was improperly made because the employee's attendance record for the month was not accurately maintained by the firm.



Exhibit 8.13: **Typical Grievance Procedure** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Tactics for Pressuring a Contract Settlement

Virtually all labor agreements specify peaceful resolution of conflicts, usually through arbitration. However, when a contract expires and a new agreement has not been reached, the union is free to strike or engage in other efforts to exert economic pressure on the employer. A *strike* occurs when employees refuse to work. The United Auto Workers union used a **selective strike strategy**, a strategy of conducting a strike at a critical plant that supplies parts to other plants, against General Motors. The union conducted its strike at a stamping and parts facility in Flint, Michigan, that supplied critical parts to other plants. The 54-day strike caused the company to stop production at many of its assembly plants because parts were not available from the Flint plant. General Motorslost approximately $2.2 billion during that dispute. Likewise, the employer can put pressure on the union through a lockout or by hiring strike replacements if the union has called a strike. For example, in 2018 aluminum producer Alcoa locked out more than 1,000 union workers from its smelter facility in Quebec, Canada, after union members went on strike.[16] **Table 8.5** provides a summary of union and employer pressure strategies for forcing a contract settlement.

Table 8.5: Strategies of Unions and Employers

Union Strategies		Employer Strategies	
Strike:	Employees refuse to work.	**Lockout:**	Employer refuses to let employees enter plant to work.
Boycott:	Employees try to keep customers and others from doing business with employer.	**Strike replacements:**	Employer uses nonunion employees to do jobs of striking union employees.
Picketing:	Employees march near entrance of firm to publicize their view of dispute and discourage customers.	**Mutual-aid pact:**	Employer receives money from other companies in industry to cover some of income lost because of strikes.
Corporate campaign:	Union disrupts stockholder meetings or buys company stock to have more influence over management.	**Shift production:**	Employer moves production to nonunion plant or out of country.

CONCEPT CHECK

1. Describe the grievance procedure.
2. In what ways do arbitrators act like judges?
3. What are some tactics for pressuring for a contract settlement?

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9.9: Legal Environment of Human Resources and Labor Relations

What are the key laws and federal agencies affecting human resource management and labor relations?

Federal laws help ensure that job applicants and employees are treated fairly and not discriminated against. Hiring, training, and job placement must be unbiased. Promotion and compensation decisions must be based on performance. These laws help all Americans who have talent, training, and the desire to get ahead. The key laws that currently impact human resource management and labor relations are listed in **Table 8.6**.

Several laws govern wages, pensions, and unemployment compensation. For instance, the Fair Labor Standards Act sets the federal minimum wage, which is periodically raised by Congress. Many minimum-wage jobs are found in service firms, such as fast-food chains and retail stores. The Pension Reform Act protects the retirement income of employees and retirees. Federal tax laws also affect compensation, including employee profit-sharing and stock purchase plans. When John F. Kennedy signed the Equal Pay Act into law in 1963, the goal was to stop the practice of paying women lower wages for the same job based on their gender. At the time, women with full-time jobs earned between 59 and 64 cents for every dollar their male counterparts earned in the same jobs. Although this law has been in place for several decades, progress has been slow. On April 17, 2012, President Barack Obama proclaimed National Equal Pay Day, noting that women who work full time earn only 77 cents for every dollar their male counterparts make. In 2016, the wage gap changed slightly, with women making 80.5 percent of what men earn.[17]

Table 8.6: Laws Impacting Human Resource Management

Law	Purpose	Agency of Enforcement
Social Security Act (1935)	Provides for retirement income and old-age health care	Social Security Administration
Wagner Act (1935)	Gives workers the right to unionize and prohibits employer unfair labor practices	National Labor Relations Board
Fair Labor Standards Act (1938)	Sets minimum wage, restricts child labor, sets overtime pay	Wage and Hour Division, Department of Labor
Taft-Hartley Act (1947)	Obligates the union to bargain in good faith and prohibits union unfair labor practices	Federal Mediation and Conciliation Service
Equal Pay Act (1963)	Eliminates pay differentials based on gender	Equal Employment Opportunity Commission
Civil Rights Act (1964), Title VII	Prohibits employment discrimination based on race, color, religion, gender, or national origin	Equal Employment Opportunity Commission
Age Discrimination Act (1967)	Prohibits age discrimination against those over 40 years of age	Equal Employment Opportunity Commission
Occupational Safety and Health Act (1970)	Protects worker health and safety, provides for hazard-free workplace	Occupational Safety and Health Administration
Vietnam Veterans' Readjustment Act (1974)	Requires affirmative employment of Vietnam War veterans	Veterans Employment Service, Department of Labor
Employee Retirement Income Security Act (1974)—also called Pension Reform Act	Establishes minimum requirements for private pension plans	Internal Revenue Service, Department of Labor, and Pension Benefit Guaranty Corporation

Law	Purpose	Agency of Enforcement
Pregnancy Discrimination Act (1978)	Treats pregnancy as a disability, prevents employment discrimination based on pregnancy	Equal Employment Opportunity Commission
Immigration Reform and Control Act (1986)	Verifies employment eligibility, prevents employment of illegal aliens	Employment Verification Systems, Immigration and Naturalization Service
Americans with Disabilities Act (1990)	Prohibits employment discrimination based on mental or physical disabilities	Department of Labor
Family and Medical Leave Act (1993)	Requires employers to provide unpaid leave for childbirth, adoption, or illness	Equal Employment Opportunity Commission

Employers must also be aware of changes to laws concerning employee safety, health, and privacy. The Occupational Safety and Health Act (OSH Act) requires employers to provide a workplace free of health and safety hazards. For instance, manufacturers must require their employees working on loading docks to wear steel-toed shoes so their feet won't be injured if materials are dropped. Drug and AIDS testing are also governed by federal laws.

Another employee law that continues to affect the workplace is the Americans with Disabilities Act. To be considered disabled, a person must have a physical or mental impairment that greatly limits one or more major life activities. More than 40 million Americans, 12.6 percent of the population, were disabled in 2015, according to the U.S. Census Bureau.[18] Employers may not discriminate against disabled persons. They must make "reasonable accommodations" so that qualified employees can perform the job, unless doing so would cause "undue hardship" for the business. Altering work schedules, modifying equipment so a wheelchair-bound person can use it, and making buildings accessible by ramps and elevators are considered reasonable. Two companies often praised for their efforts to hire the disabled are McDonald's and DuPont.

The Family and Medical Leave Act went into effect in 1993. The law guarantees continuation of paid health benefits, plus a return to the same or equivalent job, and applies to employers with 50 or more employees. It requires these employers to provide unpaid leave of up to 12 weeks during any 12-month period to workers who have been employed for at least a year and worked at least 1,250 hours during the past year. The reasons for the leave include the birth or adoption of a child; the serious illness of a child, spouse, or parent; or a serious illness that prevents the worker from doing the job.

According to the Bureau of Labor Statistics, only 11 percent of all private industry workers have access to paid family leave. Low-wage earners fare even worse. Only 5 percent of low-wage earners get any paid maternity leave, and nearly half will not take time off because they cannot afford to go without income. The United States continues to be one of only four countries in the world (along with Liberia, Suriname, and Papua New Guinea) that do not guarantee paid parental leave.[19]

The Wagner and Taft-Hartley Acts govern the relationship between an employer and union. Employees have the right to unionize and bargain collectively with the company. The employer must deal with the union fairly, bargain in good faith, and not discriminate against an employee who belongs to the union. The union must also represent all employees covered by a labor agreement fairly and deal with the employer in good faith.

Several federal agencies oversee employment, safety, compensation, and related areas. The **Occupational Safety and Health Administration** (OSHA) sets workplace safety and health standards, provides safety training, and inspects places of work (assembly plants, construction sites, and warehouse facilities, for example) to determine employer compliance with safety regulations.



Exhibit 8.14: For some occupations, danger is part of the job description. Tallies of work-related casualties routinely identify miners, loggers, pilots, commercial fishermen, and steel workers as holding the most deadly jobs. Job fatalities are often linked to the use of heavy or outdated equipment. However, many work-related deaths also happen in common highway accidents or as homicides. Pictured here are miners at the Coal Miner's Memorial and Pennsylvania Welcome Center. *What laws and agencies are designated to improve occupational safety?* (Credit: Mike Steele/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

The Wage and Hour division of the Department of Labor enforces the federal minimum-wage law and overtime provisions of the Fair Labor Standards Act. Employers covered by this law must pay certain employees a premium rate of pay (or time and one-half) for all hours worked beyond 40 in one week.

The **Equal Employment Opportunity Commission** (EEOC) was created by the 1964 Civil Rights Act. It is one of the most influential agencies responsible for enforcing employment laws. The EEOC has three basic functions: processing discrimination complaints, issuing written regulations, and gathering and disseminating information. An employment discrimination complaint can be filed by an individual or a group of employees who work for a company. The group may comprise a **protected class**, such as women, African Americans, or Hispanic Americans. The protected group may pursue a class-action complaint that may eventually become a lawsuit. As a measure to prevent employment discrimination, many employers set up **affirmative action programs** to expand job opportunities for women and minorities

Even with affirmative action and other company efforts to follow the law, each year the EEOC receives tens of thousands of complaints from current or former employees. The monetary benefits that the EEOC wins for employees has grown substantially during the past 10 years. Large monetary settlements often occur when the EEOC files a class-action suit against an employer. For example, the Ford Motor Company settled sexual and racial harassment claims by more than 30 women for more than $10 million at two Chicago-area manufacturing plants in 2017.[20] Also, Sears, Motorola, and AT&T have had to make large back-pay awards and to offer special training to minority employees after the court found they had been discriminated against.

The NLRB was established to enforce the Wagner Act. Its five members are appointed by the president; the agency's main office is in Washington, DC, and regional and field offices are scattered throughout the United States. NLRB field agents investigate charges of employer and union wrongdoing (or unfair labor practices) and supervise elections held to decide union representation. Judges conduct hearings to determine whether employers and unions have violated the law.

The Federal Mediation and Conciliation Service helps unions and employers negotiate labor agreements. Agency specialists, who serve as impartial third parties between the union and company, use two processes: conciliation and mediation, both of which require expert communication and persuasion. In **conciliation**, the specialist assists management and the union with focusing on the issues in dispute and acts as a go-between, or communication channel through which the union and employer send messages to and share information with each other. The specialist takes a stronger role in **mediation** by suggesting compromises to the disputing organizations.

CONCEPT CHECK

1. Discuss the laws that govern wages, pensions, and employee compensation.
2. Describe the Americans with Disabilities Act.
3. How do the Wagner and Taft-Hartley Acts impact labor-management relations?

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9.10: Trends in Human Resource Management and Labor Relations

What trends and issues are affecting human resource management and labor relations?

Some of today's most important trends in human resource management are using employee diversity as a competitive advantage, improving efficiency through outsourcing and technology, and hiring employees who fit the organizational culture. Although overall labor union enrollment continues to decline, a possible surge in membership in service unions is anticipated.

Employee Diversity and Competitive Advantage

American society and its workforce are becoming increasingly more diverse in terms of racial and ethnic status, age, educational background, work experience, and gender. A company with a demographic employee profile that looks like its customers may be in a position to gain a **competitive advantage**, which is a set of unique features of a company and its product or service that are perceived by the target market as superior to those of the competition. Competitive advantage is the factor that causes customers to patronize a firm and not the competition. Many things can be a source of competitive advantage: for Southwest Airlines it is route structure and high asset utilization; for Ritz-Carlton hotels it is very high-quality guest services; for Toyota it is manufacturing efficiency and product durability; and for Starbucks it is location, service, and outstanding coffee products. For these firms, a competitive advantage is also created by their HR practices. Many firms are successful because of employee diversity, which can produce more effective problem-solving, a stronger reputation for hiring women and minorities, greater employee diversity, quicker adaptation to change, and more robust product solutions because a diverse team can generate more options for improvement.[21]

In order for an organization to use employee diversity for competitive advantage, top management must be fully committed to hiring and developing women and minority individuals. An organization that highly values employee diversity is the United States Postal Service (USPS). In 1992 the Postal Service launched a diversity development program to serve as the organization's "social conscience and to increase employees' awareness of and appreciation for ethnic and cultural diversity both in the postal workplace and among customers." Twenty-five years later, 39 percent of postal service employees are minority persons: 21 percent African-American, 8 percent Hispanic, and more than 8.0 percent other minorities. In addition, women make up 40 percent of the organization's workforce.[22]

Outsourcing HR and Technology

The role of the HR professional has changed noticeably over the past 20 years. One significant change has been the use of technology in handling relatively routine HR tasks, such as payroll processing, initial screening of applicants, and benefits enrollments. Large firms such as Nokia and Lockheed Martin purchase specialized software (SAP and Oracle/PeopleSoft) to perform the information-processing aspects of many HR tasks. Other firms, such as Jacobs Engineering Group (a large professional services firm), outsource—or contract out—these tasks to HR service providers such as Aon Hewitt and Workforce Solutions.

HR outsourcing is done when another firm can perform a task better and more efficiently, thus saving costs. Sometimes HR activities are outsourced because HR requirements are extraordinary and too overwhelming to execute in-house in a timely fashion. Frequently, HR activities are outsourced simply because a provider has greater expertise. For example, media conglomerate CBS Corp. recently announced that it hired Fidelity Investments to manage its 401(k) plan, which has more than $4 billion in assets.[23]

Organizational Culture and Hiring for Fit

Regardless of general business and economic conditions, many firms are expanding operations and hiring additional employees.

For many growing firms, corporate culture can be a key aspect of developing employees into a competitive advantage for the firm. Corporate culture refers to the core values and beliefs that support the mission and business model of the firm and guide employee behavior. Companies such as JetBlue, Ritz-Carlton, and Cypress frequently hire for fit with their corporate cultures. This necessitates recruitment and selection of employees who exhibit the values of the firm. Ritz-Carlton and Cypress use carefully crafted applicant questionnaires to screen for values and behaviors that support the corporate culture. JetBlue uses behavioral-based interview questions derived from its corporate values of safety, integrity, caring, fun, and passion. Southwest Airlines has non-HR employees (flight attendants, gate agents, and pilots) and even frequent flyer passengers interview applicants to screen for cultural fit as well as strong customer-service orientation.

In addition to cultural fit, firms are increasingly hiring for technical knowledge and skills fit to the job. Tech companies such as IBM, Amazon, and Microsoft receive thousands of résumés and job applications each year and continue to look for the best and the brightest when it comes to technical knowledge and skills. For example, IBM is now focusing on a skills-based approach rather than a candidate's education level and number of academic degrees. Amazon is all about the customer and looks for employees who continue to be "relentlessly curious." Microsoft continues to raise the talent bar by embracing job applicants who have demonstrated leadership, achieved concrete results, and can prove that they love to learn.[24]

More Service Workers Joining Labor Unions

Organized labor has faced tumultuous times during the last several decades due to declining union membership, loss of factory jobs, dwindling political clout, and the shifting of jobs outside the United States. With union membership now down to a little more than 10 percent of the U.S. workforce, some wonder if labor unions, who organize as a united front against poor working conditions, still have a place in the country. Mary Kay Henry, international president of Service Employees International Union (SEIU), is optimistic that unions are capable of resurgence by organizing the growing number of service workers into labor unions. The SEIU is the fastest-growing union in the nation, having jumped to 2 million members from 1.1 million a decade ago.[25]

Henry's goal is to focus on recruiting the country's millions of low-wage service workers, positions that are primarily filled by the working poor. These workers are disproportionately women, immigrants, and members of minority groups, which have all been traditionally more open to unionization. If these workers are successfully recruited into the SEIU, Henry believes that their wages and benefits would increase in much the same way unions brought factory workers into the middle class in the 1930s.

The SEIU believes that the service industry provides a target of opportunity, with the largest expected employment growth through 2026 in low-paid local services:

Job	Projected Growth[26]
Home health aides	47%
Personal care aides	39%
Food preparation	17%
Janitorial	10%

Many believe that the future of labor lies primarily in the success of recruitment efforts and in enrolling the massive numbers of employees who are in fast-growing, low-wage service jobs. For example, the SEIU was successful recently in unionizing hundreds of workers who provide services to people with disabilities in California, with an eye toward raising standards for their work and increasing hourly wages and benefits. Reversing labor's decline will be challenging, but the SEIU looks positively toward the future.[27]

Concept Check

1. How can employee diversity give a company a competitive advantage?
2. Explain the concept of hiring for fit.
3. Why does the service industry provide an opportunity for labor union growth?

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10: MOTIVATING EMPLOYEES

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10.1: Introduction



Exhibit 9.1: (Credit: Jeff Turner /flickr / Attribution 2.0 Generic (CC BY 2.0))

EXPLORING BUSINESS CAREERS

Chuck Kaplan, Ciena Corporation

Chuck Kaplan loves music and playing in a band, but he does not work in the music industry. He works for Ciena Corporation, a global supplier of telecommunications networking equipment, software, and services. Kaplan spends his days leading a team to help customers solve business problems by updating and creating revenue through their networks—the process of modernizing and monetizing networks. He also plays music with OTN Speedwagon, Ciena's all-employee band.

OTN Speedwagon was created after Kaplan thought the entertainment at a corporate function was "cheesy." He and three others took the idea of creating an employee band to their boss, and OTN Speedwagon was born. Its name comes from the networking technology Ciena implements, Optical Transport Network, and the rock band REO Speedwagon; its members are from all over the globe.

The band is made up of employees from multiple departments, time zones, and countries. Members include an executive administrative assistant in London, England; a CTO in Dallas, Texas; sales system engineers in Dallas, Texas, and St. Louis, Missouri; an account manager in Denver, Colorado; senior managers in Baltimore, Maryland, and New York, New York; a sales consultant in Atlanta, Georgia; vice presidents in Atlanta, Georgia, and Dallas, Texas; and a materials management leader in Ottawa, Canada. When playing with the band, they set aside their job titles and focus on producing award-winning music.

OTN Speedwagon performs songs in a variety of styles and enjoys performing whenever and wherever opportunity exists. A highlight is the opportunity to compete at the *Fortune* Battle of the Corporate Band, a competition for all-employee bands. OTN Speedwagon won the event one year, beating seven other corporate bands. Two members also walked away with individual awards: best guitarist and best horns.

Producing great music together is not easy. Everyone knows one person being off-tempo or off-key can ruin a song. Because the band members have different job responsibilities and live in separate countries, they are rarely together. Scheduling live rehearsals is a major challenge, and they often happen only the day of or day before an event. The band is up to the challenge, though, and harnesses technology to solve the problem. The members discuss songs to sing (enough for a multi-hour show!) and pick a key for each song that fits the lead vocalist. One member makes an MP3 soundtrack for each song and shares it and lyrics with the others through a secure file-sharing system. Everyone spends hours practicing to the soundtracks—alone. But hard work and dedication pay off. When the band finally is together, often one time through is enough to perfect each song.

Opportunities and benefits such as being part of the band pay dividends for Ciena, certified as a “great place to work.” Band members say trust in each other to do each person’s part makes the band a success. Everyone knows what to do and does it, and that level of trust transfers back to the workplace. Members have built trust in coworkers, knocked down walls, and become more collaborative. The experience has brought the employees together, some meeting for the first time at rehearsal, and made the company seem more like a family. Bonus benefit? Corporate events are much more entertaining.

Sources: “About Chuck Kaplan,” http://www.ciena.com, accessed January 19, 2018; “What Is Network Monetization?” http://www.ciena.com, accessed January 19, 2018; “OTN Speedwagon,” http://www.ciena.com, accessed January 19, 2018; Great Place to Work, “Ciena Corporation,” http://reviews.greatplacetowork.com, November 27, 2017; Jessica Stillman, “What This Remote Company Rock Band Can Teach You About Collaboration,” *Inc.*, https://www.inc.com, March 10, 2017; Molly Winans, “Ciena’s OTN Speedwagon Gears Up to Rock Out at OFC,” https://www.ofcconference.org, March 17, 2017; Jane Hobbs, “Being a Great Place to Work Shouldn’t Be a Mystery,” http://www.ciena.com, October 24, 2016; “Ciena Takes Home National Title at 13th Annual FORTUNE Battle of the Corporate Bands,” http://www.ciena.com, October 6, 2013; Bo Gowan, “Behind the Scenes with Ciena’s Corporate Rock Band,” http://www.ciena.com, September 16, 2013.

This chapter details motivational theory, both historically and currently, and applies that theory to the business world, where motivation, whether in the form of a rock band or not, is a key to success.

People can be a firm’s most important resource. They can also be the most challenging resource to manage well. Employees who are motivated and work hard to achieve personal and organizational goals can become a crucial competitive advantage for a firm. The key then is understanding the process of motivation, *what* motivates individuals, and *how* an organization can create a workplace that allows people to perform to the best of their abilities.



Exhibit 9.2: LeBron James is on a roll. The U.S. basketball player began receiving national attention as a high school player in Ohio. By the time he was graduating from high school, he was touted as the consensus first pick in the NBA draft. James was determined to make it in professional basketball. After successful stints in Cleveland and Miami, James is a perennial all-star and has won three NBA championships. *What motivates people to achieve their personal best?* (Credit: Erik Drost/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

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10.2: Early Theories of Motivation

What are the basic principles of Frederick Taylor's concept of scientific management?

Motivation is the set of forces that prompt a person to release energy in a certain direction. As such, motivation is essentially a need- and want-satisfying process. A **need** is best defined as the gap between what is and what is *required*. Similarly, a **want** is the gap between what is and what is *desired*. Unsatisfied needs and wants create a state of tension that pushes (motivates) individuals to practice behavior that will result in the need being met or the want being fulfilled. That is, motivation is what pushes us to move from where we are to where we want to be, because expending that effort will result in some kind of reward.

Rewards can be divided into two basic categories: intrinsic and extrinsic. Intrinsic rewards come from within the individual—things like satisfaction, contentment, sense of accomplishment, confidence, and pride. By contrast, extrinsic rewards come from outside the individual and include things like pay raises, promotions, bonuses, prestigious assignments, and so forth. **Exhibit 9.3** illustrates the motivation process.

Successful managers are able to marshal the forces to motivate employees to achieve organizational goals. And just as there are many types of gaps between where organizations are and where they want to be, there are many motivational theories from which managers can draw to inspire employees to bridge those gaps. In this chapter, we will first examine motivational theories that grew out of the industrial revolution and early ideas of organizational psychology. Then we will examine needs-based theories and more contemporary ideas about employee motivation like equity, expectancy, goals, and reinforcement theories. Finally, we will show you how managers are applying these theories in real-world situations.

How can managers and organizations promote enthusiastic job performance, high productivity, and job satisfaction? Many studies of human behavior in organizations have contributed to our current understanding of these issues. A look at the evolution of management theory and research shows how managers have arrived at the practices used today to manage human behavior in the workplace. A sampling of the most influential of these theorists and research studies are discussed in this section.

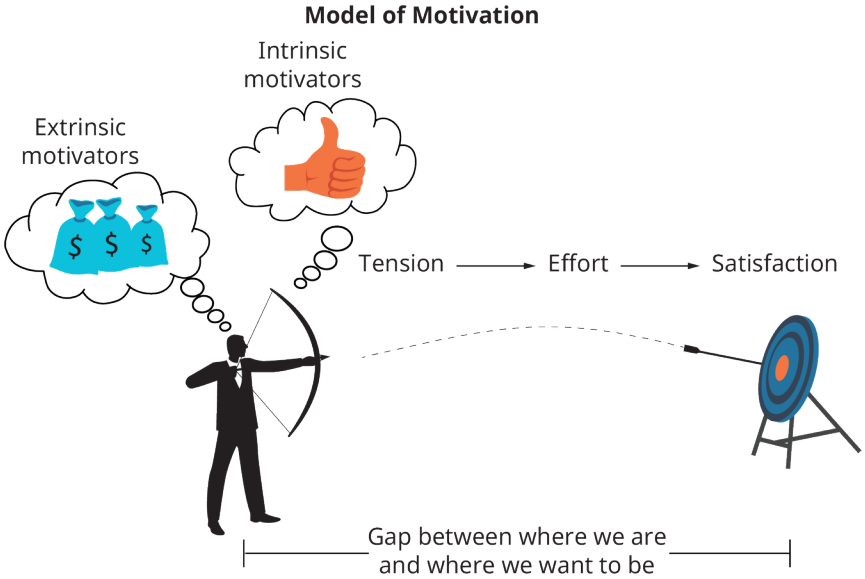


Exhibit 9.3: **Model of Motivation** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Frederick Taylor's Scientific Management

One of the most influential figures of the *classical era* of management, which lasted from about 1900 to the mid-1930s, was Frederick W. Taylor, a mechanical engineer sometimes called the "father of **scientific management**." Taylor's approach to improved performance was based on economic incentives and the premise that there is "one best way" to perform any job.

As a manager at the Midvale and Bethlehem Steel companies in Philadelphia in the early 1900s, Taylor was frustrated at the inefficiency of the laborers working in the mills.

Convinced that productivity could be improved, Taylor studied the individual jobs in the mill and redesigned the equipment and the methods used by workers. Taylor timed each job with a stopwatch and broke down every task into separate movements. He then prepared an instruction sheet telling exactly how each job should be done, how much time it should take, and what motions and tools should be used. Taylor's ideas led to dramatic increases in productivity in the steel mills and resulted in the development of four basic principles of scientific management:

1. Develop a scientific approach for each element of a person's job.
2. Scientifically select, train, teach, and develop workers.
3. Encourage cooperation between workers and managers so that each job can be accomplished in a standard, scientifically determined way.
4. Divide work and responsibility between management and workers according to who is better suited to each task.

Taylor published his ideas in *The Principles of Scientific Management*. His pioneering work vastly increased production efficiency and contributed to the specialization of labor and the assembly-line method of production. Taylor's approach is still being used nearly a century later in companies such as UPS, where industrial engineers maximize efficiency by carefully studying every step of the delivery process looking for the quickest possible way to deliver packages to customers. Though Taylor's work was a giant step forward in the evolution of management, it had a fundamental flaw in that it assumed that all people are primarily motivated by economic means. Taylor's successors in the study of management found that motivation is much more complex than he envisioned.

CONCEPT CHECK

1. How did Frederic Taylor's studies contribute to the early understanding of human motivation?
2. How are Taylor's insights still seen in today's management practices?

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10.3: The Hawthorne Studies

What did Elton Mayo's Hawthorne studies reveal about worker motivation?

The classical era of management was followed by the *human relations era,* which began in the 1930s and focused primarily on how human behavior and relations affect organizational performance. The new era was ushered in by the Hawthorne studies, which changed the way many managers thought about motivation, job productivity, and employee satisfaction. The studies began when engineers at the Hawthorne Western Electric plant decided to examine the effects of varying levels of light on worker productivity—an experiment that might have interested Frederick Taylor. The engineers expected brighter light to lead to increased productivity, but the results showed that varying the level of light in either direction (brighter or dimmer) led to increased output from the experimental group. In 1927, the Hawthorne engineers asked Harvard professor Elton Mayo and a team of researchers to join them in their investigation.

From 1927 to 1932, Mayo and his colleagues conducted experiments on job redesign, length of workday and workweek, length of break times, and incentive plans. The results of the studies indicated that increases in performance were tied to a complex set of employee attitudes. Mayo claimed that both experimental and control groups from the plant had developed a sense of group pride because they had been selected to participate in the studies. The pride that came from this special attention motivated the workers to increase their productivity. Supervisors who allowed the employees to have some control over their situation appeared to further increase the workers' motivation. These findings gave rise to what is now known as the **Hawthorne effect**, which suggests that employees will perform better when they feel singled out for special attention or feel that management is concerned about employee welfare. The studies also provided evidence that informal work groups (the social relationships of employees) and the resulting group pressure have positive effects on group productivity. The results of the Hawthorne studies enhanced our understanding of what motivates individuals in the workplace. They indicate that in addition to the personal economic needs emphasized in the classical era, social needs play an important role in influencing work-related attitudes and behaviors.

CONCEPT CHECK

1. How did Mayo's studies at the Hawthorne plant contribute to the understanding of human motivation?
2. What is the Hawthorne effect?
3. Was the practice of dimming and brightening the lights ethical?

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10.4: Maslow's Hierarchy of Needs

What is Maslow's hierarchy of needs, and how do these needs relate to employee motivation?

Another well-known theorist from the behavioral era of management history, psychologist Abraham Maslow, proposed a theory of motivation based on universal human needs. Maslow believed that each individual has a hierarchy of needs, consisting of physiological, safety, social, esteem, and self-actualization needs, as shown in **Exhibit 9.4**.

Maslow's theory of motivation contends that people act to satisfy their unmet needs. When you're hungry, for instance, you look for and eat food, thus satisfying a basic physiological need. Once a need is satisfied, its importance to the individual diminishes, and a higher-level need is more likely to motivate the person.

According to **Maslow's hierarchy of needs**, the most basic human needs are physiological needs, that is, the needs for food, shelter, and clothing. In large part, it is the physiological needs that motivate a person to find a job. People need to earn money to provide food, shelter, and clothing for themselves and their families. Once people have met these basic needs, they reach the second level in Maslow's hierarchy, which is safety needs. People need to feel secure, to be protected from physical harm, and to avoid the unexpected. In work terms, they need job security and protection from work hazards.

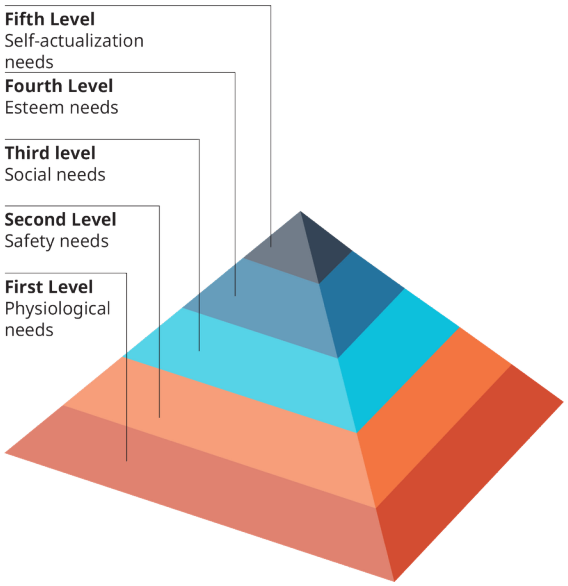


Exhibit 9.4: **Maslow's Hierarchy of Needs** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Physiological needs and safety are physical needs. Once these are satisfied, individuals focus on needs that involve relationships with other people. At Maslow's third level are social needs, or needs for belonging (acceptance by others) and for giving and receiving friendship and love. Informal social groups on and off the job help people satisfy these needs. At the fourth level in Maslow's hierarchy are esteem needs, which are needs for the respect of others and for a sense of accomplishment and achievement. Satisfaction of these needs is reflected in feelings of self-worth. Praise and recognition from managers and others in the firm contribute to the sense of self-worth. Finally, at the highest level in Maslow's hierarchy are self-actualization needs, or needs for fulfillment, for living up to one's potential, and for using one's abilities to the utmost. In order to give you a better understanding of how Maslow's hierarchy applies in the real business world, let's look at a detailed example about Wegmanssupermarkets. When you think of your first-choice job, you probably aren't thinking about working in a supermarket. With grueling hours, low pay, and annual turnover often approaching 100 percent, supermarkets are generally not considered the best places to work—unless you work at Wegmans, which has been on *Fortune*'s "Best Company to Work For" every year since the list started, earning Wegmans a spot on *Fortune*'s "Great Place to Work Legends" list.

Part of what makes Wegmans successful is the company's attention to its employees' needs at all levels of Maslow's hierarchy.

The company pays above-market wages (the sous chef at a Pittsburgh store used to work for Thomas Keller's French Laundry in Napa Valley, and talent like that doesn't come cheap), and until 2003, Wegmans paid 100 percent of its employees' medical insurance premiums (*physiological needs*). Wegmans' most comparable competitor has a turnover rate of about 19 percent, which doesn't even come close to Wegmans' 5 percent. More than half of Wegmans' store managers began working there in their teens (*safety needs*).

Because employees stay so long, the Wegmans culture has become stronger and more ingrained over time. Edward McLaughlin, director of Cornell's Food Industry Management Program, says, "When you're a 16-year-old kid, the last thing you want to do is wear a geeky shirt and work for a supermarket. But at Wegmans, it's a badge of honor. You are not a geeky cashier. You are part of the social fabric," (*social needs*).[1] Sara Goggins, a 19-year-old college student, was recently complimented on the display she helped prepare for the store's French-inspired patisserie—by Danny Wegman himself (*esteem needs*). Sara keeps a photo of her and Danny Wegman behind the counter. Maria Benjamin used to bake "chocolate meatball cookies" to celebrate coworkers' birthdays. They were so popular that she asked Danny Wegman if the store would sell them in the bakery department. He said yes, and it did. Employees like Sara and Maria are routinely recognized for their contributions to the company (*esteem needs*). Wegmanshas spent over $54 million for college scholarships to more than 17,500 full- and part-time employees over the past 20 years. Top management thinks nothing of sending store department managers on training expeditions. A cheese manager might take a 10-day trip to visit and study cheesemakers in London, Paris, and Italy; a wine manager might take a company-sponsored trip through the Napa Valley (*self-actualization needs*).[2] As you can see from this extended example, Wegmans works hard to meet its employees' needs at all levels.

Maslow's theory is not without criticism, however. Maslow claimed that a higher-level need was not activated until a lower-level need was met. He also claimed that a satisfied need is not a motivator. A farmer who has plenty to eat is not motivated by more food (the physiological hunger need). Research has not verified these principles in any strict sense. The theory also concentrates on moving up the hierarchy without fully addressing moving back down the hierarchy. Despite these limitations, Maslow's ideas are very helpful for understanding the needs of people at work and for determining what can be done to satisfy them.

CONCEPT CHECK

1. What is Maslow's hierarchy of needs, and how does it help in understanding human motivation?
2. What are some criticisms of Maslow's hierarchy

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10.5: McGregor's Theories X and Y

How are McGregor's Theories X and Y and Ouchi's Theory Z used to explain worker motivation?

Douglas McGregor, one of Maslow's students, influenced the study of motivation with his formulation of two contrasting sets of assumptions about human nature—Theory X and Theory Y.

The **Theory X** management style is based on a pessimistic view of human nature and assumes the following:

- The average person dislikes work and will avoid it if possible.
- Because people don't like to work, they must be controlled, directed, or threatened with punishment to get them to make an effort.
- The average person prefers to be directed, avoids responsibility, is relatively unambitious, and wants security above all else.

This view of people suggests that managers must constantly prod workers to perform and must closely control their on-the-job behavior. Theory X managers tell people what to do, are very directive, like to be in control, and show little confidence in employees. They often foster dependent, passive, and resentful subordinates.

In contrast, a **Theory Y** management style is based on a more optimistic view of human nature and assumes the following:

- Work is as natural as play or rest. People want to and can be self-directed and self-controlled and will try to achieve organizational goals they believe in.
- Workers can be motivated using positive incentives and will try hard to accomplish organizational goals if they believe they will be rewarded for doing so.
- Under proper conditions, the average person not only accepts responsibility but seeks it out. Most workers have a relatively high degree of imagination and creativity and are willing to help solve problems.

Managers who operate on Theory Y assumptions recognize individual differences and encourage workers to learn and develop their skills. An administrative assistant might be given the responsibility for generating a monthly report. The reward for doing so might be recognition at a meeting, a special training class to enhance computer skills, or a pay increase. In short, the Theory Y approach builds on the idea that worker and organizational interests are the same. It is not difficult to find companies that have created successful corporate cultures based on Theory Y assumptions. In fact, *Fortune*'s list of "100 Best Companies to Work For" and the Society for Human Resource Management's list of "Great Places to Work" are full of companies that operate using a Theory Ymanagement style. Starbucks, J. M. Smucker, SAS Institute, Whole Foods Market, and Wegmans are all examples of companies that encourage and support their workers. Genencor, a biotechnology firm listed on America's Best Places to Work five times, has a culture that celebrates success in all aspects of its business. Employees can reward colleagues with on-the-spot awards for extraordinary effort. According to the company's former CEO, Robert Mayer, "Genencor is truly unique among U.S. companies of any size. It is a model for innovation, teamwork, and productivity—and a direct result of our 'work hard, play hard, change the world' philosophy. Investing in our employees has always been good business for Genencor."[3]

Theory Z

William Ouchi (pronounced O Chee), a management scholar at the University of California, Los Angeles, has proposed a theory that combines U.S. and Japanese business practices. He calls it **Theory Z**. Table 9.1 compares the traditional U.S. and Japanese management styles with the Theory Z approach. Theory Z emphasizes long-term employment, slow career development, moderate specialization, group decision-making, individual responsibility, relatively informal control over the employee, and concern for workers. Theory Z has many Japanese elements. But it reflects U.S. cultural values.

In the past decade, admiration for Japanese management philosophy that centers on creating long-term relationships has declined. The cultural beliefs of groupthink, not taking risks, and employees not thinking for themselves are passé. Such conformity has limited Japanese competitiveness in the global marketplace. Today there is a realization that Japanese firms need to be more proactive and nimble in order to prosper. It was that realization that led Japanese icon Sony to name a foreigner as the CEO of Japan's most famous company. Over the years, Sony's performance has declined, until in April 2005, the company

posted its biggest loss ever. Nobuki Idei, the former CEO who inherited Sony's massive debts and stagnant product lines, realized his strategy wasn't working, so he became determined to appoint a successor who would be able to transform Sony from the lumbering giant it had become back into the forward-thinking company it had been. Idei tapped Sir Howard Stringer, a Welsh-born American who had been running Sony's U.S. operations. In doing so, Idei hoped to shock company insiders and industry analysts alike. "It's funny, 100 percent of the people around here agree we need to change, but 90 percent of them don't really want to change themselves," he says. "So I finally concluded that we needed our top management to quite literally speak another language." After seven years as CEO, Stringer assumed the position of Chairman and appointed Kazuro Hirai as President and Chief Executive Officer.[4]

Table 9.1 Sources: Comparison of traditional U.S. and Japanese management styles with the Theory Z approach. Based on information from Jerry D. Johnson, Austin College. Dr. Johnson was a research assistant for William Ouchi. William Ouchi, Theory Z, Avon, 1982.

Differences in Management Approaches			
Factor	**Traditional U.S. Management**	**Japanese Management**	**Theory Z (Combination of U.S. and Japanese Management)**
Length of employment	Relatively short-term; workers subject to layoffs if business is bad	Lifetime; layoffs never used to reduce costs	Long-term but not necessarily lifetime; layoffs "inappropriate"; stable, loyal workforce; improved business conditions don't require new hiring and training
Rate of evaluation and promotion	Relatively rapid	Relatively slow	Slow by design; managers thoroughly trained and evaluated
Specialization in a functional area	Considerable; worker acquires expertise in single functional area	Minimal; worker acquires expertise in organization instead of functional areas	Moderate; all experience various functions of the organization and have a sense of what's good for the firm rather than for a single area
Decision-making	On individual basis	Input from all concerned parties	Group decision-making for better decisions and easier implementation
Responsibility for success or failure	Assigned to individual	Shared by group	Assigned to individual
Control by manager	Very explicit and formal	More implicit and informal	Relatively informal but with explicit performance measures
Concern for workers	Focuses on work-related aspects of worker's life	Extends to whole life of worker	Is relatively concerned with worker's whole life, including the family

CONCEPT CHECK

1. How do the Theory X, Theory Y, and Theory Z management styles differ?

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10.6: Herzberg's Motivator-Hygiene Theory

What are the basic components of Herzberg's motivator-hygiene theory?

Another important contribution to our understanding of individual motivation came from Frederick Herzberg's studies, which addressed the question, "What do people really want from their work experience?" In the late 1950s, Herzberg surveyed numerous employees to find out what particular work elements made them feel exceptionally good or bad about their jobs. The results indicated that certain job factors are consistently related to employee job satisfaction, while others can create job dissatisfaction. According to Herzberg, **motivating factors** (also called *job satisfiers*) are primarily intrinsic job elements that lead to satisfaction. **Hygiene factors** (also called *job dissatisfiers*) are extrinsic elements of the work environment. A summary of motivating and hygiene factors appears in Table 9.2.

One of the most interesting results of Herzberg's studies was the implication that the opposite of satisfaction is not dissatisfaction. Herzberg believed that proper management of hygiene factors could prevent employee dissatisfaction, but that these factors could not serve as a source of satisfaction or motivation. Good working conditions, for instance, will keep employees at a job but won't make them work harder. But poor working conditions, which are job dissatisfiers, may make employees quit. According to Herzberg, a manager who wants to increase employee satisfaction needs to focus on the motivating factors, or satisfiers. A job with many satisfiers will usually motivate workers, provide job satisfaction, and prompt effective performance. But a lack of job satisfiers doesn't always lead to dissatisfaction and poor performance; instead, a lack of job satisfiers may merely lead to workers doing an adequate job, rather than their best.



Exhibit 9.5: Flexibility has been a competitive advantage for ride-sharing companies like Uber and Lyft. Companies' flexible work hours have been appealing to many workers who appreciate the flexibility that these jobs provide, either as a full-time job or a way to make supplemental income. *According to Herzberg's motivator-hygiene theory, what effect might Uber and Lyft's work environment have on employee?* (Credit: Alfredo Mendez/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Although Herzberg's ideas have been widely read and his recommendations implemented at numerous companies over the years, there are some very legitimate concerns about Herzberg's work. Although his findings have been used to explain employee motivation, in fact his studies focused on job satisfaction, a different (though related) concept from motivation. Other criticisms focus on the unreliability of Herzberg's methodology, the fact that the theory ignores the impact of situational variables, and the assumed relationship between satisfaction and productivity. Nevertheless, the questions raised by Herzberg about the nature of job satisfaction and the effects of intrinsic and extrinsic factors on employee behavior have proved a valuable contribution to the evolution of theories of motivation and job satisfaction.

Table 9.2: Herzberg's Motivating and Hygiene Factors

Motivating Factors	Hygiene Factors
Achievement	Company policy
Recognition	Supervision
Work itself	Working conditions
Responsibility	Interpersonal relationships at work
Advancement	Salary and benefits
Growth	Job security

CONCEPT CHECK

1. What is Herzberg's theory, and how does it relate to an understanding of motivation?
2. How can a manager use an understanding of Herzberg's theory to motivate employees?
3. What are the limitations of Herzberg's theory?

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10.7: Contemporary Views on Motivation

What four contemporary theories on employee motivation offer insights into improving employee performance?

The early management scholars laid a foundation that enabled managers to better understand their workers and how best to motivate them. Since then, new theories have given us an even better understanding of worker motivation. Four of these theories are explained in this section: the expectancy theory, the equity theory, the goal-setting theory, and reinforcement theory.

Expectancy Theory

One of the best-supported and most widely accepted theories of motivation is expectancy theory, which focuses on the link between motivation and behavior. According to **expectancy theory**, the probability of an individual acting in a particular way depends on the strength of that individual's belief that the act will have a particular outcome and on whether the individual values that outcome. The degree to which an employee is motivated depends on three important relationships, shown in **Exhibit 9.6**.

1. The link between *effort and performance,* or the strength of the individual's expectation that a certain amount of effort will lead to a certain level of performance
2. The link between *performance and outcome,* or the strength of the expectation that a certain level of performance will lead to a particular outcome
3. The link between *outcomes and individual needs,* or the degree to which the individual expects the anticipated outcome to satisfy personal needs. Some outcomes have more valence, or value, for individuals than others do.

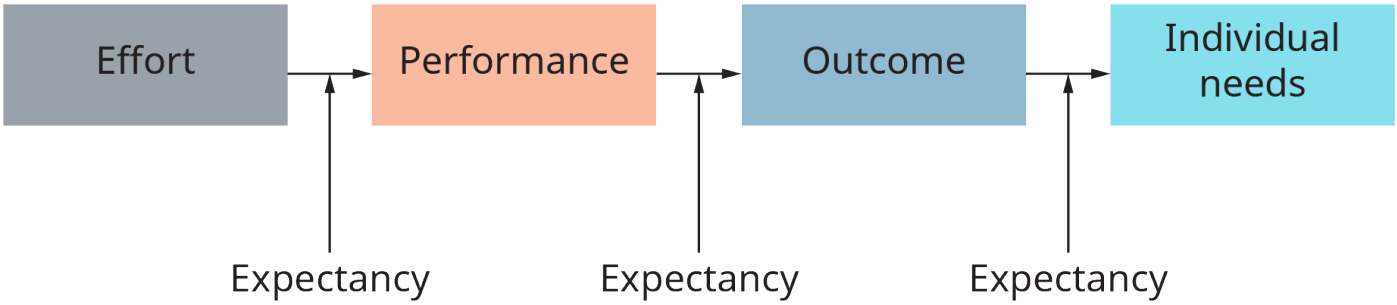


Exhibit 9.6: How Expectations Can Lead to Motivation (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Equity Theory

Another contemporary explanation of motivation, **equity theory** is based on individuals' perceptions about how fairly they are treated compared with their coworkers. Equity means justice or fairness, and in the workplace it refers to employees' perceived fairness of the way they are treated and the rewards they earn. For example, imagine that after graduation you were offered a job that paid $55,000 a year and had great benefits. You'd probably be ecstatic, even more so if you discovered that the coworker in the next cubicle was making $45,000 for the same job. But what if that same colleague were making $59,000 for the same job? You'd probably think it unfair, particularly if the coworker had the same qualifications and started at the same time as you did. Your determination of the fairness of the situation would depend on how you felt you compared to the other person, or referent. Employees evaluate their own *outcomes* (e.g., salary, benefits) in relation to their *inputs* (e.g., number of hours worked, education, and training) and then compare the outcomes-to-inputs ratio to one of the following: (1) the employee's own past experience in a different position in the current organization, (2) the employee's own past experience in a different organization, (3) another employee's experience inside the current organization, or (4) another employee's experience outside the organization.

According to equity theory, if employees perceive that an inequity exists, they will make one of the following choices:

- *Change their work habits* (exert less effort on the job)
- *Change their job benefits and income* (ask for a raise, steal from the employer)

- *Distort their perception of themselves* (“I always thought I was smart, but now I realize I’m a lot smarter than my coworkers.”)
- *Distort their perceptions of others* (“Joe’s position is really much less flexible than mine.”)
- *Look at the situation from a different perspective* (“I don’t make as much as the other department heads, but I make a lot more than most graphic artists.”)
- *Leave the situation* (quit the job)

Managers can use equity theory to improve worker satisfaction. Knowing that every employee seeks equitable and fair treatment, managers can make an effort to understand an employee’s perceptions of fairness and take steps to reduce concerns about inequity.



Exhibit 9.7: Ben & Jerry’s founders Ben Cohen and Jerry Greenfield firmly believe the maxim that companies “do well by doing good.” This idealism led the founders to once famously swear that no Ben & Jerry’s executive would ever make more than seven times the lowliest worker’s wage. But when growth required attracting exceptional top-level management, the company eventually abandoned its self-imposed ratio between its lowest and highest compensation rates. *How might perceived inequities in pay affect worker satisfaction and motivation?* (Credit: Mike Mozart/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Goal-Setting Theory

Goal-setting theory is based on the premise that an individual’s intention to work toward a goal is a primary source of motivation. Once set, the goal clarifies for the employee what needs to be accomplished and how much effort will be required for completion. The theory has three main components: (1) specific goals lead to a higher level of performance than do more generalized goals (“do your best”); (2) more difficult goals lead to better performance than do easy goals (provided the individual accepts the goal); and (3) feedback on progress toward the goal enhances performance. Feedback is particularly important because it helps the individual identify the gap between the *real* (the actual performance) and the *ideal* (the desired outcome defined by the goal). Given the trend toward employee empowerment in the workplace, more and more employees are participating in the goal-setting process.

To help employees during the peak 2017 holiday delivery season, UPS, FedEx, and the U.S. Postal Service paid additional overtime to help achieve their goals. UPS even deployed some office personnel to help deliver packages and created team goals to ensure there was cooperation and shared reward with employees from different departments within the organization. The strategy seems to have worked, with UPS reporting an on-time delivery rate of 99.1% for the week before Christmas.[5]

Reinforcement Theory

Reinforcement theory says that behavior is a function of its consequences. In other words, people do things because they know other things will follow. So, depending on what type of consequences follows, people will either practice a behavior or refrain from it. There are three basic types of consequences: positive, negative, and none. In general, we think of positive consequences as rewards, but a **reward** is anything that increases the particular behavior. By contrast, **punishment** is anything that decreases the

behavior.

Motivating with the reinforcement theory can be tricky because the theory is functional. All of its components are defined by their function rather than their structure. That is, consequences can operate differently for different people and in different situations. What is considered a punishment by one person may, in fact, be a reward for another. Nonetheless, managers can successfully use reinforcement theory to motivate workers to practice certain behaviors and avoid others. Often, managers use both rewards and punishment to achieve the desired results.

For example, retailers have long needed additional help during peak selling days like Black Friday and Cyber Monday. To help meet these needs, Urban Outfitters recruited salaried workers for a six-hour shift at its new fulfillment facility to help out some of their colleagues and sold the idea to salaried employees as a team-building activity. The workers were offered transportation and paid lunches and asked to wear comfortable shoes. Although it was not mandatory, an Urban Outfitters spokesperson commented: "After successfully opening our new fulfillment center in June, we asked salaried employees at our home office to volunteer for shifts that would help support the new center through a busy month of October. Unsurprisingly, we received a tremendous response, including many of our senior management."[6]

EXPANDING AROUND THE GLOBE

Motivation Is Culture Bound

Most motivation theories in use today were developed in the United States by Americans and about Americans. Of those that were not, many have been strongly influenced by American theories. But several motivation theories do not apply to all cultures. For example, Maslow's theory does not often hold outside the United States. In countries higher on uncertainty avoidance (such as Greece and Japan) as compared with those lower on uncertainty avoidance (such as the United States), security motivates employees more strongly than does self-actualization. Employees in high-uncertainty-avoidance countries often consider job security and lifetime employment more important than holding a more interesting or challenging job. Also contrasting with the American pattern, social needs often dominate the motivation of workers in countries such as Denmark, Norway, and Sweden that stress the quality of life over materialism and productivity.

When researchers tested Herzberg's theory outside the United States, they encountered different results. In New Zealand, for example, supervision and interpersonal relationships appear to contribute significantly to satisfaction and not merely to reducing dissatisfaction. Similarly, researchers found that citizens of Asia, Canada, Europe, Latin America, the Republic of Panama, and the West Indies cited certain extrinsic factors as satisfiers with greater frequency than did their American counterparts. In other words, the factors that motivate U.S. employees may not spark the same motivation in employees in other cultures. Some of the major differences among the cultural groups include the following:

1. English-speaking countries such as England and the United States rank higher on individual achievement and lower on the desire for security.
2. French-speaking countries and areas such as France and the province of Quebec in Canada, although similar to the English-speaking countries, give greater importance to security and somewhat less to challenging work.
3. Northern European countries such as Sweden have less interest in getting ahead and work towards recognition goals and place more emphasis on job accomplishment. In addition, they have more concern for people and less for the organization as a whole (it is important that their jobs not interfere with their personal lives).
4. Latin American and Southern European countries find individual achievement somewhat less important; Southern Europeans place the highest emphasis on job security, whereas both groups of countries emphasize fringe benefits.
5. Germany ranks high on security and fringe benefits and among the highest on getting ahead.
6. Japan, although low on advancement, also ranks second-highest on challenge and lowest on autonomy, with a strong emphasis on good working conditions and a friendly working environment.

Critical Thinking Questions

1. In today's global business environment, with its diversity of perspectives, can a manager ever successfully use equity theory? Why or why not?
2. What impact, if any, do these cultural differences have on managers managing an entirely American workforce? Explain.

Sources: Adapted from Nancy J. Adler and Allison Gunderson, *International Dimensions of Organizational Behavior*, 5th ed. (Cengage Learning, 2008), pp. 174–181; "Motivation across Cultures: Same Value-Different Approach," *Authentic Journeys*,

http://blog.authenticjourneys.info, July 10, 2014.

CONCEPT CHECK

1. Discuss the three relationships central to expectancy theory.
2. Explain the comparison process that is a part of equity theory.
3. How does goal-setting theory contribute to our understanding of motivation?
4. What are the main elements of reinforcement theory?

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10.8: From Motivation Theory to Application

How can managers redesign existing jobs to increase employee motivation and performance?

The material presented thus far in this chapter demonstrates the wide variety of theorists and research studies that have contributed to our current understanding of employee motivation. Now we turn our attention to more practical matters, to ways that these concepts can be applied in the workplace to meet organizational goals and improve individual performance.

Motivational Job Design

How might managers redesign or modify existing jobs to increase employee motivation and performance? The following three options have been used extensively in the workplace:

- *Job enlargement*. The horizontal expansion of a job, increasing the number and variety of tasks that a person performs, is called **job enlargement**. Increasing task diversity can enhance job satisfaction, particularly when the job is mundane and repetitive in nature. A potential drawback to job enlargement is that employees may perceive that they are being asked to work harder and do more with no change in their level of responsibility or compensation. This can cause resentment and lead to dissatisfaction.
- *Job enrichment*. **Job enrichment** is the vertical expansion of an employee's job. Whereas job enlargement addresses the breadth or scope of a job, enrichment attempts to increase job depth by providing the employee with more autonomy, responsibility, and decision-making authority. In an enriched job, the employee can use a variety of talents and skills and has more control over the planning, execution, and evaluation of the required tasks. In general, job enrichment has been found to increase job satisfaction and reduce absenteeism and turnover.
- *Job rotation*. Also called *cross-training,* **job rotation** is the shifting of workers from one job to another. This may be done to broaden an employee's skill base or because an employee has ceased to be interested in or challenged by a particular job. The organization may benefit from job rotation because it increases flexibility in scheduling and production and because employees can be shifted to cover for absent workers or changes in production or operations. It is also a valuable tool for training lower-level managers in a variety of functional areas. Drawbacks of job rotation include an increase in training costs and decreased productivity while employees are getting "up to speed" in new task areas.

Work-Scheduling Options

As companies try to meet the needs of a diverse workforce and retain quality employees while remaining competitive and financially prosperous, managers are challenged to find new ways to keep workers motivated and satisfied. Increasingly popular are alternatives to the traditional work schedule, such as flextime, compressed workweek, four-day workweek, telecommuting, and job sharing.

One option for employees who want an adjustable schedule is *flextime*, in use at 57 percent of U.S. companies.[7] Flextime allows employees to decide what their work hours will be. Employees are generally expected to work a certain number of hours per week but have some discretion as to when they arrive at work and when they leave for the day.

Another option for employees who want to maximize their leisure hours, indulge in three-day weekends, and avoid commuting during morning and evening rush hours is the *compressed workweek*. Employees work the traditional 40 hours, but fit those hours into a shorter workweek. Most common is the 4-40 schedule, where employees work four 10-hour days a week. Organizations that offer this option claim benefits ranging from increased motivation and productivity to reduced absenteeism and turnover. According to the Society for Human Resource Management, 29 percent of U.S. companies offered employees a compressed workweek in 2017, down from 35 percent in 2013. One of the reasons for the downward trend may be the increasing popularity of a four-day workweek.[8]

In 2017 the Society for Human Resource Management began tracking the popularity of a *four-day workweek*, offered in 13 percent of U.S. companies. In this option, employees work only four days a week, the same as a compressed workweek, but work 32 hours

or less. The year before, Amazon announced a pilot project that allows some tech teams in their human resources department to work fewer hours for 75 percent of pay but retain the same benefits as full-time employees. In contrast, Tower Paddle Boards made permanent its pilot of reducing the workday to only five hours for the entire company. Employees retain the same pay and obligations as before so are challenged to be more productive in less time. In addition, the company started a 5 percent profit-sharing plan. Founder Stephan Aarstol says he expected to lose some revenue for a bit, but that didn't happen. Revenue the first year was up 40 percent.[9]

Telecommuting is a work-scheduling option that allows employees to work from home via a computer that is linked with their office, headquarters, or colleagues. Often employers will use a mix of these scheduling options depending on the situation. Jacqueline Pawela-Crew was a group leader in Intel's management engineering unit who worked a compressed schedule. She worked Monday through Thursday, and on two of those days she telecommuted from her home. On the other two days, she worked a flexible schedule, sometimes getting to the office at 6 a.m., so she could be home when her children came home from school. Her former manager, Dan Enloe, was a U.S. Navy reservist and divorced dad, so he also used Intel's flexible schedule to meet his military and family needs.[10] He sees the flexible scheduling as a key motivator for Intel's employees. "I've had workers tell me flat out, they were going to leave Intel if they didn't have the option of some flexibility with their schedules," he says.[11] Ricardo Semler, CEO of Semco, a Brazilian conglomerate with 3,000 employees, sums up flexible work schedules this way: "The essence to us [at Semco] was that people who are free people, who [can act] based on self-interest, who can balance their own lives, are much happier, more productive people. If you take a business call on a Sunday afternoon, for instance, why not go to the movies on a Monday?" Semco's employees not only choose their own schedules, they often choose which part of the business to work for and even how much they'll be paid.[12]

Job sharing is a scheduling option that allows two individuals to split the tasks, responsibilities, and work hours of one 40-hour-per-week job. Though used less frequently than flextime and the compressed workweek, this option can also provide employees with job flexibility. The primary benefit to the company is that it gets "two for the price of one"—the company can draw on two sets of skills and abilities to accomplish one set of job objectives. Mary Kaye Stuart is an account executive at a broadcasting company is Austin, Texas. After her doctor warned her that the stress of her 100-mile commute could shorten her life, she pursued job sharing. She teamed up with a former coworker, and each works three days a week, working together on Wednesdays. "Job sharing is a great solution to keeping people from burning out and preventing turnover," says Melissa Nicholson. She believes in the power of job sharing so much that, after years of doing it herself, she founded Work Muse to help companies set up job-share arrangements. Not all partnerships have been successful, she admits, but when they are, she loves having the ability to be flexible and for the workers to cover each other and support each other. "I'm able to just not think about email or work for four days a week," she said. "That's just an impossibility for most people."[13]

Although each of these work-scheduling options may have some drawbacks for the sponsoring organizations, the benefits far outweigh the problems. The number of companies offering flexible work options has grown, and the trend is expected to continue.

Recognition and Empowerment

All employees have unique needs that they seek to fulfill through their jobs. Organizations must devise a wide array of incentives to ensure that a broad spectrum of employee needs can be addressed in the work environment, thus increasing the likelihood of motivated employees. A sampling of these motivational tools is discussed here.

Formal recognition of superior effort by individuals or groups in the workplace is one way to enhance employee motivation. Recognition serves as positive feedback and reinforcement, letting employees know what they have done well and that their contribution is valued by the organization. Recognition can take many forms, both formal and informal. Some companies use formal awards ceremonies to acknowledge and celebrate their employees' accomplishments. Others take advantage of informal interaction to congratulate employees on a job well done and offer encouragement for the future. Recognition can take the form of a monetary reward, a day off, a congratulatory e-mail, or a verbal "pat on the back." Recognition does not have to come from superiors to be meaningful, however. At The Motley Fool, a financial services company dedicated to helping people invest better, employees use the app YouEarnedIt to recognize the contributions of coworkers. In the app, employees are given "gold" to spend by thanking or complimenting one other along with a statement of what the recipient did to earn it. The recipients cash in the gold for real prizes or gift cards. Employees say this type of recognition may be better than management recognition.[14]

Employee empowerment, sometimes called employee involvement or participative management, involves delegating decision-making authority to employees at all levels of the organization, trusting employees to make the right decision. Employees are given greater responsibility for planning, implementing, and evaluating the results of decisions. Empowerment is based on the

premise that human resources, especially at lower levels in the firm, are an underutilized asset. Employees are capable of contributing much more of their skills and abilities to organizational success if they are allowed to participate in the decision-making process and are given access to the resources needed to implement their decisions. Netflix removes obstacles from employees' paths to success by eliminating policies and procedures to show its trust in employee decision-making, including in decisions about expenses and vacations. Netflix hires "fully formed adults" and tells them to use their best judgment to act in the company's best interest. The company believes employees will be more productive if not bound by processes. As a result of following these practices, Netflix is noted among companies 40 percent more productive than others.[15]

Economic Incentives

Any discussion of motivation has to include the use of monetary incentives to enhance performance. Currently, companies are using a variety of variable-pay programs such as piece-rate plans, profit sharing, gain sharing, stock options, and bonuses to encourage employees to be more productive. Unlike the standard salary or hourly wage, variable pay means that a portion of an employee's pay is directly linked to an individual or organizational performance measure. In *piece-rate pay plans,* for example, employees are paid a given amount for each unit they produce, directly linking the amount they earn to their productivity. *Profit-sharing plans* are based on overall company profitability. Using an established formula, management distributes some portion of company profits to all employees. *Gain-sharing plans* are incentive programs based on group productivity. Employees share in the financial gains attributed to the increased productivity of their group. This encourages employees to increase productivity within their specific work area regardless of the overall profit picture for the organization as a whole.

One well-known approach to monetary incentives is the award of *stock options*, or giving employees the right to purchase a given amount of stock at below-market prices. Stock can be a strong motivator because those who receive the options have the chance to make a lot of money. Government tax incentive changes have affected how much equity (stock) companies offer each year, indicating that stock options are declining in popularity.[16]

One popular incentive is the bonus. A *bonus* is simply a one-time lump-sum monetary award. In many cases, employees receive bonuses for achieving a particular performance level, such as meeting or exceeding a sales quota, and it is not uncommon for bonuses to be substantial. Google created a Founders' Award and once gave $12 million in restricted stock to the winners, a huge spot bonus for great work on a project. For line and staff employees, bonuses can add up to 3 to 5 percent of their annual pay; for middle managers, that figure rises to the low double-digit percentage range. For executives, specifically senior executives, bonuses can constitute up to 50 percent of their annual compensation.

That's not to say that small bonuses aren't good motivators. Google discovered the large range in values for the award created jealousy instead of fostering better teamwork. Based on employee input, Google changed from monetary awards to experiential awards, such as gifts and trips, and everyone was happier.[17] "Spot" bonuses allow companies to target employees that impact the bottom line and can help motivate average employees. Sarah Clausen received her first bonus from Dallas-based Associa, a property management company, for overseeing the rollout of video-based town halls. "It really creates a feeling that your work is being valued and appreciated," she says. "It definitely leads me to want to stay here and do a good job."[18]

Regardless of their size, bonuses are replacing the raise as the way companies compensate employees for a job well done and motivate them to perform at even higher levels. That is because bonuses can vary according to outcomes. Financial incentives that allow variability in compensation to reflect an individual employee's contribution are generally known as *pay-for-performance*programs. One of the many companies that use pay-for-performance programs is Allstate, which assigns employees' individual performance one of five grades. The size of an employee's bonus depends on his or her grade. For example, one worker may receive a bonus of 5.5 percent of her annual pay, but the worker in the next cubicle doing the exact same job—though less efficiently or productively—may receive only 2 percent. The pay-for-performance approach can also be used for CEOs. Teslaannounced that CEO Elon Musk's compensation could be worth up to $55.8 billion over the next ten years, or nothing. Musk's compensation is tied to the market capitalization of the company.[19] The percentage of annual payroll companies commit for pay-for-performance bonuses has fluctuated slightly in recent years but remains above 12 percent and is expected to continue.[20]

CONCEPT CHECK

1. Explain the difference between job enlargement and job enrichment.
2. What are the four work-scheduling options that can enhance employee performance?

3. Are all employees motivated by the same economic incentives? Explain.

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10.9: Trends in Employee Motivation

What initiatives are organizations using today to motivate and retain employees?

This chapter has focused on understanding what motivates people and how employee motivation and satisfaction affect productivity and organizational performance. Organizations can improve performance by investing in people. In reviewing the ways companies are currently choosing to invest in their human resources, we can spot four positive trends: (1) education and training, (2) employee ownership, (3) work-life benefits, and (4) nurturing knowledge workers. All of the companies making *Fortune*'s annual list of the "100 Best Companies to Work For" know the importance of treating employees right. They all have programs that allow them to invest in their employees through programs such as these and many more. Today's businesses also face the challenge of increased costs of absenteeism. This section discusses each of these trends in motivating employees.

Education and Training

Companies that provide educational and training opportunities for their employees reap the benefits of a more motivated, as well as a more skilled, workforce. Employees who are properly trained in new technologies are more productive and less resistant to job change. Education and training provide additional benefits by increasing employees' feelings of competence and self-worth. When companies spend money to upgrade employee knowledge and skills, they convey the message "we value you and are committed to your growth and development as an employee."

CATCHING THE ENTREPRENEURIAL SPIRIT

Everyone's a CFO

Andrew Levine, president of DCI, a New York public relations firm, wanted to implement a more open management style at his company, so he added a financial segment to monthly staff meetings, during which he would share results and trends with his employees. Much to his surprise, employees seemed bored. During one staff meeting he asked his employees how to calculate a profit, and only the receptionist, Sergio Barrios, knew how. Levine was astounded, both at his employees' general deficit in math concepts and at Barrios' knack for figures. Levine then decided to require employees to present the financial reports themselves.

For the next staff meeting, Levine appointed Barrios the chief financial officer (CFO) of the day. Barrios explained the terminology in ways laymen could understand. Since then, Levine has watched his employees become financial whizzes. Each CFO of the day meets with DCI's real CFO for only one day before the meeting. They review income, expenses, and all manner of financial ratios and statements. They discuss revenue projections and general financial trends. The CFO of the day then presents this information at the monthly staff meeting. Maria Mantz, a junior employee, thinks the training is extremely beneficial. "I'm a new, young employee, and I'm being trained not only as a PR executive, but also as a business executive." When Mantz's turn came around, she stood before 30 of her colleagues and began detailing accounts and asking her audience to refer to the revenue table in their handouts. She asked if anyone know what the five clients who showed an increase in activity had in common, and awarded the coworker who knew the answer (they were all performance-based accounts) with a gift card to a local sandwich shop. Then she opened the floor for debate by asking, "Is that a good thing or a bad thing?"

"CFO of the day" has definitely been a good thing for DCI, which has been profitable ever since Levine instituted the program. Employees stay an average of five years, up from two-and-a-half years before the program. And customers are also sticking around longer—the length of the client relationship has doubled to over four years.

Levine has embraced the lessons of open management, or participative management, pioneered by Jack Stack and Springfield Remanufacturing Corporation. Whether the term is CFO for a day, participative or open-book management, or great game of business, the goal is to teach employees about business, thereby engaging them in the business. Companies that embrace these practices believe employees will be more productive if they understand financials and feel like owners. And in the example of DCI, employees are no longer bored during the financial review section of the monthly meeting.

Sources: Peter Carbonara, "Small Business Guide: What Owners Need to Know about Open-Book Management," *Forbes*, https://www.forbes.com, accessed January 19, 2018; Peter Carbonara, "Gaming the System: How a Traditional Manufacturer Opened Its Books and Turned Employees into Millionaires," *Forbes*, https://www.forbes.com, accessed January 19, 2018; Nadine Heintz, "Everyone's a CFO," *Inc.,* https://www.inc.com, accessed January 15, 2018; Bill Fotsch and John Case, "The Business Case for Open-Book Management," *Forbes*, https://www.forbes.com, accessed January 19, 2018; Louis Mosca, "The Dangers of Opening Your Books to Employees," *Forbes*, https://www.forbes.com, accessed January 19, 2018.

Critical Thinking Questions

1. Do you think a CFO-of-the-day program is a good idea for all companies? Why or why not?
2. How comfortable would you be leading the financial discussion at a monthly staff meeting? What could you do to improve your skills in this area?

Employee Ownership

A trend that seems to have leveled off is employee ownership, most commonly implemented as employee stock ownership plans, or *ESOP*s. ESOPs are not the same as stock options, however. In an ESOP, employees receive compensation in the form of company stock. Recall that stock options give employees the opportunity to purchase company stock at a set price, even if the market price of the stock increases above that point. Because ESOP employees are compensated with stock, over time they can become the owners of the company, an attractive exit strategy for current owners seeking a smooth transition. Behind employee ownership programs is the belief that employees who think like owners are more motivated to take care of customers' needs, reduce unnecessary expenses, make operations smoother, and stay with the company longer.



Exhibit 9.8: Companies sometimes create unusual perks to help attract and retain talented workers. Timberland employees receive a $3,000 subsidy to buy a hybrid automobile. Worthington Industries offers workers on-site haircuts for just $4. And at SC Johnson, retirees receive a lifetime membership to the company fitness center. One company even has a beer tap that it offers after 3 p.m. every Friday to get workers off to a relaxing weekend. *What trends are emerging in the ways companies seek to motivate workers and keep them happy on the job?* (Credit: nyuhuhuu/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

According to the National Center for Employee Ownership, there are roughly 6,717 ESOPs in the United States, with a total of 14 million participants.[21] Despite changes in tax laws that resulted in a decrease in the number of publicly traded companies with ESOPs and the closure of dubious plans, the amount of stock held by ESOPs continues to increase.[22] Multiple studies over 30 years conclude definitively that employee ownership results in a powerful competitive tool when combined with participative management.[23]

ESOPs, however, also have drawbacks. The biggest concern is that some employees have so much of their nest eggs tied to their company's ESOP. If the company's performance starts to decline, they risk losing a significant portion of their wealth. This is what happened at Piggly Wiggly Carolina, a chain of grocery stores. Business started to decline. Employee and retirees watched as senior management made decisions to raise prices and then sell stores. The share value started declining each year, losing 90

percent of its value, until employees received notice the company did not have enough value to pay distributions that year. The notice stated that trustees planned to continue selling assets in the hope of making future payments. Former employees filed a lawsuit alleging senior management decisions resulted in lining their own pockets at the cost of the company's value.[24]

Still, many companies successfully implement ESOPs. Axia Home Loans, a national residential mortgage lender based in Seattle, experienced record-breaking production and was able to attract top talent in the first year after creating its ESOP. After taking questions from non-managing shareholders about exit strategies, Gellert Dornay, president and CEO, looked into an ESOP and thought it would fit with the company's innovative and forward-thinking culture. "Studies show that employee-owned companies experience increased employee satisfaction, retention, and productivity gains," Dornay said, adding, "an ESOP rewards employees who contribute to the company's success by allowing them to share in the company's future increase in value."[25]

So what enables one company with an ESOP, such as Axia Home Loans, to be more successful than another, such as Piggly Wiggly? It has a lot to do with the way companies treat employees. You can't just call an employee an owner and expect them to respond positively. You have to do something to make them feel like an owner and then involve them as owners. Piggly Wigglyillustrates that employee ownership is not a magic elixir. "When employees run the company, our decision methodology is different. Everything is in the primary best interest of the shareholders, who are the employees," Dornay said.[26]

Work-Life Benefits

In another growing trend in the workplace, companies are helping their employees to manage the numerous and sometimes competing demands in their lives. Organizations are taking a more active role in helping employees achieve a balance between their work responsibilities and their personal obligations. The desired result is employees who are less stressed, better able to focus on their jobs, and, therefore, more productive. One tool companies are using to help their employees achieve work-life balance is the sabbatical. Sabbaticals can be traced back to the need for an incentive that would attract potential faculty members to Harvard University in the late 1800s. Today, sabbaticals can mean time off of a month or more, paid or unpaid. In today's business environment, companies are juggling cutting costs and increasing profits while simultaneously battling to keep employees motivated and positive about work. Sabbaticals can be an important tool to help managers achieve this balancing act.

Reports vary on whether the use of sabbaticals is rising or declining, but all agree that everyone benefits when employees take them.[27] One benefit is that employees return refreshed and recharged. Morris Financial Concepts, Inc., a small financial planning firm, offers all full-time employees a paid, month-long sabbatical every five years. Kyra Morris, president and owner, says employees were working during vacations, even when discouraged not to. They are required to unplug during sabbaticals. Morris says sabbaticals work for both millennials and older employees and are a great recruiting tool.[28] Zillow, the online real estate giant, offers six-week half-paid sabbaticals to employees at all levels of the organization after six years. Amy Bohutinsky, Zillow Group's chief operating officer, says the company wants to reward long-term employees, encourage them to have a life outside of work, and have them come back recharged.[29] Another benefit is the opportunity to learn new skills, which can be an alternative to layoffs. Buffer, a social media management platform, avoided laying off an employee by creating a 12-week, in-house sabbatical at 50 percent pay for him to learn new skills—skills the company needed—to successfully transition into another department. Learning sabbaticals fit the company's value of self-improvement.[30]

Nurturing Knowledge and Learning Workers

Most organizations have specialized workers, and managing them all effectively is a big challenge. In many companies, knowledge workers may have a supervisor, but they are not "subordinates." They are "associates." Within their area of knowledge, they are supposed to do the telling. Because knowledge is effective only if specialized, knowledge workers are not homogeneous, particularly the fast-growing group of knowledge technologists such as computer systems specialists, lawyers, programmers, and others. And because knowledge work is specialized, it is deeply splintered.

A knowledge-based workforce is qualitatively different from a less-skilled workforce. Increasingly, the success—indeed, the survival—of every business will depend on the performance of its knowledge workforce. The challenging part of managing knowledge workers is finding ways to motivate proud, skilled professionals to share expertise and cooperate in such a way that they advance the frontiers of their knowledge to the benefit of the shareholders and society in general. To achieve that auspicious goal, several companies have created what they call "communities of practice."



Exhibit 9.9: Employers seeking to stem the rising tide of absenteeism are developing innovative, flexible benefits for their employees. SC Johnson offers workers on-site childcare, an in-house doctor, and paternity leave. Prudential allows employees to take time off to care for sick children and elderly parents. Hewlett-Packard boasts a range of flexible work options to fit employees' hectic lives. *Do flexible options and benefits adequately address the root causes of absenteeism?* (Credit: MarylandGovPics/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Coping with the Rising Costs of Absenteeism

With today's companies trying to do more work with fewer employees, managers must be attentive to two major trends that affect the performance and morale of their employees: absenteeism and turnover. According to the Bureau of Labor Statistics, the absence rate for full-time workers has remained relatively steady in recent years, slightly below 3 percent, for absences due to the employee's own illness, injury, or medical problems; child care problems; other family or personal obligations; civic or military duty; and maternity or paternity leave.[31] Every day almost 3 percent of the full-time workforce does not show up for work, and this costs companies billions per year.[32] However, not all reasons for unscheduled absences are genuine. CareerBuilder, a global end-to-end human capital solutions company, reports that 40 percent of unscheduled absences in 2017 were due to employees calling in sick when not. The top two reasons employees gave were a doctor's appointment and just didn't feel like going to work. Needing to relax, needing to catch up on sleep, running errands, catching up on housework, and plans with family and friends were also listed.[33]

While some employees are taking a day off, employees covering for unscheduled absences are pushed to do more. The result is lower productivity and lower morale, especially if chronic absenteeism is not addressed. In addition to an attendance policy, offering incentives for attendance, wellness programs, employee assistance programs, and other benefits that show care for employees can lower absenteeism rates.[34]

MANAGING CHANGE

Using Communities of Practice to Motivate Knowledge Workers

Communities of practice (CoP) have been so named since the early 1990s as a way to motivate knowledge workers. One company that has experienced tremendous success with CoPs is Schlumberger Limited, an oil-field-services company with nearly $28 billion in annual revenue. As with all CoPs, what Schlumberger calls Eureka groups are comprised of similar professional employees from across the entire organization. Employees participate in one or more of 284 Eureka groups ranging from chemistry to oil-well engineering.

Before the establishment of the communities, Schlumberger's engineers, physicists, and geologists worked well on individual projects, but the company was ignorant of how to help its employees develop the professional sides of their lives. Since the company sells services and expertise, motivating and cultivating its knowledge workers was a critical success factor. Former CEO

Euan Baird felt he had tried everything to manage and motivate the company's technical professionals—and failed. That's when he decided to let them manage themselves. He ordered Schlumberger veteran Henry Edmundson to implement communities of practice.

Schlumberger's Eureka communities have been a tremendous success and helped the company leverage its knowledge assets. Today, self-created CVs are posted on the company's internal website, allowing employees across the 85 countries where the company operates to consult the résumé of nearly every company employee to find someone with a particular area of knowledge or expertise. Another reason the Eureka groups are so successful is that they are completely democratic. Participating employees vote on who will lead each community. An employee who is backed by his or her manager and at least one other community member can run for a term of office that lasts one year. The elected leaders of Schlumberger's Eureka communities cost the company about $1 million a year. "Compared with other knowledge initiatives, it's a cheapie," said Edmundson.

John Afilaka, a geological engineer who was a Schlumberger business-development manager in Nigeria, stood for election to the head of the company's rock-characterization community, a group of more than 1,000 people who are experts in determining what might be in an underground reservoir. He beat an opponent and spent 15 to 20 percent of his time organizing the group's annual conference and occasional workshops, overseeing the group's website, coordinating subgroups, and so forth.

Retired CEO Andrew Gould says the self-governing feature is crucial to the Eureka communities' success. Technical professionals are often motivated by peer review and peer esteem, he says, implying that stock options and corner offices aren't sufficient. The election of leaders, he says, "ensures the integrity of peer judgments."

Schlumberger's use of CoPs is known worldwide. The company has been cited a dozen times in the European MAKE (Most Admired Knowledge Enterprises) study and declared the overall winner three times, most recently in 2017.

Critical Thinking Questions

1. How do you think communities of practice help companies like Schlumberger manage in dynamic business environments?
2. Although communities of practice are commonly thought of in regard to knowledge workers, could they successfully motivate other employees as well? Why do you think as you do?

Sources: Rory L. Chase, "2017 European Most Admired Knowledge Enterprises MAKE Report," *Teleos—The KNOW Network*, http://www.theknowledgebusiness.com, accessed January 24, 2018; "Schlumberger Cited for Knowledge Management," https://www.slb.com, accessed January 24, 2018; "2016 Annual Report," Schlumberger Limited, 2017; "John Afilaka," www.zoominfo.com, accessed January 24, 2018; "RezFlo Services Company Limited," http://www.rezflo.com/, accessed January 24, 2018; Olivia Pulsinelli, "Reemerged Energy Co. Hires Halliburton Exec, Names Former Energy CEOs to Board," *Houston Business Journal*, https://www.bizjournals.com, accessed January 24, 2018.

Another trend related to employee morale and absenteeism is turnover. The number of employees who are job-searching is on the rise. A recent Gallup survey found that 51 percent of current employees are looking to leave their current job, but an IBM survey found only 16 percent are actively seeking new employment.[35] Both figures are great cause for concern. A high rate of turnover can be expensive and dampen the morale of other employees who watch their colleagues leave the company. The biggest reasons behind increasing turnover rates: career opportunities elsewhere and to get away from a bad manager.[36]

High rates of turnover (or absenteeism) at the management level can be destabilizing for employees, who need to develop specific strategies to manage a steady flow of new bosses. High rates of turnover (or absenteeism) at the employee level compromises the company's ability to perform at its highest levels. In order to stay competitive, companies need to have programs in place to motivate employees to come to work each day and to stay with the company year after year.

CONCEPT CHECK

1. What benefits can an organization derive from training and educational opportunities and stock ownership programs?
2. Why are sabbaticals growing in popularity as work-life balance tools?
3. How are knowledge workers different from traditional employees?
4. Why are absenteeism and turnover rates increasing, and what is the impact on companies?

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11: MARKETING

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11.1: The Marketing Concept

What is the marketing concept and relationship-building?

Marketing is the process of getting the right goods or services or ideas to the right people at the right place, time, and price, using the right promotion techniques and utilizing the appropriate people to provide the customer service associated with those goods, services, or ideas. This concept is referred to as the *"right" principle* and is the basis of all marketing strategy. We can say that **marketing** is finding out the needs and wants of potential buyers (whether organizations or consumers) and then providing goods and services that meet or exceed the expectations of those buyers. Marketing is about creating exchanges. An **exchange** takes place when two parties give something of value to each other to satisfy their respective needs or wants. In a typical exchange, a consumer trades money for a good or service. In some exchanges, nonmonetary things are exchanged, such as when a person who volunteers for the company charity receives a T-shirt in exchange for time spent. One common misconception is that some people see no difference between marketing and sales. They are two different things that are both part of a company's strategy. Sales incorporates actually selling the company's products or service to its customers, while marketing is the process of communicating the value of a product or service to customers so that the product or service sells.

To encourage exchanges, marketers follow the "right" principle. If a local Avon representative doesn't have the right lipstick for a potential customer when the customer wants it, at the right price, the potential customer will not exchange money for a new lipstick from Avon. Think about the last exchange (purchase) you made: What if the price had been 30 percent higher? What if the store or other source had been less accessible? Would you have bought anything? The "right" principle tells us that marketers control many factors that determine marketing success.

Most successful organizations have adopted the **marketing concept**. The marketing concept is based on the "right" principle. The marketing concept is the use of marketing data to focus on the needs and wants of customers in order to develop marketing strategies that not only satisfy the needs of the customers but also the accomplish the goals of the organization. An organization uses the marketing concept when it identifies the buyer's needs and then produces the goods, services, or ideas that will satisfy them (using the "right" principle). The marketing concept is oriented toward pleasing customers (be those customers organizations or consumers) by offering value. Specifically, the marketing concept involves the following:

- Focusing on the needs and wants of the customers so the organization can distinguish its product(s) from competitors' offerings. Products can be goods, services, or ideas.
- Integrating all of the organization's activities, including production and promotion, to satisfy these wants and needs
- Achieving long-term goals for the organization by satisfying customer wants and needs legally and responsibly

Today, companies of every size in all industries are applying the marketing concept. Enterprise Rent-A-Car found that its customers didn't want to have to drive to its offices. Therefore, Enterprise began delivering vehicles to customers' homes or places of work. Disney found that some of its patrons really disliked waiting in lines. In response, Disney began offering FastPass at a premium price, which allows patrons to avoid standing in long lines waiting for attractions. One important key to understanding the marketing concept is to know that using the marketing concept means the product is created *after* market research is used to identify the needs and wants of the customers. Products are not just created by production departments and then marketing departments are expected to identify ways to sell them based on the research. An organization that truly utilizes the marketing concept uses the data about potential customers from the very inception of the product to create the best good, service, or idea possible, as well as other marketing strategies to support it.

Customer Value

Customer value is the ratio of benefits for the customer (organization or consumer) to the sacrifice necessary to obtain those benefits. The customer determines the value of both the benefits and the sacrifices. Creating customer value is a core business strategy of many successful firms. Customer value is rooted in the belief that price is not the only thing that matters. A business that focuses on the cost of production and price to the customer will be managed as though it were providing a commodity differentiated only by price. In contrast, businesses that provide customer value believe that many customers will pay a premium for superior customer service or accept fewer services for a value price. It is important not to base value on price (instead of service or quality) because customers who only value price will buy from the competition as soon as a competitor can offer a lower price. It is much better to use marketing strategies based on customer relationships and service, which are harder for the

competition to replicate. Southwest Airlines doesn't offer assigned seats, meals, or in-flight movies. Instead the budget carrier delivers what it promises: on-time departures. In "service value" surveys, Southwest routinely beats the full-service airlines such as American Airlines, which actually provide passengers with luxuries such as movies and food on selected long-haul flights.

Customer Satisfaction

Customer satisfaction is a theme stressed throughout this text. **Customer satisfaction** is the customer's feeling that a product has met or exceeded expectations. Expectations are often the result of communication, especially promotion. Utilizing marketing research to identify specific expectations and then crafting marketing strategy to meet or exceed those expectations is a major contributor to success for an organization. Lexus consistently wins awards for its outstanding customer satisfaction. JD Powers surveys car owners two years after they make their purchase. Its Customer Satisfaction Survey is made up of four measures that each describe an element of overall ownership satisfaction at two years: vehicle quality/ reliability, vehicle appeal, ownership costs, and service satisfaction from a dealer. Lexus continues to lead the industry and has been America's top-ranked vehicle for five years in a row.[1]



Exhibit 11.2: Geico—the major auto insurer with the scaly mascot—famously boasts a 97 percent customer-satisfaction rating. Although the firm's claim may be exaggerated a bit, consumers get the message that Geico delivers quality insurance coverage at low prices. *In what way does the company's quirky and ubiquitous advertising—in which customers claim to have saved a bunch of money on car insurance by switching to Geico—influence customers' service expectations?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Building Relationships

Relationship marketing is a strategy that focuses on forging long-term partnerships with customers. Companies build relationships with customers by offering value and providing customer satisfaction. Once relationships are built with customers, customers tend to continue to purchase from the same company, even if the prices of the competitors are less or if the competition offers sales promotions or incentives. Customers (both organizations and consumers) tend to buy products from suppliers whom they trust and feel a kinship with, regardless of offerings of unknown competitors. Companies benefit from repeat sales and referrals that lead to increases in sales, market share, and profits. Costs fall because it is less expensive to serve existing customers than to attract new ones. Focusing on customer retention can be a winning tactic; studies show that increasing customer retention rates by 5 percent increases profits by anywhere from 25 to 95 percent.[2]

Customers also benefit from stable relationships with suppliers. Business buyers have found that partnerships with their suppliers are essential to producing high-quality products while cutting costs. Customers remain loyal to firms that provide them greater value and satisfaction than they expect from competing firms.

Frequent-buyer clubs are an excellent way to build long-term relationships. All major airlines have frequent-flyer programs. After you fly a certain number of miles, you become eligible for a free ticket. Now, cruise lines, hotels, car rental agencies, credit-card companies, and even mortgage companies give away "airline miles" with purchases. Consumers patronize the airline and its

partners because they want the free tickets. Thus, the program helps to create a long-term relationship with (and ongoing benefits for) the customer. Southwest Airlines carries its loyalty program a bit further than most. Members get birthday cards, and some even get profiled in the airline's in-flight magazine!

CONCEPT CHECK

1. Explain the marketing concept.
2. Explain the difference between customer value and customer satisfaction.
3. What is meant by relationship marketing?

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11.2: Creating a Marketing Strategy

How do managers create a marketing strategy?

What Is Marketing Strategy?

Marketers use a number of different "tools" to develop the products or services that meet the needs and wants of their customers, provide excellent value for the customers, and satisfy those customers. Marketing strategy is really five different components of marketing. These components are called "the **Five Ps**" of marketing. They are the methods, tools, and processes used by marketers to develop and market products. These five tools are also called "the marketing mix." These are the 5Ps:

- **Product:** Something offered in exchange and for which marketing actions are taken and marketing decisions made. Products can be goods (physical things such as smartphones) or services (such as the telecommunications that must be used for a smartphone to work) or ideas (such as the thought that being constantly connected through telecommunications is absolutely crucial in today's society). All products have both tangible and intangible aspects.
- **Price:** Something given in exchange for a product. Price may be monetary or nonmonetary (such as waiting in long lines for a restaurant or giving blood at the local blood bank). Price has many names, such as rent, fees, charges, and others.
- **Place:** Some method of getting the product from the creator of the product to the customer. Place includes a myriad of important tasks: transportation, location, supply chain management (managing each entity that deals with the product in its route to the buyer), online presence, inventory, and atmospherics (how the office, store, or even the website looks).
- **Promotion:** Methods for informing and influencing customers to buy the product. Promotion includes several different components – traditional advertising, sales promotion, public relations, personal selling, social media, and e-commerce. Promotion is often mistaken for marketing because it is the most visible part of marketing; however, marketing encompasses much more than just promotion.
- **People:** Methods of utilizing organization employees to support the marketing strategies of the company. All products have both tangible and intangible aspects. People (as a marketing strategy) are crucial to the development of the product's intangible aspects.

Marketers utilize the tools of marketing strategy to develop new products and sell them in the marketplace. But marketers cannot create products in isolation. Marketers must understand and consider all aspects of the external environment in order to create marketing programs (plans) that will be successful in the current market and in future markets. Thus, many organizations assemble a team of specialists to continually collect and evaluate environmental information, a process called **environmental scanning**. The goal in gathering the environmental data is to identify current and future market opportunities and threats.

Computer manufacturers understand the importance of environmental scanning to monitor rapidly changing consumer interests. Since the invention of the personal computer (PC), computer technicians and other enthusiasts have taken two things for granted: processor speeds will grow exponentially, and PCs will become indistinguishable from televisions. The result of this will be "convergence," which means that the digital industry (manufacturers of computers, smartphones, and other mobile devices) will merge together with entertainment (such as television, radio, streaming video, and the internet). This convergence is already creating great opportunities for new products—watches that have both computers and cell phones in them, cell phones used to download videos not available except by independent entertainment producers (who are not affiliated with traditional media) such as Amazon and Google.

One clear winner in this new world so far is Apple, which has leveraged its computer platform to make it easy and fashionable for consumers to become experts in the digital age. Apple has capitalized on this through the development of iTunes, the iPhone and iPads, and the iWatch. Apple sells almost as many iPads per quarter as it does Macintosh computers, and it certainly sells a massive number of iPhones. Microsoft wants in on this business badly, but Hewlett-Packard decided to shift its loyalty to Apple, so Microsoft doesn't have much leverage just now. The other company to watch over the next few years is Samsung, which has doubled its efforts to make its consumer electronics offerings strong competition to Apple products. Finally, the device-free streaming services such as Amazon Music, Pandora, and Spotify have provided competition to Apple while restoring profitability to the music industry.[3]

In general, six categories of environmental data shape most marketing decisions:

- *Cultural/social forces:* Includes such factors as the buying behaviors of specific cultures and subcultures, the values of potential customers, the changing roles of families, and other societal trends such as employees working from home and flexible work hours
- *Demographic forces:* Includes such factors as changes in the ages of potential customers (e.g., baby boomers, millennials), birth and death rates, and locations of various groups of people
- *Economic forces:* Includes such factors as changing incomes, unemployment levels, inflation, and recession
- *Technological forces:* Includes such factors as advances in telecommunications and computer technology
- *Political and legal forces:* Includes such factors as changes in laws, regulatory agency activities, and political movements
- *Competitive forces:* Includes such factors as new and shifting competition from domestic and foreign-based firms

Defining the Target Market

Marketers develop the information about the environment to get a clear picture of the total market for the product, including environmental factors. Once the marketers understand the various environmental factors, specific target markets must then be chosen from the total market. Marketers focus on providing value for a well-defined target market or target markets. The **target market** is the specific group of customers (which could be organizations or individual consumers) toward which a firm directs its marketing efforts. Quaker Oats targets its grits to blue-collar consumers in the South. Williams Sonoma has several different types of stores, each geared toward a distinct target market: Pottery Barn for upscale home furnishings; its specialty stores, West Elm, Mark and Graham, and Rejuvenation, that specialize in jewelry and other accessories; and home improvement and furnishings that are affordable and sustainable. These target markets are all part of the overall retail market for housewares and lifestyle. Identifying a target market helps a company focus its marketing efforts on those who are most likely to buy its products or services. Concentrating on potential customers lets the firm use its resources efficiently. Examples of the target markets for Marriott Hotel Brands' lodging alternatives are shown in Table 11.2.1.

Table 11.2.1: Creating a Competitive Advantage - Examples of Target Markets for Marriott Hotel Brands

	Price Range	Target Market
Fairfield Inn	$105–125	Economizing business and leisure travelers
Towne Place Suites	$110–140	Moderate-tier travelers who stay three to four weeks
SpringHill Suites	$120–165	Business and leisure travelers looking for more space and amenities
Courtyard	$120–170	Travelers seeking quality and affordable accommodations designed for the road warrior
Residence Inn	$126–175	Travelers seeking a residential-style hotel
Marriott Hotels, Resorts, and Suites	$135–410	Grounded achievers who desire consistent quality
Renaissance Hotels and Resorts	$135–415	Discerning business and leisure travelers who seek creative attention to detail
Ritz-Carlton	$295–1,500	Senior executives and entrepreneurs looking for a unique, luxury, personalized experience

Creating a Competitive Advantage

A **competitive advantage**, also called a *differential advantage*, is a set of unique features of a company and its products that are perceived by the target market(s) as significant and superior to those of the competition. Competitive advantage is the factor that causes customers to patronize a specific firm and not the competition. There are four types of competitive advantage: cost, product differentiation, service differentiation, and niche.

Cost Competitive Advantage

A firm that has a **cost competitive advantage** can produce a product or service at a lower cost than all its competitors while maintaining satisfactory profit margins. Firms become cost leaders by obtaining inexpensive raw materials, making plant

operations more efficient, designing products for ease of manufacture, controlling overhead costs, and avoiding marginal customers.

Over time, the cost competitive advantage may fail. Typically, if one firm is using an innovative technology to reduce its costs, then other firms in the industry will adopt this technology and reduce their costs as well. For example, Bell Labs invented fiber-optic cables that reduced the cost of voice and data transmission by dramatically increasing the number of calls that could be transmitted simultaneously through a two-inch cable. Within five years, however, fiber-optic technology had spread through the industry, and Bell Labs lost its cost competitive advantage. Firms may also lose their cost competitive advantage if competing firms match their low costs by using the same lower-cost suppliers. Therefore, a cost competitive advantage may not offer a long-term competitive advantage.

Product Differentiation Competitive Advantage

Because cost competitive advantages are subject to continual erosion, other types of competitive advantage tend to provide a longer-lasting competitive advantage. The durability of a **differential competitive advantage** can be more successful for the long-term viability of the company. Common differential advantages are brand names (Tide detergent), a strong dealer network (Caterpillar for construction equipment), product reliability (Lexus vehicles), image (Neiman Marcus in retailing), and service (Federal Express). Brand names such as Chanel, BMW, and Cartier stand for quality the world over. Through continual product and marketing innovations and attention to quality and value, marketers at these organizations have created enduring competitive advantages.

Service Differentiation Competitive Advantage

In today's world of instant connection and social media, services are crucial for both tangible and nontangible products. Almost every day, the media report the consequences of poor service that went "viral" on social media because the service interaction was videotaped and uploaded to the internet. Customers now demand a higher level of service for all kinds of products, and if the service level does not meet customer expectations, it is likely that the customer will post negative comments on a review site or upload the interaction to various social media platforms. Some small companies have had to close their doors on the basis of one poor service interaction that went viral. Service levels that delight customers are even more important for intangible products such as engineering and accounting. More than 80 percent of the U.S. GDP is based on services. The ability to create the service product, continually refine the service process, and interact with customers (co-creators of the service) is crucial. Higher-level services require more planning, better execution, and constant evolution through the relationships with the customers. The use of service differentiation as a competitive advantage can be one of the most enduring and viable types of advantage.

Niche Competitive Advantage

A company with a **niche competitive advantage** targets and effectively serves a single segment of the market. For small companies with limited resources that potentially face giant competitors, utilizing a niche competitive advantage may be the only viable option. A market segment that has good growth potential but is not crucial to the success of major competitors is a good candidate for a niche strategy. Once a potential segment has been identified, the firm needs to make certain it can defend against challengers through its superior ability to serve buyers in the segment. For example, Regions Bank–Music Row Private Bank follows a niche strategy with its concentration on country music stars and entertainment industry professionals in Nashville. Its office is in the heart of Nashville's music district. Music Row Private Bank has decided to expand its niche strategy to Miami, the "epicenter" of Latin music, and to Atlanta. The latter is a longtime rhythm-and-blues capital and now is the center of contemporary "urban" music. Both new markets have the kinds of music professionals—entertainers, record executives, producers, agents, and others—that have made Regions Bank–Music Row Private Bank so successful in Nashville.

CONCEPT CHECK

1. What is environmental scanning?
2. What is a target market, and why should a company have one?
3. Explain the four types of competitive advantages and provide examples of each.

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11.3: Developing a Marketing Mix

What is the marketing mix?

Once a firm has defined its target market and identified its competitive advantage, it can create the **marketing mix**, which is based on the 5Ps discussed earlier, that brings a specific group of consumers a product with superior value. Every target market requires a unique marketing mix to satisfy the needs of the target customers and meet the firm's goals. A strategy must be constructed for each of the 5Ps, and all strategies must be blended with the strategies of the other elements. Thus, the marketing mix is only as good as its weakest part. For example, an excellent product with a poor distribution system could be doomed to failure. An excellent product with an excellent distribution system but an inappropriate price is also doomed to failure. A successful marketing mix requires careful tailoring. For instance, at first glance you might think that McDonald's and Wendy's have roughly the same marketing mix. After all, they are both in the fast-food business. But McDonald's targets parents with young children through Ronald McDonald, heavily promoted children's Happy Meals, and in-store playgrounds. Wendy's is targeted to a more adult crowd. Wendy'shas no playgrounds, but it does have flat-screen TVs, digital menu boards, and comfy leather seating by a fireplace in many stores (a more adult atmosphere), and it has expanded its menu to include more items for adult tastes.

Product Strategy

Marketing strategy typically starts with the product. Marketers can't plan a distribution system or set a price if they don't know exactly what product will be offered to the market. Marketers use the term *product* to refer to *goods, services*, or even *ideas*.Examples of goods would include tires, MP3 players, and clothing. Goods can be divided into business goods (commercial or industrial) or consumer goods. Examples of services would be hotels, hair salons, airlines, and engineering and accounting firms. Services can be divided into consumer services, such as lawn care and hair styling, or professional services, such as engineering, accounting, or consultancy. In addition, marketing is often used to "market" ideas that benefit companies or industries, such as the idea to "go green" or to "give blood." Businesses often use marketing to improve the long-term viability of their industries, such as the avocado industry or the milk industry, which run advertising spots and post social media messages to encourage consumers to view their industries favorably. Thus, the heart of the marketing mix is the good, service, or idea. Creating a **product strategy**involves choosing a brand name, packaging, colors, a warranty, accessories, and a service program.

Marketers view products in a much larger context than is often thought. They include not only the item itself but also the brand name and the company image. The names Ralph Lauren and Gucci, for instance, create extra value for everything from cosmetics to bath towels. That is, products with those names sell at higher prices than identical products without the names. Consumers buy things not only for what they do, but also for what they mean.

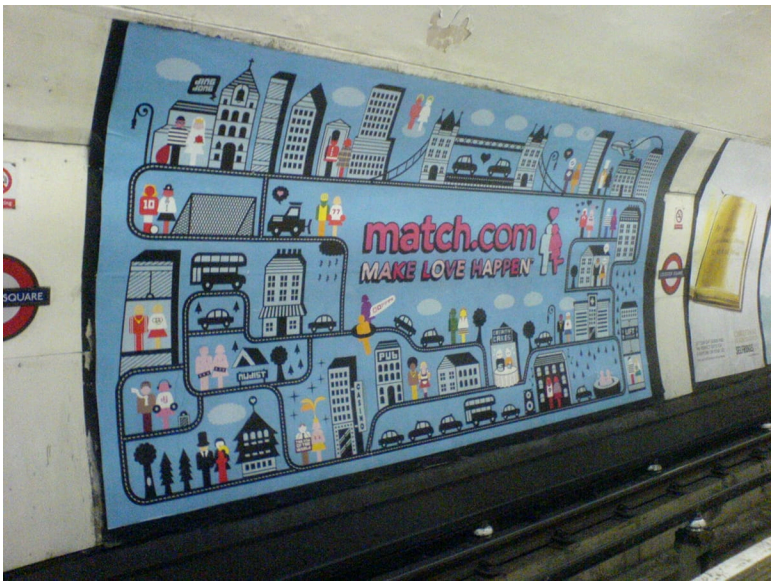


Exhibit 11.3: With their computerized profile-matching capabilities, online dating services are a high-tech way to make a love connection. Today's date-seeking singles want more than automated personals, however. They want advice from experts. At Match.com, popular shrink Dr. Phil guides subscribers toward healthy relationships. At eHarmony.com, Dr. Neil Clark Warren helps the lovelorn find a soulmate. *How do internet dating services use various elements of the marketing mix to bolster the effectiveness of their product strategies?* (Credit: Bixentro/ Flickr/ Attribution-2.0 Generic (CC BY 2.0))

Pricing Strategy

Pricing strategy is based on demand for the product and the cost of producing that product. However, price can have a major impact on the success of a product if the price is not in balance with the other components of the 5Ps. For some products (especially service products), having a price that is too low may actually hurt sales. In services, a higher price is often equated with higher value. For some types of specialty products, a high price is expected, such as prices for designer clothes or luxury cars. Even costume jewelry is often marked up more than 1000 percent over the cost to produce it because of the image factor of a higher price. Special considerations can also influence the price. Sometimes an introductory price is used to get people to try a new product. Some firms enter the market with low prices and keep them low, such as Carnival Cruise Lines and Suzuki cars. Others enter a market with very high prices and then lower them over time, such as producers of high-definition televisions and personal computers.

Place (Distribution) Strategy

Place (distribution) strategy is creating the means (the channel) by which a product flows from the producer to the consumer. Place includes many parts of the marketing endeavor. It includes the physical location and physical attributes of the business, as well as inventory and control systems, transportation, supply chain management, and even presence on the web. One aspect of distribution strategy is deciding how many stores and which specific wholesalers and retailers will handle the product in a geographic area. Cosmetics, for instance, are distributed in many different ways. Avon has a sales force of several hundred thousand representatives who call directly on consumers. Clinique and Estée Lauder are distributed through selected department stores. Cover Girl and Coty use mostly chain drugstores and other mass merchandisers. Redken products sell through hair salons. Revlon uses several of these distribution channels. For services, place often becomes synonymous with both physical location (and attributes of that location such as atmospherics) and online presence. Place strategy for services also includes such items as supply chain management. An example would be that an engineering firm would develop offices with lush interiors (to denote success) and would also have to manage the supplies for ongoing operations such as the purchase of computers for computer-aided drafting.

Promotion Strategy

Many people feel that promotion is the most exciting part of the marketing mix. **Promotion strategy** covers personal selling, traditional advertising, public relations, sales promotion, social media, and e-commerce. These elements are called the

promotional mix. Each element is coordinated with the others to create a promotional blend. An advertisement, for instance, helps a buyer get to know the company and paves the way for a sales call. A good promotional strategy can dramatically increase a firm's sales.

Public relations plays a special role in promotion. It is used to create a good image of the company and its products. Bad publicity costs nothing to send out, but it can cost a firm a great deal in lost business. Public relations uses many tools, such as publicity, crisis management strategy, and in-house communication to employees. Good publicity, such as a television or magazine story about a firm's new product, may be the result of much time, money, and effort spent by a public-relations department. Public-relations activities always cost money—in salaries and supplies. Public-relations efforts are the least "controllable" of all the tools of promotion, and a great deal of effort and relationship-building is required to develop the ongoing goodwill and networking that is needed to enhance the image of a company.

Sales promotion directly stimulates sales. It includes trade shows, catalogs, contests, games, premiums, coupons, and special offers. It is a direct incentive for the customer to purchase the product immediately. It takes many forms and must adhere to strict laws and regulations. For example, some types of contests and giveaways are not allowed in all the states within the United States. McDonald's discount coupons and contests offering money and food prizes are examples of sales promotions.

Social media is a major element of the promotion mix in today's world. Most businesses have a corporate website, as well as pages on different social media sites such as Facebook, Pinterest, and Twitter. Social media is more powerful as a channel for getting the company's message out to the target market (or general public) than traditional advertising, especially for some target markets. Companies (and even individuals) can use social media to create instant branding. E-commerce is the use of the company website to support and expand the marketing strategies of the 5Ps. It can include actual "order online" capabilities, create online communities, and be used to collect data from both existing and potential customers. Some e-commerce websites offer free games and other interactive options for their customers. All of this activity helps to build and strengthen the long-term relationships of customers with the company.

Not-for-Profit Marketing

Profit-oriented companies are not the only ones that analyze the marketing environment, find a competitive advantage, and create a marketing mix. The application of marketing principles and techniques is also vital to not-for-profit organizations. Marketing helps not-for-profit groups identify target markets and develop effective marketing mixes. In some cases, marketing has kept symphonies, museums, and other cultural groups from having to close their doors. In other organizations, such as the American Heart Association, marketing ideas and techniques have helped managers do their jobs better. In the private sector, the profit motive is both an objective for guiding decisions and a criterion for evaluating results. Not-for-profit organizations do not seek to make a profit for redistribution to owners or shareholders. Rather, their focus is often on generating enough funds to cover expenses or generating enough funds to expand their services to assist more people. For example, the Methodist Church does not gauge its success by the amount of money left in offering plates. The Museum of Science and Industry does not base its performance evaluations on the dollar value of tokens put into the turnstile. An organization such as the American Red Cross raises funds to provide basic services, but if enough funds are raised (beyond just the amount to cover expenses), those funds are used to expand services or improve current services.

CONCEPT CHECK

1. What is meant by the marketing mix?
2. What are the components of the marketing mix?
3. How can marketing techniques help not-for-profit organizations?

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11.4: Buyer Behavior

How do consumers and organizations make buying decisions?

An organization that wants to be successful must consider buyer behavior when developing the marketing mix. **Buyer behavior** is the actions people take with regard to buying and using products. Marketers must understand buyer behavior, such as how raising or lowering a price will affect the buyer's perception of the product and therefore create a fluctuation in sales, or how a specific review on social media can create an entirely new direction for the marketing mix based on the comments (buyer behavior/input) of the target market.

To understand buyer behavior, marketers must understand how customers make buying decisions. Consumers and businesses have processes for making decisions about purchases. These decision-making processes are affected by cultural, social, individual, and psychological factors. The consumer decision-making process has several steps, which are shown in **Exhibit 11.4**.

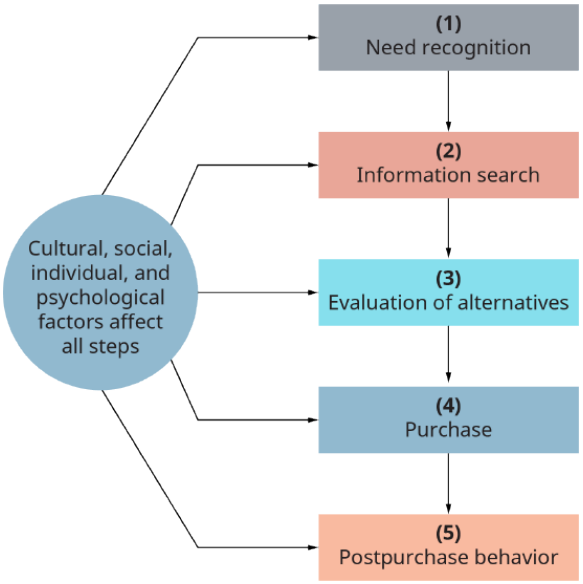


Exhibit 11.4: **Consumer Purchase Decision-Making Process** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

The process starts with need recognition. Need recognition could be as simple as running out of coffee. Need recognition could also take place over several months, such as when repeated car repairs influence a consumer to make a decision to buy a new car. (Step 1 in **Exhibit 11.4**).

Next, the buyer gathers information. If the consumer is making a decision to purchase a house, he or she might research information about financing, available homes, styles, locations, and so forth (Step 2). Once the consumer has gathered the information, he or she must evaluate alternatives (Step 3). For example, a consumer might eliminate all homes that cost over $150,000 or are more than a 30-minute drive to work. After evaluating the alternatives, the consumer will make a decision based on those alternatives. Then the consumer makes the purchase decision, the decision to buy or not to buy (Step 4). Finally, the consumer assesses the decision itself and his or her satisfaction with the purchase, which would include not only the home, but the buying experience as well (Step 5).

Influences on Consumer Decision-Making

Cultural, social, individual, and psychological factors have an impact on consumer decision-making from the time a person recognizes a need through post-purchase behavior. We will examine each of these factors in more detail. It is important to understand the relevance of these influences on consumer decision-making.

Culture

Purchase roles within the family are influenced by culture. **Culture** is the set of values, ideas, attitudes, and symbols created to shape human behavior. Culture is the part of customs and traditions of a group of people that is transformed into its art, food, costumes/clothing, architecture, and language, as well as other unique manifestations of a specific group of related individuals. Culture is environmentally oriented. For example, the nomads of Finland have developed a culture for Arctic survival. Similarly, the natives of the Brazilian jungle have created a culture suitable for jungle living.

Culture by definition is social in nature. It is human interaction that creates values and prescribes acceptable behavior. Culture gives order to society by creating common expectations. Sometimes these expectations are codified into law; for example, if you come to a red light, you stop the car. In some cultures, a young man undergoes a special rite of passage from youth into adulthood (such as a bar mitzvah in Jewish culture). In other cultures, young women have a rite of passage but young men do not (such as a quinceañera in Hispanic culture). As long as a value or belief meets the needs of society, it will remain part of the culture. If it is no longer functional, the value or belief fades away. For example, the value that very large families are "good" is no longer held by a majority of Americans. This is because most Americans live in an urban rather than a rural environment, and children are no longer needed to perform farm chores.

Social Factors

Most consumers are likely to seek out the opinions of others to reduce their search and evaluation effort or uncertainty, especially as the perceived risk of the decision increases. Consumers may also seek out others' opinions for guidance on new products or services, products with image-related attributes, or products where attribute information is lacking or uninformative. Specifically, consumers interact socially with reference groups, opinion leaders, and family members to obtain product information and decision approval. All the formal and informal groups that influence the buying behavior of an individual are considered that person's **reference groups**. Consumers may use products or brands to identify with or become a member of a group. They learn from observing how members of their reference groups consume, and they use the same criteria to make their own consumer decisions. A reference group might be a fraternity or sorority, a group you work with, or a club to which you belong.

Individual Influences

A person's buying decisions are also influenced by personal characteristics unique to each individual, such as gender and personality. Individual characteristics are generally stable over the course of one's life. For instance, most people do not change their gender, and the act of changing personality requires a complete reorientation of one's life.

Physiological differences between men and women result in different needs, such as health and beauty products. Just as important are the distinct cultural, social, and economic roles played by men and women and the effects that these have on their decision-making processes. Men and women also shop differently. Studies show that men and women share similar motivations in terms of where to shop—that is, seeking reasonable prices, merchandise quality, and a friendly, low-pressure environment—but they don't necessarily feel the same about shopping in general. Most women enjoy shopping; their male counterparts claim to dislike the experience and shop only out of necessity. Furthermore, men desire simple shopping experiences, stores with less variety, and convenience. When it comes to online shopping, gender differences continue. According to recent research, women tend to shop based on their future needs, while men tend to shop when their need is immediate. In addition, women tend to make impulse buys more frequently than men, who tend to think logically when making purchase decisions.[4]

Each consumer has a unique personality. **Personality** is a broad concept that can be thought of as a way of organizing and grouping how an individual typically reacts to situations. Thus, personality combines psychological makeup and environmental forces. It includes people's underlying dispositions, especially their most dominant characteristics. Although personality is one of the least useful concepts in the study of consumer behavior, some marketers believe that personality influences the types and brands of products purchased. For instance, the type of car, clothes, or jewelry a consumer buys may reflect one or more personality traits.

Psychological Influences

An individual's buying decisions are further influenced by psychological factors such as perception, beliefs, and attitudes. These factors are what consumers use to interact with their world. They are the tools consumers use to recognize their feelings, gather and analyze information, formulate thoughts and opinions, and take action. Unlike the other three influences on consumer

behavior, psychological influences can be affected by a person's environment because they are applied on specific occasions. For example, individuals will perceive different stimuli and process these stimuli in different ways depending on whether the individual is sitting in class concentrating on an instructor's lecture, sitting outside of class talking to friends, or sitting at home watching television.

B2B Purchase Decision-Making

Business-to-business (B2B) buyer behavior and business markets are different from consumer markets. Business markets include institutions such as hospitals and schools, manufacturers, wholesalers and retailers, and various branches of government. The key difference between a consumer product and a business product is the intended use. For example, if a consumer purchases a certain brand of computer for use at home, it is considered a consumer good. If a purchasing agent for Netflix buys exactly the same computer for Netflix scriptwriter, it is considered a business good. Why? The reason is that Netflix is a business, so the computer will be used in a business environment.

The Decision-Making Process

The purchases that organizations make often involve greater risk than purchases made by individual consumers. For this reason, businesses (and other organizations) tend to base purchase decisions on more data and make purchase decisions based on rational decision-making so purchases will optimize value for the organization and minimize risk. For this reason, the business purchase decision-making process differs from the consumer process. The steps are similar: need recognition, setting specifications, information search (including identification of suppliers), evaluation (including evaluation of suppliers), purchase ("go or no-go"), and post-purchase evaluation. The major difference between the two processes is that businesses decide beforehand what exactly is needed on the purchase (setting specifications) and then seek information regarding products that meet those specifications. In this way, the purchases are more likely to satisfy the needs of the overall organization, thus reducing the risk.

Characteristics of the B2B Market

The main differences between consumer markets and business markets include the following:

1. *Purchase volume:* Business customers buy in much larger quantities than consumers. Mars must purchase many truckloads of sugar to make one day's output of M&Ms. Home Depot buys thousands of batteries each day for resale to consumers. The federal government must use (and purchase) millions of pens each day.
2. *Number of customers:* Business marketers usually have far fewer customers than consumer marketers. As a result, it is much easier to identify prospective buyers and monitor current needs. For example, there are far fewer customers for airplanes or industrial crane companies than there are for consumer goods companies since there are more than 125 million consumer households in the United States.
3. *Location of buyers:* Business customers tend to be much more geographically concentrated than consumers. The computer industry is concentrated in Silicon Valley and a few other areas. Aircraft manufacturing is found in Seattle, Washington; St. Louis, Missouri; and Dallas/Fort Worth, Texas. Suppliers to these manufacturers often locate close to the manufacturers to lower distribution costs and facilitate communication.
4. *Direct distribution:* Business sales tend to be made directly to the buyer because such sales frequently involve large quantities or custom-made items such as heavy machinery. Consumer goods are more likely to be sold through intermediaries such as wholesalers and retailers.

CONCEPT CHECK

1. Explain the consumer purchase decision-making process.
2. Explain the differences between the business purchase decision-making process and the consumer purchase decision-making process.
3. How do business markets differ from consumer markets?

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11.5: Market Segmentation

What are the five basic forms of consumer and business market segmentation?

Most organizations cannot target the total market for a specific product. For each separate part of the market that an organization wants to target, a marketing mix (a set of 5Ps) must be created. It would be very expensive to try to create a marketing mix for every part of the target market. Instead, companies cut up those targets into specific "segments" of the market that the organization is more strategically positioned to be successful in targeting. Segmentation also varies based on the target market being a consumer market or a business market.

The study of buyer behavior helps marketing managers better understand why people make purchases. To identify the target markets that may be most profitable for the firm, marketers use **market segmentation**, which is the process of separating, identifying, and evaluating the layers of a market to identify a target market. For instance, a target market might be segmented into two groups: families with children and families without children. Families with young children are likely to buy hot cereals and presweetened cereals. Families with no children are more likely to buy health-oriented cereals. Cereal companies plan their marketing mixes with this difference in mind. A business market may be segmented by large customers and small customers or by geographic area.

The five basic forms of consumer market segmentation are demographic, geographic, psychographic, benefit, and volume. Their characteristics are summarized in Table 11.2 and discussed in the following sections.

Demographic Segmentation

Demographic segmentation uses categories such as age, education, gender, income, and household size to differentiate among markets. This form of market segmentation is the most common because demographic information is easy to obtain. The U.S. Census Bureau provides a great deal of demographic data, especially about metropolitan areas. For example, marketing researchers can use census data to find areas within cities that contain high concentrations of high-income consumers, singles, blue-collar workers, and so forth. However, even though demographic information is easier to obtain than other types of information, it may not always be the best approach to segmentation because it is limited on what it can reveal about consumers.

Table 11.2: Forms of Consumer Market Segmentation

Form General	Characteristics
Demographic segmentation	Age, education, gender, income, race, social class, household size
Geographic segmentation	Regional location (e.g., New England, Mid-Atlantic, Southeast, Great Lakes, Plains States, Northwest, Central, Southwest, Rocky Mountains, Far West), population density (urban, suburban, rural), city or county size, climate
Psychographic segmentation	Lifestyle, personality, interests, values, attitudes
Benefit segmentation	Benefits provided by the good or service
Volume segmentation	Amount of use (light versus heavy)

Many products are targeted to various age groups. Most music CDs, Pepsi, Coke, many movies, the Honda Fit, and thousands of other products are targeted toward teenagers and persons under 25 years old. In contrast, most cruises, medical products, fine jewelry, vacation homes, Teslas, and denture products are targeted toward people 50 years old and up. An example of how Frito Lay targets various age groups for three of its most popular products is shown in Table 11.3.

Table 11.3: Age Segmentation for Fritos, Doritos, and Tostitos - Source: Adapted from Frito Lay website, accessed October 1, 2017.

	Name Derivation	Year Introduced	Main Ingredients	Demographic	Niche, According to Frito Lay
Fritos	"Little fried bits" (Spanish)	1932	Corn, vegetable oil, salt	33- to 51-year-old males	"Hunger satisfaction"
Doritos	"Little bits of gold"	1964	Corn, vegetable oil, cheddar cheese, salt	Teens, mostly males	"Bold and daring snacking"
Tostitos	"Little toasted bits" (Spanish)	1981	White corn, vegetable oil, salt	Upscale consumers born between 1946 and 1964	"Casual interaction through friends and family . . . a social food that brings people together"

Income is another popular way to segment markets. Income level influences consumers' wants and determines their buying power. Housing, clothing, automobiles, and alcoholic beverages are among the many markets segmented by income. Budget Gourmet frozen dinners are targeted to lower-income groups, whereas the Stouffer's line and California Pizza Kitchen frozen pizzas are aimed at higher-income consumers.

Geographic Segmentation

Geographic segmentation means segmenting markets by region of the country, city or county size, market density, or climate. *Market density* is the number of people or businesses within a certain area. Many companies segment their markets geographically to meet regional preferences and buying habits. Pizza Hut, for instance, gives easterners extra cheese, westerners more ingredients, and midwesterners both. Both Ford and Chevrolet sell more pickup trucks and truck parts in the middle of the country than on either coast. The well-defined "pickup truck belt" runs from the upper Midwest south through Texas and the Gulf states. Ford"owns" the northern half of this truck belt and Chevrolet the southern half.

Psychographic Segmentation

Race, income, occupation, and other demographic variables help in developing strategies but often do not paint the entire picture of consumer needs. Demographics provide basic data that can be observed about individuals, but psychographics provide vital information that is often much more useful in crafting the marketing message. Demographics provide the skeleton, but psychographics add meat to the bones. **Psychographic segmentation** is market segmentation by personality or lifestyle. People with common activities, interests, and opinions are grouped together and given a "lifestyle name." For example, Harley-Davidsondivides its customers into seven lifestyle segments, from "cocky misfits" who are most likely to be arrogant troublemakers, to "laid-back camper types" committed to cycling and nature, to "classy capitalists" who have wealth and privilege. Two different managers could be described by demographics as male, managers, 35 years old, with $80,000 per year income. A marketer who just saw the demographics might create one advertisement to reach both of them. However, if the marketer knew that one of the managers was president of his homeowner's association and captain of a rugby league team and the other manager was a holder of opera season tickets and president of the Friends of the Public Library, the messages might be designed very differently in order to be more successful.

Benefit Segmentation

Benefit segmentation is based on what a product will do rather than on consumer characteristics. For years Crest toothpaste was targeted toward consumers concerned with preventing cavities. Recently, Crest subdivided its market. It now offers regular Crest, Crest Tartar Control for people who want to prevent cavities and tartar buildup, Crest for kids with sparkles that taste like bubble gum, and another Crest that prevents gum disease. Another toothpaste, Topol, targets people who want whiter teeth—teeth without coffee, tea, or tobacco stains. Sensodyne toothpaste is aimed at people with highly sensitive teeth.

Volume Segmentation

The fifth main type of segmentation is **volume segmentation**, which is based on the amount of the product purchased. Just

about every product has heavy, moderate, and light users, as well as nonusers. Heavy users often account for a very large portion of a product's sales. Thus, a firm might want to target its marketing mix to the heavy-user segment. For example, in the fast-food industry, the heavy user (a young, single male) accounts for only one in five fast-food patrons. Yet this heavy user makes over 60 percent of all visits to fast-food restaurants.

Retailers are aware that heavy shoppers not only spend more, but also visit each outlet more frequently than other shoppers. Heavy shoppers visit the grocery store 122 times per year, compared with 93 annual visits for the medium shopper. They visit discount stores more than twice as often as medium shoppers, and they visit convenience/gas stores more than five times as often. On each trip, they consistently spend more than their medium-shopping counterparts.

Business Market Segmentation

Business markets are segmented differently than consumer markets. Business markets may segment based on geography, volume, and benefits, just as consumer markets are. However, organizations might also segment based on use of the product (such as a petrochemical company having one market segment for purchasers who use polyethylene for instrumentation panels and one for purchasers who use polyethylene for car seats), characteristics of purchasing function (such as purchasing committees, purchasing managers, or purchasing departments), size of the client (one segment for large customers who have different needs than smaller customers), or industry (such as segmenting food systems into restaurants or government agencies such as schools or military bases), as well as other considerations related to characteristics of business customers.

Using Marketing Research to Serve Existing Customers and Find New Customers

How do successful companies learn what their customers value? Through marketing research, companies can be sure they are listening to the voice of the customer. **Marketing research** is the process of planning, collecting, and analyzing data relevant to a marketing decision. The results of this analysis are then communicated to management. The information collected through marketing research includes the preferences of customers, the perceived benefits of products, and consumer lifestyles. Research helps companies make better use of their marketing budgets. Marketing research has a range of uses, from fine-tuning existing products to discovering whole new marketing concepts.

For example, everything at the Olive Garden restaurant chain, from the décor to the wine list, is based on marketing research. Each new menu item is put through a series of consumer taste tests before being added to the menu. Hallmark Cards uses marketing research to test messages, cover designs, and even the size of the cards. Hallmark's experts know which kinds of cards will sell best in which places. Engagement cards, for instance, sell best in the Northeast, where engagement parties are popular. Birthday cards for "Daddy" sell best in the South because even adult southerners tend to call their fathers Daddy.

Marketing research can use either primary data (where the organization actually gets the data and analyzes it) or secondary data (where the organization uses data that has already been developed and published by another entity and the organization is able to utilize the data for its own purposes). There are three basic research methods used for gathering primary data: survey, observation, and experiment.

With **survey research**, data is gathered from respondents—in person, through the internet, by telephone, or by mail—to obtain facts, opinions, and attitudes. A questionnaire is used to provide an orderly and structured approach to data-gathering. Face-to-face interviews may take place at the respondent's home, in a shopping mall, or at a place of business.

Observation research is research that monitors respondents' actions without direct interaction. In the fastest-growing form of observation research, researchers use cash registers with scanners that read tags with bar codes to identify the item being purchased. Technological advances are rapidly expanding the future of observation research. Arbitron research has developed a portable people meter (PPM) about the size of a cell phone that research participants clip to their belts or any article of clothing. They agree to wear it during all waking hours. Before the study participants go to sleep, they put the PPM in a cradle that automatically sends data back to Arbitron (now Nielsen Audio). The PPM will tell the marketing research company exactly which television programs the person watched and for how long. It also records radio programs listened to, any web streaming, supermarket piped-in music, or any other electronic media that the research participant encountered during the day.[5]

In the third research method, **experiment**, the investigator changes one or more variables—price, package, design, shelf space, advertising theme, or advertising expenditures—while observing the effects of those changes on another variable (usually sales).

The objective of experiments is to measure causality. For example, an experiment may reveal the impact that a change in package design has on sales.

CONCEPT CHECK

1. Define market segmentation.
2. List and discuss the five basic forms of consumer market segmentation.
3. What are some additional forms of business segmentation?
4. How does marketing research help companies make better use of their marketing budgets?

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11.6: What Is a Product?

6. What is a product, and how is it classified?

The goal of marketing research is to create products that are desired by the target market(s) chosen as strategic markets in line with the organization's goals. In marketing, a **product** (a good, service, or idea), along with its perceived attributes and benefits, creates value for the customer. Attributes can be tangible or intangible. Among the tangible attributes are packaging and warranties as illustrated in **Exhibit 11.5**. Intangible attributes are symbolic, such as brand image. Intangible attributes can include things like image as well as the depth of the relationship between a service provider and a customer. People make decisions about which products to buy after considering both tangible and intangible attributes of a product. For example, when a consumer buys a pair of jeans, he or she considers price, brand, store image, and style before making the purchase. These factors are all part of the marketing mix.

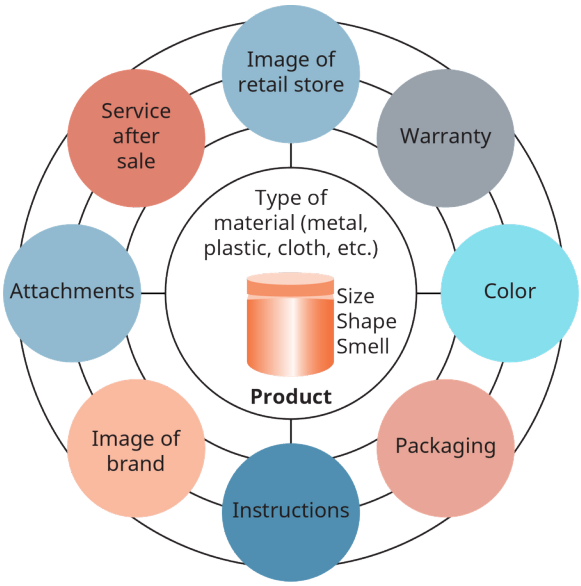


Exhibit 11.5: **T**angible and Intangible Attributes of a Product Create Value (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Classifying Consumer Products

Consumers are really buying packages of benefits that deliver value, which always includes some tangible aspects and some intangible aspects. The person who buys a plane ride on United Airlines is looking for a quick way to get from one city to another (the benefit). Providing this benefit requires a tangible part of the product (a plane) and an intangible part of the product (ticketing, maintenance, and piloting services). A person who purchases accounting services buys the benefit of having taxes completed on the correct tax form (tangible part of the service) and having the taxes prepared correctly by a trusted person (intangible part of the service).

Marketers must know how consumers view the types of products their companies sell so that they can design the marketing mix to appeal to the selected target market. To help them define target markets, marketers have devised product categories. Products that are bought by the end user are called *consumer products*. They include electric razors, sandwiches, cars, stereos, magazines, and houses. Consumer products that get used up, such as Nexxus shampoo and Lay's potato chips, are called *consumer nondurables*. Those that last for a long time, such as Whirlpool washing machines and Apple computers, are *consumer durables*.

Another way to classify consumer products is by the amount of effort consumers are willing to make to acquire them. The four major categories of consumer products are unsought products, convenience products, shopping products, and specialty products, as summarized in Table 11.4. **Unsought products** are products unplanned by the potential buyer or known products that the buyer

does not actively seek.

Convenience products are relatively inexpensive items that require little shopping effort. Soft drinks, candy bars, milk, bread, and small hardware items are examples. Consumers buy them routinely without much planning. This does not mean that such products are unimportant or obscure. Many, in fact, are well known by their brand names—such as Pepsi-Cola, Pepperidge Farm breads, Domino's pizza, Sure deodorant, and UPS shipping.

In contrast to convenience products, **shopping products** are bought only after a brand-to-brand and store-to-store comparison of price, suitability, and style. Examples are furniture, automobiles, a vacation in Europe, and some items of clothing. Convenience products are bought with little planning, but shopping products may be purchased after months or even years of search and evaluation.

Specialty products are products for which consumers search long and hard and for which they refuse to accept substitutes. Expensive jewelry, designer clothing, state-of-the-art stereo equipment, limited-production automobiles, and gourmet restaurants fall into this category. Because consumers are willing to spend much time and effort to find specialty products, distribution is often limited to one or two sellers in a given region, such as Neiman-Marcus, Gucci, or a Porsche dealer.

Table 11.4: Classification of Consumer Products by the Effort Expended to Buy Them

Consumer	Product Examples	Degree of Effort Expended by Consumer
Unsought products	Life insurance	No effort
	Burial plots	Some to considerable effort
	Time-share condos	Some to considerable effort
Convenience products	Soft drinks	Very little or minimum effort
	Bread	Very little or minimum effort
	Milk	Very little or minimum effort
	Coffee	Very little or minimum effort
Shopping products	Automobiles	Considerable effort
	Homes	Considerable effort
	Vacations	Considerable effort
Specialty products	Expensive jewelry	Maximum effort
	Gourmet restaurants	Maximum effort
	Limited-production automobiles	Maximum effort

CUSTOMER SATISFACTION AND QUALITY

Ferrari Targets Successful Consumers

Kevin Crowder walked onto the famed Monza, Italy, race track, climbed into a Ferrari F2000 racer, and circled the course with a Grand Prix champion. Mr. Crowder, a Texas businessman who earned millions when he sold a software company he cofounded, isn't himself a professional driver. He's a customer of one of Ferrari's marketing programs: the F-1 Clienti program, under which Ferrari resurrects old race cars that would otherwise be headed for the scrap heap. Instead, it sells them for $1 million or more, along with the chance to drive them with a professional pit crew's help.

Ferrari has long built its business around exclusivity. It limits production to around 4,500 to 5,000 cars a year at around $180,000 and up. Some customers pay additional money to race these street cars against fellow owners at company-sponsored Ferrari Challenge events. The F-1 Clienti program adds a super-premium service by giving people a chance to drive the same Ferraris used in Formula One, a series of auto races that are especially popular among Europeans.

The program gives customers "an experience they can't get elsewhere," says Ferrari CEO Dieter Knechtel. Mr. Knechtel says that the "brand experience is very much related to the ownership experience: It's about driving and the experience of the car while

doing it in a community of like-minded people. This is why, we organise track days and tours in Italy with road tours in different countries, we can organise almost any experience with the car—what we offer to our customers is often a 'money can't buy' experience."

Critical Thinking Questions

1. For Mr. Crowder, the Ferrari is a specialty good. What kind of product would it be for you? Why?
2. Do you think that Ferrari has done a good job of building brand loyalty? Could Ford do the same thing?

Sources: "Corse Clienti: Overview," http://races.ferrari.com, accessed October 8, 2017; James Allen, "Ferrari's F1 Clienti Is the World's Ultimate Used Car Buying Program," *Car Buzz,* http://www.carbuzz.com, accessed October 8, 2017; Jonathan Ho, "Ferrari Celebrates 70 Years," *Luxuo,* http://www.luxuo.com, July 13, 2017; Jonathan Welsh, "Checkered-Flag Past Helps Ferrari Unload a Fleet of Used Cars," *The Wall Street Journal,* January 11, 2005, pp. A1, A10.

Classifying Business Products

Products bought by businesses or institutions for use in making other products are called *business products*. These products can be commercial, industrial, or services products. A commercial product would be an 18-wheeler truck used by a major transportation company as part of the business. An industrial product might be a major robotics installation in a state-of-the-art manufacturing facility. A services product (for business) might be telecommunications consulting for a large corporation setting up offices in Singapore. Business products are classified as either capital products or expense items. **Capital products** are usually large, expensive items with a long life span. Examples are buildings, large machines, and airplanes. **Expense items** are typically smaller, less expensive items that usually have a life span of less than a year. Examples are printer cartridges and paper. Industrial products are sometimes further classified in the following categories:

1. *Installations:* These are large, expensive capital items that determine the nature, scope, and efficiency of a company. Capital products such as General Motors' truck assembly plant in Fort Wayne, Indiana, represent a big commitment against future earnings and profitability. Buying an installation requires longer negotiations, more planning, and the judgments of more people than buying any other type of product.
2. *Accessories:* Accessories do not have the same long-run impact on the firm as installations, and they are less expensive and more standardized. But they are still capital products. Minolta photocopy machines, HP laptops, and smaller machines such as Black & Decker table drills and saws are typical accessories. Marketers of accessories often rely on well-known brand names and extensive advertising as well as personal selling.
3. *Component parts and materials:* These are expense items that are built into the end product. Some component parts are custom-made, such as a drive shaft for an automobile, a case for a computer, or a special pigment for painting U.S. Navyharbor buoys; others are standardized for sale to many industrial users. Intel's Pentium chip for PCs and cement for the construction trade are examples of standardized component parts and materials.
4. *Raw materials:* Raw materials are expense items that have undergone little or no processing and are used to create a final product. Examples include lumber, copper, and zinc.
5. *Supplies:* Supplies do not become part of the final product. They are bought routinely and in fairly large quantities. Supply items run the gamut from pencils and paper to paint and machine oil. They have little impact on the firm's long-run profits. Bic pens, Champion copier paper, and Pennzoil machine oil are typical supply items.
6. *Services*. These are expense items used to plan or support company operations—for example, janitorial cleaning and management consulting services.

CONCEPT CHECK

1. What is a product?
2. What are the classes of consumer products?
3. Explain how business products are classified.

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11.7: Creating Products That Deliver Value

How do organizations create new products?

New products pump life into company sales, enabling the firm not only to survive but also to grow. Companies like Allegheny Ludlum (steel), Dow (chemicals), Samsung (electronics), Campbell Soup (foods), and Stryker (medical products) get most of their profits from new products. Companies that lead their industries in profitability and sales growth get a large percentage of their revenues from products developed within the last five years. A recent McKinsey survey found that 94 percent of top executives believed that their companies' innovation approach and process needed to be updated, signaling how important new products are as the lifeblood of a company.[6]

Marketers have several different terms for new products, depending on how the product fits into a company's existing product line. When a firm introduces a product that has a new brand name and is in a product category new to the organization, it is classified as a new product.

A new flavor, size, or model using an existing brand name in an existing category is called a **line extension**. Diet Cherry Coke and caffeine-free Coke are line extensions. The strategy of expanding the line by adding new models has enabled companies like Seiko (watches), Kraft (cheeses), Oscar Mayer (lunch meats), and Sony (consumer electronics) to tie up a large amount of shelf space and brand recognition in a product category. Crayola now offers Crayola bubble bath shampoo. Services companies also develop new products—new services based on market research—or make changes in ongoing services. Services companies can often introduce and adapt their products faster than companies that manufacture goods because service delivery can be more flexible and changes can often be made immediately. Due to this, customers often expect and require immediate improvements to services.

How New Products Are Developed

Developing new products is both costly and risky, especially for companies that sell products that are goods. New-product failure rates for household and grocery products can approach 80 percent. Overall, companies report that only 3 percent of their products exceed their initial sales targets in Year 1. Even companies such as Facebook, which launched Facebook Home in 2013 at an initial price of $99 per year, have experienced new product failures.[7] Industrial goods failure rates tend to be lower than those for consumer goods. To increase their chances for success, most firms use the following product development process, which is also summarized in **Exhibit 11.6**.

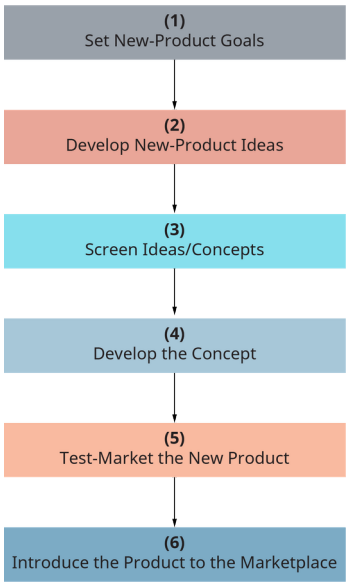


Exhibit 11.6: **Steps to Develop New Products That Satisfy Customers** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

1. *Set new-product goals:* New-product goals are usually stated as financial objectives. For example, a company may want to recover its investment in three years or less. Or it may want to earn at least a 15 percent return on the investment. Nonfinancial goals may include using existing equipment or facilities.
2. *Develop new-product ideas:* Smaller firms usually depend on employees, customers, investors, and distributors for new ideas. Larger companies use these sources and more-structured marketing research techniques, such as focus groups and brainstorming. A **focus group** consists of eight to 12 participants led by a moderator in an in-depth discussion on one particular topic or concept. The goal of focus group research is to learn and understand what people have to say and why. The emphasis is on getting people to speak at length and in detail about the subject at hand. The intent is to find out how they feel about a product, concept, idea, or organization; how it fits into their lives; and their emotional involvement with it. Focus groups often generate excellent product ideas. A few examples of focus group–influenced products are the interior design of the Toyota RAV4, Stick Ups room deodorizers, Swiffer WetJet, and Wendy's Salad Sensations. In the business market, machine tools, keyboard designs, aircraft interiors, and backhoe accessories evolved from focus groups.

   Brainstorming is also used to generate new-product ideas. With **brainstorming**, the members of a group think of as many ways to vary a product or solve a problem as possible. Criticism is avoided, no matter how ridiculous an idea seems at the time. The emphasis is on sheer numbers of ideas. Evaluation of these ideas is postponed to later steps of development.

3. *Screen ideas and concepts:* As ideas emerge, they are checked against the firm's new-product goals and its long-range strategies. Many product concepts are rejected because they don't fit well with existing products, needed technology is not available, the company doesn't have enough resources, or the sales potential is low.
4. *Develop the concept:* Developing the new-product concept involves creating a prototype of the product, testing the prototype, and building the marketing strategy. Building the marketing strategy means developing a test set of 5Ps. The type and amount of product testing varies, depending on such factors as the company's experience with similar products, how easy it is to make the item, and how easy it will be for consumers to use it. If Kraft wanted to develop a new salad dressing flavor, the company would benefit from the fact that the company already has a lot of experience in this area. The new dressing will go directly into advanced taste tests and perhaps home-use tests. To develop a new line of soft drinks, however, Kraft would most likely do a great deal of testing. It would study many aspects of the new product before actually making it.

   While the product is tested, the marketing strategy is refined. Channels of distribution are selected, pricing policies are developed and tested, the target market is further defined, and demand for the product is estimated. Management also continually updates the profit plan.

   As the marketing strategy and prototype tests mature, a communication strategy is developed. A logo and package wording are created. As part of the communication strategy, promotion themes are developed, and the product is introduced to the sales force.

5. *Test-market the new product:* **Test-marketing** is testing the product among potential users. It allows management to evaluate various strategies and to see how well the parts of the marketing mix fit together. Few new-product concepts reach this stage. For those that pass this stage, the firm must decide whether to introduce the product on a regional or national basis.

   Companies that don't test-market their products run a strong risk of product failure. In essence, test-marketing is the "acid test" of new-product development. The product is put into the marketplace, and then the manufacturer can see how it performs against the competition.

6. *Introduce the product:* A product that passes test-marketing is ready for market introduction, called *rollout,* which requires a lot of logistical coordination. Various divisions of the company must be encouraged to give the new item the attention it deserves. Packaging and labeling in a different language may be required. Sales training sessions must be scheduled, spare parts inventoried, service personnel trained, advertising and promotion campaigns readied, and wholesalers and retailers informed about the new item. If the new product is to be sold internationally, it may have to be altered to meet the requirements of the target countries. For instance, electrical products may have to run on different electrical currents.

For services companies, the new product develop process is similar, but developing the prototype can take less time and resources. It will mean developing the service and training service personnel on the new service in order to test it in the market.

The Role of the Product Manager

When a new product enters the marketplace in large organizations, it is often placed under the control of a product or brand

manager. A **product manager** develops and implements a complete strategy and marketing program for a specific product or brand of product. Some companies may have numerous brands of the same type of product, such as many versions of laundry soap, each with different target markets, brand names, and attributes. Product management first appeared at Procter & Gamble in 1929. A new company soap, Camay, was not doing well, so a young Procter & Gamble executive was assigned to devote his exclusive attention to developing and promoting this product. He was successful, and the company soon added other product managers. Since then, many firms, especially consumer products companies, have set up product management organizations.

CONCEPT CHECK

1. How do companies organize for new-product development?
2. What are the steps in the new-product development process?
3. How does new-product development differ for services companies?
4. Explain the role of the product manager.

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11.8: The Product Life Cycle

What are the stages of the product life cycle?

Product managers create marketing mixes for their products as they move through the life cycle. The **product life cycle** is a pattern of sales and profits over time for a product (Ivory dishwashing liquid) or a product category (liquid detergents). As the product moves through the stages of the life cycle, the firm must keep revising the marketing mix to stay competitive and meet the needs of target customers.

Stages of the Life Cycle

As illustrated in **Exhibit 11.7**, the product life cycle consists of the following stages:

1. *Introduction:* When a product enters the life cycle, it faces many obstacles. Although competition may be light, the *introductory stage* usually features frequent product modifications, limited distribution, and heavy promotion. The failure rate is high. Production and marketing costs are also high, and sales volume is low. Hence, profits are usually small or negative.
2. *Growth:* If a product survives the introductory stage, it advances to the *growth stage* of the life cycle. In this stage, sales grow at an increasing rate, profits are healthy, and many competitors enter the market. Large companies may start to acquire small pioneering firms that have reached this stage. Emphasis switches from primary demand promotion to aggressive brand advertising and communicating the differences between brands. For example, the goal changes from convincing people to buy flat-screen TVs to convincing them to buy Sony versus Panasonic or Sharp.

   Distribution becomes a major key to success during the growth stage, as well as in later stages. Manufacturers scramble to acquire dealers and distributors and to build long-term relationships. Without adequate distribution, it is impossible to establish a strong market position.

   Toward the end of the growth phase, prices normally begin falling, and profits peak. Price reductions result from increased competition and from cost reductions from producing larger quantities of items (economies of scale). Also, most firms have recovered their development costs by now, and their priority is in increasing or retaining market share and enhancing profits.

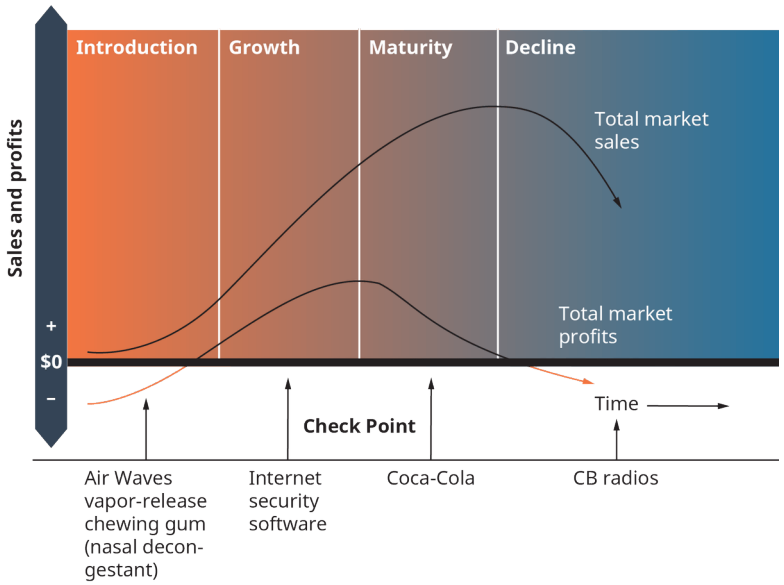


Exhibit 11.7: Sales and Profits during the Product Life Cycle (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

3. *Maturity:* After the growth stage, sales continue to mount—but at a decreasing rate. This is the *maturity stage*. Most products that have been on the market for a long time are in this stage. Thus, most marketing strategies are designed for mature products. One such strategy is to bring out several variations of a basic product (line extension). Kool-Aid, for instance, was

originally offered in six flavors. Today there are more than 50, as well as sweetened and unsweetened varieties.

4. *Decline (and death):* When sales and profits fall, the product has reached the *decline stage*. The rate of decline is governed by two factors: the rate of change in consumer tastes and the rate at which new products enter the market. Sony VCRs are an example of a product in the decline stage. The demand for VCRs has now been surpassed by the demand for DVDs and online streaming of content. Sometimes companies can improve a product by implementing changes to the product, such as new ingredients or new services. If the changes are accepted by customers, it can lead to a product moving out of the decline stage and back into the introduction stage.



Exhibit 11.8: Each year Coca-Cola adds new drinks to its product portfolio. While some of these new beverages are close relatives of the original Coca-Cola Classic, others, such as Vitaminwater, constitute entirely new categories of soft drink. *What challenges do new products such as Vitaminwater face during the introduction phase of the product life cycle? (Credit: kobakou/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

The Product Life Cycle as a Management Tool

The product life cycle may be used in planning. Marketers who understand the cycle concept are better able to forecast future sales and plan new marketing strategies. Table 11.5 is a brief summary of strategic needs at various stages of the product life cycle. Marketers must be sure that a product has moved from one stage to the next before changing its marketing strategy. A temporary sales decline should not be interpreted as a sign that the product is dying. Pulling back marketing support can become a self-fulfilling prophecy that brings about the early death of a healthy product.

Table 11.5: Strategies for Success at Each Stage of the Product Life Cycle

Category	Introduction	Growth	Maturity	Decline
Marketing objectives	Encourage trial, establish distribution	Get triers to repurchase, attract new users	Seek new user or users	Reduce marketing expenses, used to keep loyal users
Product	Establish competitive advantage	Maintain product quality	Modify product	Maintain product
Distribution	Establish distribution network	Solidify distribution relationships	Provide additional incentives to ensure support	Eliminate trade allowances
Promotional	Build brand awareness	Provide information	Reposition product	Eliminate most advertising and sales promotions
Pricing	Set introductory price (skimming or penetration pricing)	Maintain prices	Reduce prices to meet competition	Maintain prices

CONCEPT CHECK

1. What is the product life cycle?
2. Describe each stage of the product life cycle.
3. What are the marketing strategies for each stage of the product life cycle?

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11.9: Pricing Strategies and Future Trends

What strategies are used for pricing products, and what are the future trends?

An important part of the marketing planning process is setting the right price. Price is the perceived value that is exchanged for something else. Value in our society is most commonly expressed in dollars and cents. Thus, price is typically the amount of money exchanged for a product. Note that *perceived value* refers to the perception of the product's value at the time of the transaction. After a consumer has used a product, the consumer may decide that its actual value was less than its perceived value at the time it was purchased. The price paid for a product is based on the *expected satisfaction* that the customer will receive and not necessarily the *actual satisfaction of the customer*.

Although price is usually a dollar amount, it can be anything with perceived value. When products are exchanged for each other, the trade is called *barter*. If a student exchanges this book for a math book at the end of the term, that student has engaged in barter.

Pricing Objectives

Price is important in determining how much a firm earns. The prices charged customers times the number of units sold equals the *gross revenue* for the firm. Revenue is what pays for every activity of the company (production, finance, sales, distribution, and so forth). The money that is left over (if any) is profit. Managers strive to charge a price that will allow the firm to earn a fair return on its investment and will maximize return on investment to the highest extent while still maintaining a fair return.

The chosen price must be neither too high nor too low, and the price must equal the perceived value to target consumers. If consumers think the price is too high, sales opportunities will be lost. Lost sales mean lost revenue. If the price is too low, consumers may view the product as a great value, but the company may not meet its profit goals. Sometimes, as in the case of services, a price that is too low will cause the product to viewed as less than credible and lose sales for the company.

Product Pricing

Managers use various pricing strategies when determining the price of a product, as this section explains. Price skimming and penetration pricing are strategies used in pricing new products; other strategies such as leader pricing and bundling may be used for established products as well.

Price Skimming

The practice of introducing a new product on the market with a high price and then lowering the price over time is called **price skimming**. As the product moves through its life cycle, the price usually is lowered because competitors are entering the market. As the price falls, more and more consumers can buy the product. Recent example are DVD players and flat-screen televisions. When they first came out, DVD players were priced at around $500 while flat-screen televisions were priced at over $1,000. Over time, the price of DVD players has sunk to under $100, while 4-inch Insignia brand flat-screen TVs can be purchased for under $220.

Price skimming has four important advantages. First, a high initial price can be a way to find out what buyers are willing to pay. Second, if consumers find the introductory price too high, it can be lowered. Third, a high introductory price can create an image of quality and prestige. Fourth, when the price is lowered later, consumers may think they are getting a bargain. The disadvantage is that high prices attract competition.

Price skimming can be used to price virtually any new products, such as high-definition televisions, new cancer drugs, and color computer printers. For example, the Republic of Tea recently launched Emperor's White Tea, which it says is among the rarest of teas. Because it is minimally processed, white tea is said to retain the highest level of antioxidants and has a lower caffeine content than black and green teas. The company says the tea is picked only a few days each year, right before the leaf opens,

yielding a small harvest. The product retails for $16 per tin of 50 bags. Products don't have to cost hundreds of dollars to use a skimming strategy.

Penetration Pricing

A company that doesn't use price skimming will probably use **penetration pricing**. With this strategy, the company offers new products at low prices in the hope of achieving a large sales volume. Procter & Gamble did this with its SpinBrush toothbrush. Penetration pricing requires more extensive planning than skimming does because the company must gear up for mass production and marketing. When Texas Instruments entered the digital-watch market, its facilities in Lubbock, Texas, could produce 6 million watches a year, enough to meet the entire world demand for low-priced watches. If the company had been wrong about demand, its losses would have been huge.

Penetration pricing has two advantages. First, the low initial price may induce consumers to switch brands or companies. Using penetration pricing on its jug wines, Gallo has lured customers away from Taylor California Cellars and Inglenook. Second, penetration pricing may discourage competitors from entering the market. Their costs would tend to be higher, so they would need to sell more at the same price to break even.

Leader Pricing

Pricing products below the normal markup or even below cost to attract customers to a store where they wouldn't otherwise shop is **leader pricing**. A product priced below cost is referred to as a **loss leader**. Retailers hope that this type of pricing will increase their overall sales volume and thus their profit.

Items that are leader priced are usually well known and priced low enough to appeal to many customers. They also are items that consumers will buy at a lower price, even if they have to switch brands. Supermarkets often feature coffee and bacon in their leader pricing. Department stores and specialty stores also rely heavily on leader pricing.

Pricing of Services

Pricing of services tends to be more complex than pricing of products that are goods. Services may be priced as standard services, such as the price a hair stylist might charge for a haircut, or pricing may be based on tailored services designed for a specific buyer, such as the prices charged for the design of a new building by an architect.

ETHICS IN PRACTICE

Pricing Before, During, and After Hurricanes

The late summer of 2017 brought several devastating hurricanes that impacted large areas of Texas, Florida, Puerto Rico, and the Virgin Islands. As often happens during events like these, there were several reports of stores, hotels, and service stations engaging in price gouging. Many states have laws against price gouging during natural disasters, but a Twitter photo of a Best Buy store charging $42 for a case of 24 bottles of water was widely circulated. Usually a case of water can be purchased for about $5 to $8, so the $42 price was thought to be an instance of price gouging. Best Buy quickly addressed the exorbitant price and issued an apology, stating they normally do not sell cases of water, and that an employee wanting to provide a service in advance of the hurricane simply multiplied the price of a single bottle they normally sell by 24 to arrive at the price-per-case total. Best Buy's response was clearly aimed at deflecting any negative public reaction to the pricing "error."

Another example of how companies might be accused of price gouging occurs with companies that use "**dynamic pricing**," which uses computer algorithms to analyze demand and automatically raises prices as demand increases. Amazon, the large online retailer, uses dynamic pricing, and consumers saw an increase in the price of things like generators and water in the days prior to hurricanes Harvey, Irma, and Juan in 2017.

There are some economists and business thought leaders who believe that price increases during events like hurricanes is a good thing. Economists from the Chicago School of Economics state that regulating lower prices during natural disasters actually discourages consumers from purchasing essential supplies such as water and gasoline until the disaster occurs because they can anticipate regulated prices. In addition, let's say that a hotel usually rents a room for $50 a night and decides to raise the price

during a hurricane to $100. A family might decide to stay in one room rather than rent two rooms, thus saving some money while at the same time increasing the supply of hotel rooms for people who need them the most.

Critical Thinking Questions

1. What risks do companies such as Best Buy and Amazon face when selling a product that they normally don't sell and then are accused of price gouging, or when they using dynamic pricing?
2. Why is the use of dynamic pricing deemed acceptable for selling tickets to sporting events but not during a natural disaster?
3. Do you agree with the arguments in support of higher prices put forth by free-market economists?

Sources: Andrew Ross Sorkin, "Hurricane Price Gouging Is Despicable Right? Not to Some Economists," *The New York Times*, https://www.nytimes.com, September 11, 2017; Tom Popomaronis, "Amid Preparations for Hurricane Irma, Amazon Draws Scrutiny for Price Increases," *Forbes*, https://www.forbes.com, September 6, 2017; Dennis Green, "Best Buy Explains Why It Charges $42 for a Case of Water in Texas During the Hurricane in 'a Big Mistake,'" *Business Insider*, http://www.businessinsider.com, August 29, 2017; Matt Zwolinski, "The Ethics of Price Gouging," *Business Ethics Quarterly,* 18(3): 347–378, 2008, http://facpub.stjohns.edu.

Bundling

Bundling means grouping two or more related products together and pricing them as a single product. Marriott's special weekend rates often include the room, breakfast, and free Wi-Fi. Department stores may offer a washer and dryer together for a price lower than if the units were bought separately.

The idea behind bundling is to reach a segment of the market that the products sold separately would not reach as effectively. Some buyers are more than willing to buy one product but have much less use for the second. Bundling the second product to the first at a slightly reduced price thus creates some sales that otherwise would not be made. For example, Aussie 3-Minute Miracle Shampoo is typically bundled with its conditioner because many people use shampoo more than conditioner, so they don't need a new bottle of conditioner.

Odd-Even Pricing

Psychology often plays a big role in how consumers view prices and what prices they will pay. **Odd-even pricing** (or **psychological pricing**) is the strategy of setting a price at an odd number to connote a bargain and at an even number to imply quality. For years, many retailers have priced their products in odd numbers—for example, $99.95 or $49.95—to make consumers feel that they are paying a lower price for the product.

Prestige Pricing

The strategy of raising the price of a product so consumers will perceive it as being of higher quality, status, or value is called **prestige pricing**. This type of pricing is common where high prices indicate high status. In the specialty shops on Rodeo Drive in Beverly Hills, which cater to the super-rich of Hollywood, shirts that would sell for $65 elsewhere sell for at least $150. If the price were lower, customers would perceive them as being of low quality. Prestige pricing is also very prevalent in services because services providers with reputations for excellent service are more in demand, often with a waiting list. This is due to the fact that services are tied directly to the people who provide them and those people have only so much time in a week in which to provide services. Once the calendar fills up, the demand goes up, and the prices become prestige prices.

CONCEPT CHECK

1. What is the difference between penetration pricing and price skimming?
2. Explain the concept of price bundling.
3. Describe odd-even pricing and prestige pricing.
4. Why is prestige pricing prevalent in services?

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11.10: Introduction



Exhibit 11.1: (Credit: Hamza Butt / flickr / Attribution Generic 2.0 (CC BY))

EXPLORING BUSINESS CAREERS

Rachel Kuhr: Mark Cuban's Shark Tank Empire

Rachel Kuhr is the product innovation and development specialist for Mark Cuban's investments in the ABC show *Shark Tank*. Two years ago, after watching an episode, Kuhr e-mailed Mark Cuban and attached a resume that highlighted her mechanical engineering and product development expertise. Her approach appealed to Cuban, and she was contacted the next day by Abe Minkara, head of Cuban's business development team. After a Skype interview in which Minkara was impressed with Kuhr's skill set of both creativity and attention to process, she was hired to fill that role and work with several start-ups that Cuban acquired an investment in through the show.

Kuhr now coaches and collaborates with over 60 companies that reside in Cuban's business portfolio. Rather than start out with detailed plans and building sophisticated prototypes, Kuhr favors using things like a whiteboard, Post-it notes, colored pens, and highlighters to sketch out the ideas. Such an approach uses the best practices from brainstorming that allow fatal flaws to steer the direction of product development before spending lots of resources, both human and financial, on a single idea for too long. This approach also allows the product development team to incorporate the user experience, which is sometimes overlooked when the focus is squarely on the product.

One of the companies that Kuhr works with created Chapul Cricket Bars. Chapul Cricket Bars was the first company to use insect-based "flour" in the manufacture of high- energy protein bars. After the deal on Shark Tank, company founder Pat Crowley and Kuhr decided to take the flying insect logo off the product design and renamed the bars with names such as Aztec, Matcha, and Chaco instead of the "Cricket Bar" name.

Another Cuban investment was the Austin, Texas–based BeatBox Beverages. To better understand how typical consumers would relate to boxed flavored cocktails, Kuhr attended several fraternity parties at Southern Methodist University and off-campus bars. She asked questions that addressed how a variety of consumers decide on what to drink on different occasions and in different settings. Since securing a $1 million dollar investment from Cuban, and working with Rachel Kuhr, online and distribution sales through stores has skyrocketed according to Justin Fenchel, BeatBox Beverages' CEO.

Sources: Cheryl Hall, "Why Rachel Kuhr Is the Innovator for Mark Cuban's Shark Tank Startups," *Dallas News*, https://www.dallasnews.com, accessed October 1, 2017; "About Us," https://chapul.com, accessed October 1, 2017; "The Story," https://www.beatboxbeverages.com, accessed October 1, 2017; Teddy Nykiel, "Shark Tank's Biggest Deals and How They Panned

Out," *NerdWallet*, https://www.nerdwallet.com, January 9, 2015.

Marketing plays a key role in the success of businesses. It is the task of marketing to generate sales for the firm. Sales revenue, in turn, pays workers' salaries, buys supplies, covers the costs of new buildings and equipment, and hopefully enables the company to earn a profit. This chapter looks at the nature of marketing and the creation of product and pricing strategies to meet customers' needs. In this chapter, you will learn about the marketing concept, marketing strategies, and consumer and business buying decisions. You will also see how the marketing mix is used to create sales opportunities. We discuss how new products are created and how they go through periods of sales growth and then decline. Next you will discover how managers set prices to reach organizational goals.

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11.11: Trends in Developing Products and Pricing

What trends are occurring in products and pricing?

As customer expectations increase and competition becomes fiercer, perceptive managers will find innovative strategies to satisfy demanding consumers and establish unique products in the market. Satisfying customers requires the right prices. The internet has delivered pricing power to both buyers and sellers. Another significant trend is the use of one-to-one marketing to create a customized marketing mix for each consumer.

Impact of the Internet on Pricing

The internet, corporate networks, and wireless setups are linking people, machines, and companies around the globe—and connecting sellers and buyers as never before. This link is enabling buyers to quickly and easily compare products and prices, putting them in a better bargaining position. At the same time, the technology enables sellers to collect detailed data about customers' buying habits, preferences, and even spending limits so that they can tailor their products and prices. Amazon, as well as online businesses from traditional retailers such as Walmart, have drastically changed the retail landscape. Amazon's Prime membership, which offers free shipping and other amenities for an annual fee, has also taken market share from traditional low-cost warehouse clubs such as Costco and Sam's Club.[8]

Online price-comparison engines, known as shopbots, are continuing to add new features. ShopSmarter.com now includes coupons and additional retailer discounts in its price results. In the past, consumers had to click deep into a retailer's site to find out about these additional savings. Vendio eCommerce introduced a toolbar that people can download. If a person is on the web page of a particular product—whether it's an iPhone or a Canon digital camera—the toolbar flashes a blinking alert when it finds a lower price for that same item somewhere else. The person can then open a window on the side of the site to learn details of the cheaper price—or simply ignore the alert. BuySAFE introduced a website that lets consumers search among about 1.5 million products that are backed by antifraud guarantees. If a buyer purchases one of the items and the seller fails to deliver, the buyer can get reimbursed for the full cost up to $25,000. Merchants on the site include those that sell on eBay and Overstock.com.

Use of these sites has boomed in the past few years as people have become more reliant on the web both as a research tool and as a place to shop. According to a recent survey, more than 90 percent of consumers have used a smartphone when comparison-shopping in stores.[9] Much of the growth has come from the more-established sites such as Shopify, Bizrate, and NexTag, as well as the shopping sections of Amazon, Microsoft's MSN, and Google. The big attraction with shopping comparison services, of course, is the hunt for a better bargain. Merchants like the sites because they help drive consumer spending. Consumers who use comparison-shopping sites for product information or in-store discount coupons spend more than those who don't.[10]

One-to-One Marketing

One-to-one marketing is creating a unique marketing mix for every consumer. The key to creating one-to-one marketing is a good marketing database. The information contained in a marketing database helps managers know and understand customers, and potential customers, on an individual basis. A **marketing database** is a computerized file of customers' and potential customers' profiles and purchase patterns.

In the 1960s, network television enabled advertisers to "get the same message to everyone simultaneously." Database marketing can get a customized, individual message to everyone simultaneously through direct mail or through the internet. This is why database marketing is sometimes called *micromarketing*. Database marketing can create a computerized form of the old-fashioned relationship that people used to have with the corner grocer, butcher, or baker. "A database is sort of a collective memory," says Richard G. Barlow, president of Frequency Marketing, Inc., a Cincinnati-based consulting firm. "It deals with you in the same personalized way as a mom-and-pop grocery store, where they knew customers by name and stocked what they wanted."

You have also probably heard the term **big data**. Companies such as Facebook and Google can process information and then tailor information to provide marketers with higher-probability targets. For instance, imagine that you and some friends are discussing a spring break vacation and you are searching for possible locations on the Florida gulf coast. That data, along with the social group considering the vacation, can be sold to companies that provide travel services, airline flights, hotel rentals, and

the like. Suddenly, you and your friends see travel offers and alternate destinations on your Facebook page. Likewise, imagine you are looking for a mystery novel to read on a long flight. Let's say that you are also searching for ways to remove a rust stain on a favorite sweater. When you go to your Amazon page, you see several new mystery novels as well as cleaning solutions highlighted on your page. All of this was done through the use of big data and analytics to provide consumers solutions they are looking for as well as products that they don't even know that they want. Exhibit 11.9 contrasts the differences in approaches in traditional advertising versus targeted marketing using big data.

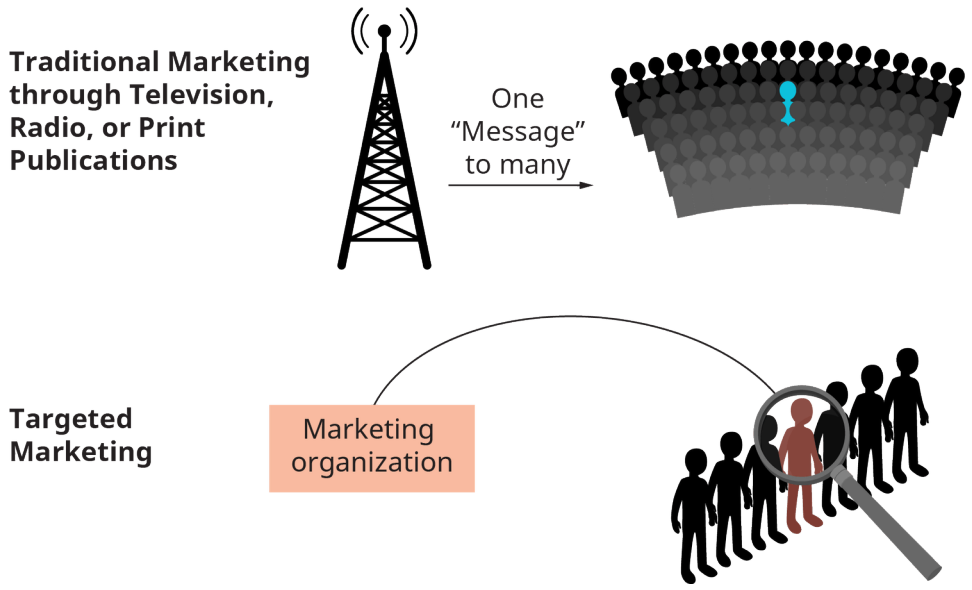


Exhibit 11.9: Traditional Advertising and Targeted Marketing Using Big Data (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

The size of some databases is impressive: Ford Motor Company's is about 50 million names; Kraft General Foods, 30 million; Citicorp, 30 million; and Kimberly Clark, maker of Huggies diapers, 10 million new parents. American Express can pull from its database all cardholders who made purchases at golf pro shops in the past six months, who attended symphony concerts, or who traveled to Europe more than once in the past year, as well as the very few people who did all three.

Companies are using their marketing databases to implement one-to-one marketing. For example, Novartis Seeds, Inc., a Minneapolis-based agriculture business, produces individually customized, full-color brochures for 7,000 farmers. Each piece features products selected by Novartis dealers specifically for the farmer based on information collected about the farm operation and the types of crops grown. Instead of the 30-page catalog Novartis traditionally sent, these customers get a one-page brochure with only the five or six products they need, plus other complementary products dealers feel they should consider.

Concept Check

1. How have online price-comparison engines helped consumers shop for the best price?
2. Describe one-to-one marketing and the role of marketing databases.

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12: MARKETING MIX

12.1: Why It Matters - Marketing Mix
12.2: Product
12.3: Promotion
12.4: Place
12.5: Price
12.6: Putting It Together- Marketing Mix

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12.1: Why It Matters - Marketing Mix

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

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

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12.2: Product

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

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

Learning Objectives

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

Consumer Product Categories

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

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

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

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

Convenience Products



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

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

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

Shopping Products

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

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

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

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

Specialty Products

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


Blizzcon attendees, 2014

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

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

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

Unsought Products

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

Elements and Benefits of Branding

What Is a Brand?

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

Click here to read a transcript of the video.

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

1. **A brand is an identifier:** a name, sign, symbol, design, term, or some combination of these things that identifies an offering

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

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

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

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

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

Brands Create Market Perceptions

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

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


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

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

Brands Create an Experience

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

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

Brands Create Value



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

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

Value of Branding for the Consumer

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

Value of Branding for Product and Service Providers



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

For companies and other organizations that produce goods, branding helps create loyalty. It decreases the risk of losing market

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

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

Value of Branding for the Retailer

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

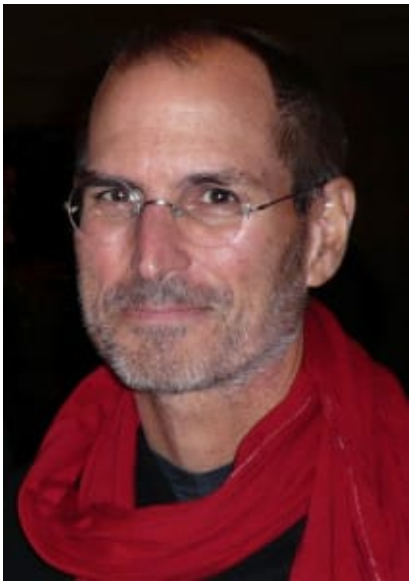
Retailers also benefit from carrying the branded products customers want. Brand-marketing support from retailers or manufacturers can help attract more customers (ideally ones who normally don't frequent an establishment). For example, a customer who truly values organic brands might decide to visit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

Common Branding Strategies

Managing Brands As Strategic Assets

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

Brand Ownership



Steve Jobs, co-founder and CEO of Apple

Who "owns" the brand? The legal owner of a brand is generally the individual or entity in whose name the legal registration has been filed. Operationally speaking, brand ownership should be the responsibility of an organization's management and employees. Brand ownership is about building and maintaining a brand that reflects your principles and values. Brand *building*

is about effectively persuading customers to believe in and purchase your product or service. Iconic brands, such as Apple and Disney, often have a history of visionary leaders who champion the brand, evangelize about it, and build it into the organizational culture and operations.

Branding Strategies

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

"Branded House" Strategy

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

"House of Brands" Strategy



Kool-Aid Man

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

Private-Label or Store Branding

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

"No-Brand" Branding

A number of companies successfully pursue "no-brand" strategies by creating packaging that imitates generic-brand simplicity. "No brand" branding can be considered a type of branding since the product is made conspicuous by the absence of a brand

name. “Tapa Amarilla” or “Yellow Cap” in Venezuela during the 1980s is a prime example of no-brand strategy. It was recognized simply by the color of the cap of this cleaning products company.

Personal and Organizational Brands



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

Place Branding

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

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

Co-Branding

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

The following are some examples of co-branded offerings:

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



Fiat 500 "Barbie"

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

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

Brand Licensing



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

Brand licensing is the process of leasing or renting the right to use a brand in association with a product or set of products for a defined period and within a defined market, geography, or territory. Through a licensing agreement, a firm (licensor) provides some tangible or intangible asset to another firm (licensee) and grants that firm the right to use the licensor's brand name and

related brand assets in return for some payment. The licensee obtains a competitive advantage in this arrangement, while the licensor obtains inexpensive access to the market in question.

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

Line Extensions and Brand Extensions

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



Diet Coke is a line extension of the Coke brand.

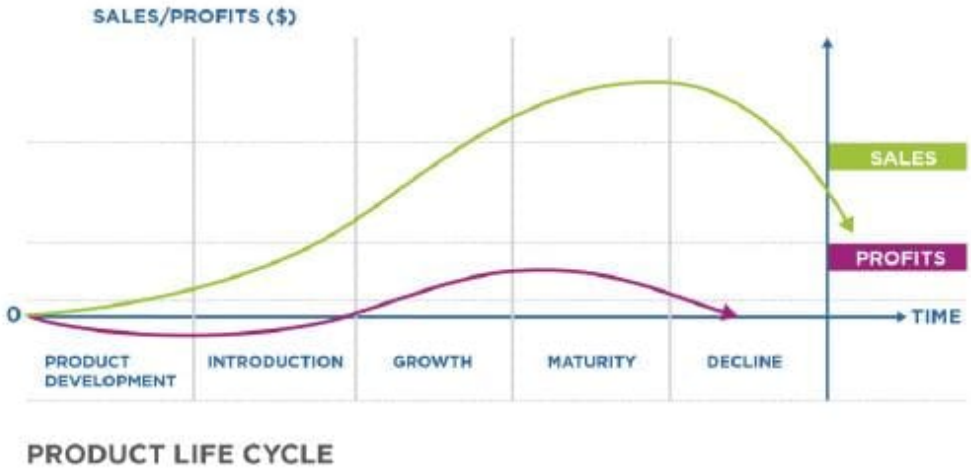
A company creates a **line extension** when it introduces a new variety of offering within the same product category. To illustrate with the food industry, a company might add new flavors, package sizes, nutritional content, or products containing special additives in line extensions. Line extensions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

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

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

Stages of the Product Life Cycle

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



PRODUCT LIFE CYCLE

The five stages of the PLC are:

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

The table below shows common characteristics of each stage.

Common Characteristics	
0. Product development stage	1. investment is made 2. sales have not begun 3. new product ideas are generated, operationalized, and tested
1. Market introduction stage	1. costs are very high 2. slow sales volumes to start 3. little or no competition 4. demand has to be created 5. customers have to be prompted to try the product 6. makes little money at this stage
2. Growth stage	1. costs reduced due to economies of scale 2. sales volume increases significantly 3. profitability begins to rise 4. public awareness increases 5. competition begins to increase with a few new players in establishing market 6. increased competition leads to price decreases

3. Maturity stage	1. costs are lowered as a result of increasing production volumes and experience curve effects 2. sales volume peaks and market saturation is reached 3. new competitors enter the market 4. prices tend to drop due to the proliferation of competing products 5. brand differentiation and feature diversification is emphasized to maintain or increase market share 6. profits decline
4. Decline stage	1. costs increase due to some loss of economies of scale 2. sales volume declines 3. prices and profitability diminish 4. profit becomes more a challenge of production/distribution efficiency than increased sales

Using the Product Life Cycle

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

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

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

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

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

Marketing through the Product Cycle

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

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

Market Introduction Stage

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

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

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


Google Glass

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

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

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

Growth Stage

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

These emerging competitive threats drive new marketing tactics. Marketers who have been seeking to build broad market

awareness through the introduction phase must now differentiate their products from competitors, emphasizing unique features that appeal to target customers. The central thrust of market messaging and promotion during this stage is “This brand is the best!” Pricing also becomes more competitive and must be adjusted to align with the differentiation strategy.

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

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

Maturity Stage

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

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

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

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

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

Decline Stage

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

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

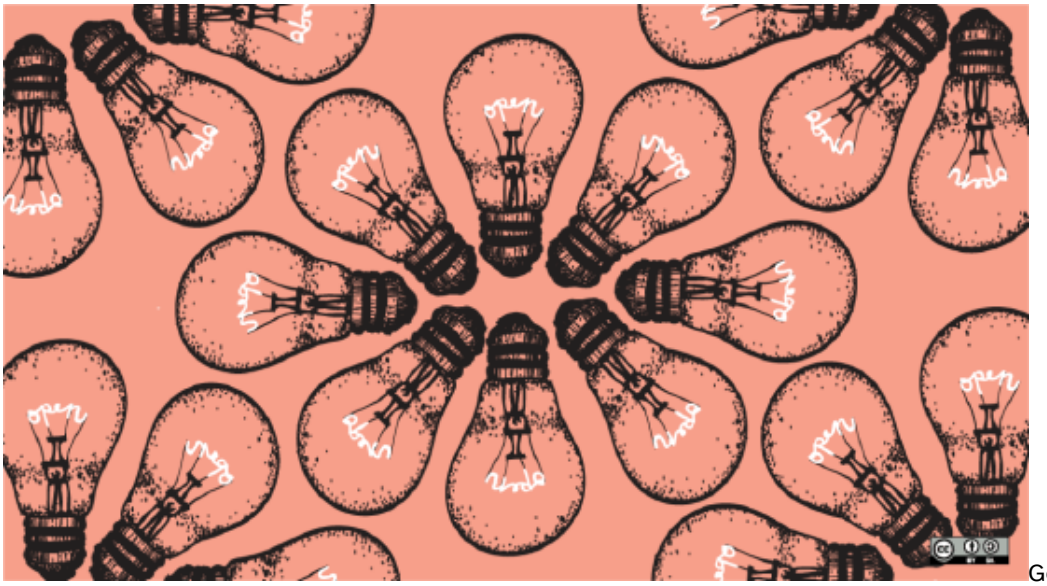
The New-Product Development Process



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

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

Stage 1: Generating New Product Ideas



Generating new product ideas is a

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

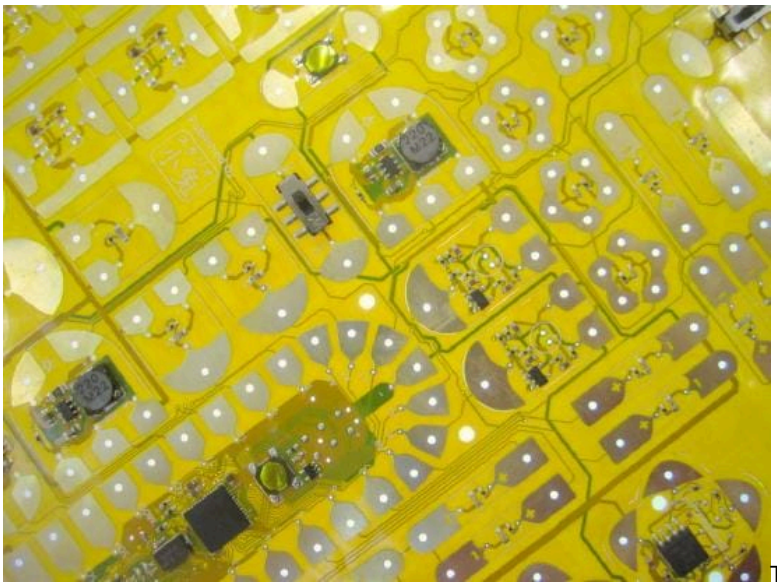
The key to the idea generation stage is to explore possibilities, knowing that most will not result in products that go to market.

Stage 2: Screening Product Ideas

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

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

Stage 3: Concept Development and Testing

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

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

Stage 4: Business Case Analysis

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

The company seeks to answer such questions as the following:

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

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

Stage 5: Technical and Marketing Development



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

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

Stage 6: Test Marketing and Validation

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

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

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

Stage 7: Launch

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

Stage 8: Evaluation

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

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1. www.ama.org/resources/Pages/...tter=P#product ↵
2. www.businessdictionary.com/de...ial-goods.html ↵
3. http://www.safeway.com/ShopStores/Br...ur-Brands.page ↵
4. Mullor-Sebastian, Alicia. "The Product Life Cycle Theory: Empirical Evidence." Journal of International Business Studies 14.3 (1983): 95–105. ↵
5. https://en.Wikipedia.org/wiki/Post-it_note ↵

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12.3: Promotion

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

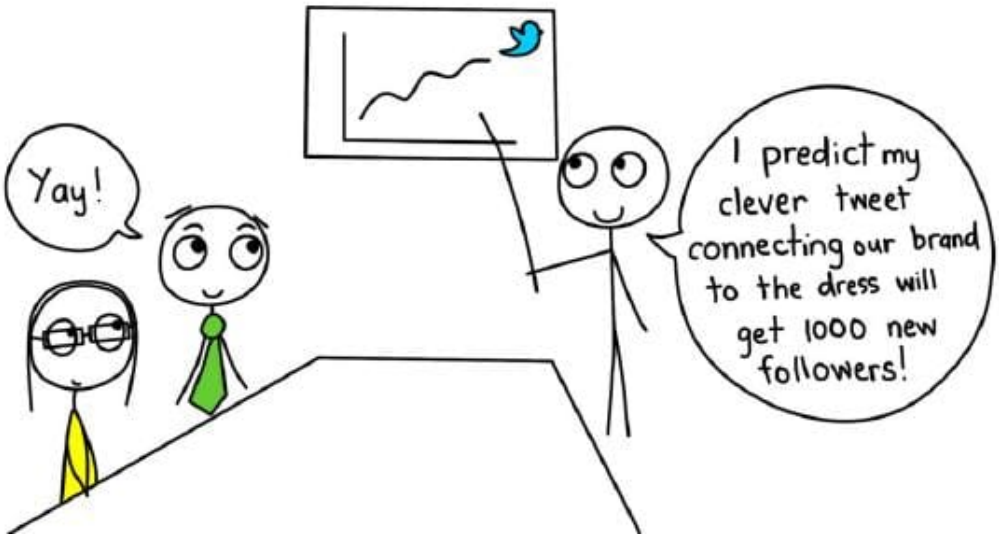
The readings in this section cover seven different marketing communication methods that are commonly used today. This section will help you become familiar with each method, common tools associated with each method, and the advantages and disadvantages of each one.

Learning Objectives

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

Integrated Marketing Communication (IMC) Definition

IMC: Making an Impact with Marketing Communication



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

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

What Is Marketing Communication?

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

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

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

The Promotion Mix: Marketing Communication Methods

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



Seven common methods of marketing communication are described below:

- **Advertising:** Any paid form of presenting ideas, goods, or services by an identified sponsor. Historically, advertising messages have been tailored to a group and employ mass media such as radio, television, newspaper, and magazines. Advertising may also target individuals according to their profile characteristics or behavior; examples are the weekly ads mailed by supermarkets to local residents or online banner ads targeted to individuals based on the sites they visit or their Internet search terms.
- **Public relations (PR):** The purpose of public relations is to create goodwill between an organization (or the things it promotes) and the "public" or target segments it is trying to reach. This happens through unpaid or earned promotional opportunities: articles, press and media coverage, winning awards, giving presentations at conferences and events, and otherwise getting favorable attention through vehicles not paid for by the sponsor. Although organizations earn rather than pay for the PR attention they receive, they may spend significant resources on the activities, events, and people who generate this attention.
- **Personal selling:** Personal selling uses people to develop relationships with target audiences for the purpose of selling products and services. Personal selling puts an emphasis on face-to-face interaction, understanding the customer's needs, and demonstrating how the product or service provides value.
- **Sales promotion:** Sales promotions are marketing activities that aim to temporarily boost sales of a product or service by adding to the basic value offered, such as "buy one get one free" offers to consumers or "buy twelve cases and get a 10 percent discount" to wholesalers, retailers, or distributors.
- **Direct marketing:** This method aims to sell products or services directly to consumers rather than going through retailer. Catalogs, telemarketing, mailed brochures, or promotional materials and television home shopping channels are all common

traditional direct marketing tools. Email and mobile marketing are two next-generation direct marketing channels.

- **Digital marketing:** Digital marketing covers a lot of ground, from Web sites to search-engine, content, and social media marketing. Digital marketing tools and techniques evolve rapidly with technological advances, but this umbrella term covers all of the ways in which digital technologies are used to market and sell organizations, products, services, ideas, and experiences.
- **Guerrilla marketing:** This newer category of marketing communication involves unconventional, innovative, and usually low-cost marketing tactics to engage consumers in the marketing activity, generate attention and achieve maximum exposure for an organization, its products, and/or services. Generally guerrilla marketing is experiential: it creates a novel situation or memorable experience consumers connect to a product or brand.



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

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

The Objectives of Marketing Communication

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

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

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

Common Marketing Communication Methods

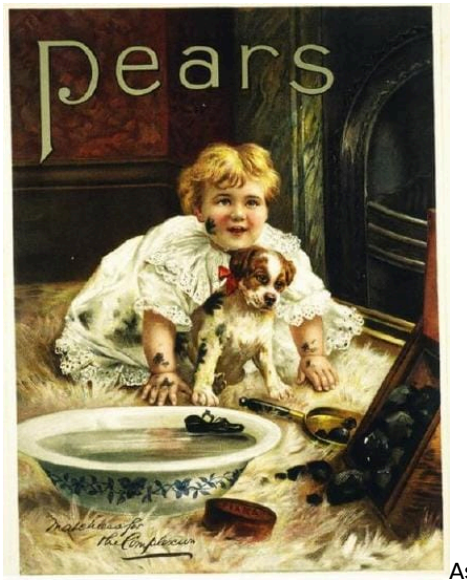
In a successfully operated campaign, all activities will be well coordinated to build on one another and increase the overall impact. For example, a single campaign might include:

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

Advertising

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

Advantages and Disadvantages of Advertising



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

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

Direct Marketing



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

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

Advantages and Disadvantages of Direct Marketing

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

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

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

Personal Selling

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

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

Advantages and Disadvantages of Personal Selling

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

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

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

Sales Promotions

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

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

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

Advantages and Disadvantages of Sales Promotions[2]

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

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

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

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

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

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

Digital Marketing

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

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

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

Advantages and Disadvantages of Digital Marketing

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

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

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

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

Public Relations

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

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

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

Advantages and Disadvantages of Public Relations

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

Using IMC to Support Marketing Strategies



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

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

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

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



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

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

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

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12.4: Place

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

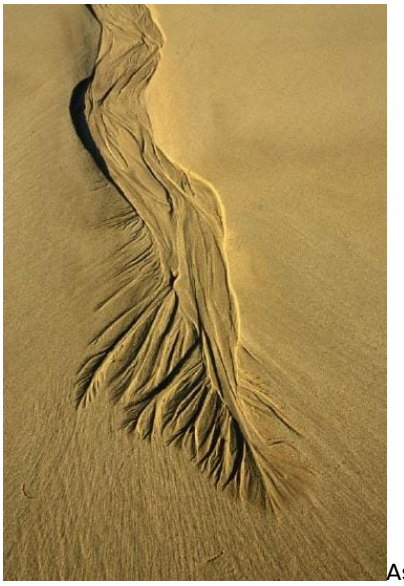
Distribution channels—which is "place" in the four Ps—cover all the activities needed to transfer the ownership of goods and move them from the point of production to the point of consumption. In this section you'll learn more about distribution channels and some of the common strategies companies use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

Learning Objectives

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

Channels of Distribution

Evolution of Channels of Distribution

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

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

With the growth of specialization, particularly industrial specialization, and with improvements in methods of transportation and communication, channels of distribution have become longer and more complex. Thus, corn grown in Illinois may be processed into corn chips in West Texas, which are then distributed throughout the United States. Or, turkeys raised in Virginia are sent to

New York so that they can be shipped to supermarkets in Virginia. Channels do not always make sense.

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

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

This definition implies several important characteristics of the channel.

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

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

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

Channel Flows

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

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

monster channel flow

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



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

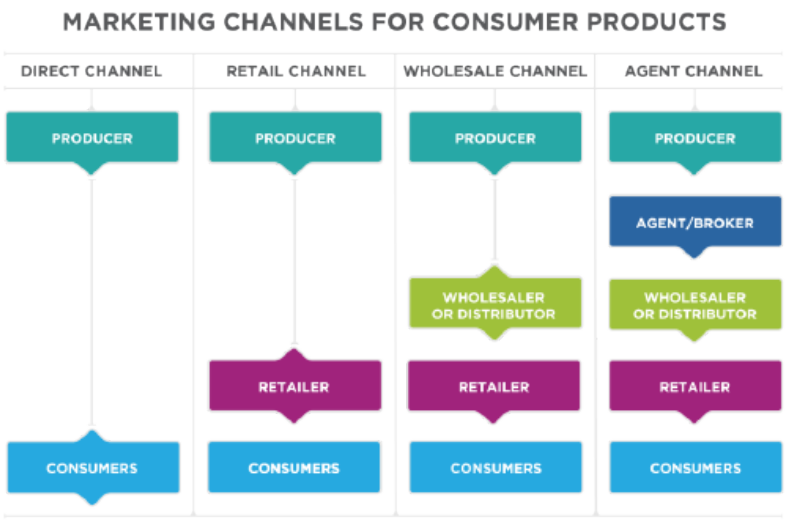
> "While many view our Company as simply “Coca-Cola,” our system operates through multiple local channels. Our Company manufactures and sells concentrates, beverage bases and syrups to bottling operations, owns the brands and is responsible for consumer brand marketing initiatives. Our bottling partners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

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

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

Channel Partners

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





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

Examples of the direct channel include:

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

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

Examples of retailers include:

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

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

Examples of wholesalers include:

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

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

Examples of brokers include:

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

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

The Role of Wholesale Intermediaries



While we are probably most familiar with the retail channel, wholesalers play an important role as intermediaries. Intermediaries act as a link in the distribution process,

but the roles they fill are broader than simply connecting the different channel partners. Wholesalers, often called “merchant wholesalers,” help move goods between producers and retailers.

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

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

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

Purchasing

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

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

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

Warehousing and Transportation

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

Grading and Packaging

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

Risk Bearing

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

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

Marketing

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

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

Distribution

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

Retailers that Distribute Products



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

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

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

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

Department Stores

Department stores are characterized by their very wide product mixes. That is, they carry many different types of merchandise,

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

Chain Stores

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

Supermarkets



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

Discount Retailers

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

Warehouse Retailers

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

Franchises

The franchise approach brings together national chains and local ownership. An owner purchases a franchise which gives her the right to use the firm's business model and brand for a set period of time. Often, the franchise agreement includes well-

defined guidance for the owner, training, and on-going support. The owner, or franchisee, builds and manages the local business. *Entrepreneur* magazine posts a list each year of the 500 top franchises according to an evaluation of financial strength and stability, growth rate, and size. The 2016 list is led by Jimmy John's gourmet sandwiches, Hampton by Hilton midprice hotels, Supercuts hair salon, Servpro insurance/disaster restoration and cleaning, and Subway restaurants.

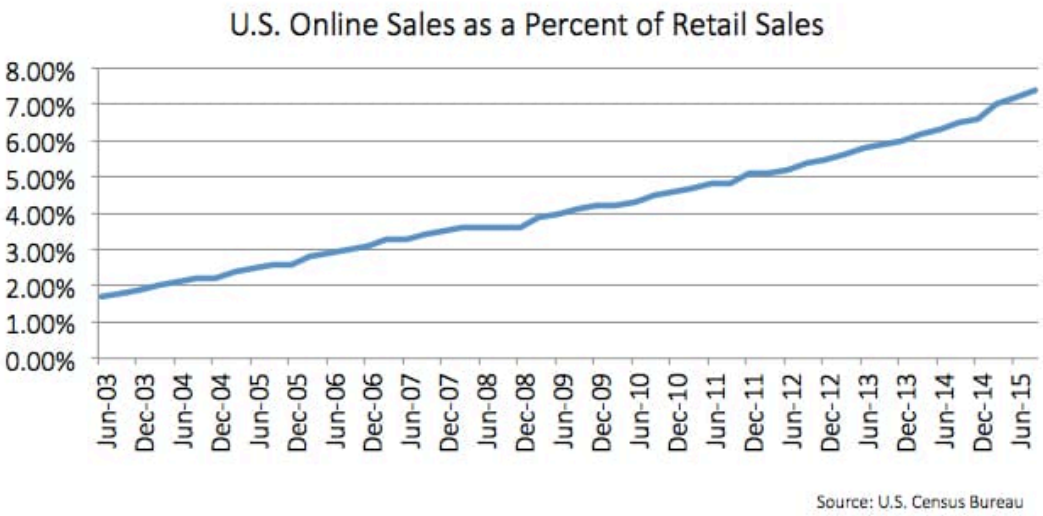
Malls and Shopping Centers



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

Online Retailing

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



Catalog Retailing

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

Nonstore Retailing

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

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



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

Supply Chains and Distribution Channels

What Is a Supply Chain?



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

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

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

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

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

Supply Chain vs. Marketing Channels

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

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

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

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

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2. www.mclaneco.com/content/mcl.../about-us.html ↩
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12.5: Price

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

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

learning objective

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

Customer Value and Price



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

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

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

What does value really mean in the pricing equation?

The Customer's View of Price

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



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

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

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

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

Pricing Objectives

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

nike

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

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

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

southwest airlines

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

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

Common Pricing Objectives

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

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

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

Profit-Oriented Pricing

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

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

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

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

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

order to increase the value they provide to customers.

Competitor-Oriented Pricing

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

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

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

Customer-Oriented Pricing



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

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

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

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

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

Cost-Plus Pricing Method

Cost-Plus Pricing

Cost-plus pricing, sometimes called *gross margin pricing*, is perhaps the most widely used pricing method. The manager selects as a goal a particular gross margin that will produce a desirable profit level. Gross margin is the difference between how much the

goods cost and the actual price for which it sells. This gross margin is designated by a percent of net sales. The percent chosen varies among types of merchandise. That means that one product may have a goal of 48 percent gross margin while another has a target of 33.5 percent or 2 percent.

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

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

Markups



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

Cost-Oriented Pricing of New Products

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

Discounting Strategies

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

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

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

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

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

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

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

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

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

than $10,000 in a year.

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

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

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

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

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

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1. http://footwearnews.com/2014/busines...growth-144128/ ↩
2. http://www.forbes.com/sites/greatspe...0b103622d442d5 ↩
3. http://www.homedepot.com/c/Pro_Xtra ↩

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12.6: Putting It Together- Marketing Mix

Synthesis



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

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

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

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

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

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

Summary

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

Product Marketing

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

Pricing Strategies

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

Place: Distribution Channels

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

Promotion: Integrated Marketing Communication (IMC)

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

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1. https://us.coca-cola.com/ ↵
2. https://us.coca-cola.com/ ↵
3. https://us.coca-cola.com/ ↵
4. SEC Filings, 2015 ↵

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13: ACCOUNTING

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13.3: The Accounting Profession
13.4: Basic Accounting Procedures
13.5: The Balance Sheet
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13.9: Trends in Accounting

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13.1: Introduction



Exhibit 14.1: (Credit: Matt Madd /flickr / Attribution 2.0 Generic (CC BY 2.0))

EXPLORING BUSINESS CAREERS

Theresa Lee

Future Glory Theresa Lee always knew she would start her own business; it was just a matter of time. In 2013, after working as a designer in the Bay Area for more than a decade, Lee cofounded Future Glory, which specializes in handmade leather bags and accessories, now made in a small studio in the Dogpatch neighborhood of San Francisco.

Lee would be the first to tell you that she is a creative person and not so great with numbers and other business details. But the business details, including financial statements and cash flow, are key to any company. That's where accounting software like QuickBooks Online comes in handy. QuickBooks is a global online accounting program that has helped tech-savvy entrepreneurs take the worry out of crunching the numbers that can make or break their business ventures.

Intuit, the global leader in accounting software, has revolutionized the approach taken by small businesses with its products, including QuickBooks and TurboTax, programs that can be used by new businesses, independent contractors, product sellers, accountants, and other types of businesses. The company estimates more than two million global customers are currently using the online version of QuickBooks. Intuit provides online support that includes expert help, a resource blog, accounting advice, and other features utilized by QuickBooks users and those wanting more information about how to track typical business accounting functions.

As Lee points out, using a cloud-based accounting program has helped her gain control over company finances and provided insight into key business components such as profit and loss, cost of goods sold, and labor. In addition, QuickBooks' ability to work with other apps has helped her manage e-commerce sales efficiently. Lee uses Shopify as an e-commerce platform and PayPal as a payment system. By using a version of these apps designed to work with QuickBooks, Lee can import sales data (line items, fees, and taxes) as well as customer information into the accounting program. In addition, Shopify e-commerce data automatically syncs with QuickBooks, allowing her to keep bookkeeping activities to a minimum and giving her more time to focus on designing and creating new products and fulfilling the social goals of her business.

According to Lee, a significant part of her operation is dedicated to providing training and jobs to members of the local community. In addition, Future Glory supports various social causes, donating a portion of revenue to various organizations that assistant women and children in need.

Keeping a close eye on financial and accounting information is an important part of any business, whether it's a startup or a global conglomerate. The continuing revolution in technology has enabled bookkeeping and accounting activities to be done more efficiently while giving business owners, particularly small businesses like Future Glory, the time to spend expanding their business and giving back to their local communities.

Sources: "Corporate Profile," https://www.intuit.com, accessed August 11, 2017; "QuickBooks Online," https://quickbooks.intuit.com, accessed August 11, 2017; "Our Story," https://futureglory.co, accessed August 10, 2017; "It's in the Bag—Future Glory Blends Apps with QuickBooks to Craft Fine Leather Goods," https://quickbooks.intuit.com, accessed August 10, 2017; Jordan Kushins, "Guide to Dogpatch's Flourishing Design Shops," *San Francisco Chronicle,*http://www.sfchronicle.com, March 1, 2017; David Leøng Photography blog, "November—Theresa Lee," http://www.davidleongphoto.com, November 30, 2016.

Financial information is central to every organization. To operate effectively, businesses must have a way to track income, expenses, assets, and liabilities in an organized manner. Financial information is also essential for decision-making. Managers prepare financial reports using accounting, a set of procedures and guidelines for companies to follow when preparing financial reports. Unless you understand basic accounting concepts, you will not be able to "speak" the standard financial language of businesses. This module examines the role of accounting in business, how accounting contributes to a company's overall success, the three primary financial statements, and careers in accounting.

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13.2: Accounting- More than Numbers

Why are financial reports and accounting information important, and who uses them?

Prior to 2001, accounting topics rarely made the news. That changed when Enron Corp.'s manipulation of accounting rules to improve its financial statements hit the front pages of newspapers. The company filed bankruptcy in 2001, and its former top executives were charged with multiple counts of conspiracy and fraud. Arthur Andersen, Enron's accounting firm, was indicted and convicted of obstruction of justice, and in 2002, the once-respected firm went out of business. Soon financial abuses at other companies—among them Tyco, Adelphia, WorldCom, and more recently Madoff Investment Securities—surfaced. Top executives at these and other companies were accused of knowingly flouting accepted accounting standards to inflate current profits and increase their compensation. Many were subsequently convicted:

- Investment securities broker Bernard Madoff and his accountant bilked investors out of more than $65 billion; Madoff is currently serving a 150-year prison term.
- Andrew Fastow, Enron's former chief financial officer, and Ben Glisan Jr., its former treasurer, pleaded guilty and received prison terms of 10 and five years, respectively. The company's former chairman, Ken Lay, and CEO, Jeffrey Skilling, were convicted of multiple charges.
- Bernard Ebbers, WorldCom's CEO, was sentenced to 25 years in prison for conspiracy, securities fraud, and filing false reports with regulatory agencies—crimes that totaled $11 billion in accounting fraud.
- Tyco's CEO L. Dennis Kozlowski was fined $70 million and sentenced to 8 to 25 years.[1]

These and other cases raised critical concerns about the independence of those who audit a company's financial statements, questions of integrity and public trust, and issues with current financial reporting standards. Investors suffered as a result because the crisis in confidence sent stock prices tumbling, and companies lost billions in value.

So it's no surprise that more people are paying attention to accounting topics. We now recognize that accounting is the backbone of any business, providing a framework to understand the firm's financial condition. Reading about accounting irregularities, fraud, audit (financial statement review) shortcomings, out-of-control business executives, and bankruptcies, we have become very aware of the importance of accurate financial information and sound financial procedures.

All of us—whether we are self-employed, work for a local small business or a multinational Fortune 100 firm, or are not currently in the workforce—benefit from knowing the basics of accounting and financial statements. We can use this information to educate ourselves about companies before interviewing for a job or buying a company's stock or bonds. Employees at all levels of an organization use accounting information to monitor operations. They also must decide which financial information is important for their company or business unit, what those numbers mean, and how to use them to make decisions.



Exhibit 14.2: This advertisement by the U.S. Marshals Service underscores the greed and financial abuse caused by Bernard Madoff, as his personal belongings were seized by the government and auctioned off to help pay for the $65 billion lost by individuals who invested in his financial securities firm. Madoff is serving a jail term of 150 years for his fraudulent actions. *What should be the lessons learned by executives and accounting professionals about Madoff's behavior?* (Credit: P K /Flickr/ Attribution 2.0 Generic (CC BY 2.0))

This chapter starts by discussing why accounting is important for businesses and for users of financial information. Then it provides a brief overview of the accounting profession and the post-Enron regulatory environment. Next it presents an overview of basic accounting procedures, followed by a description of the three main financial statements—the balance sheet, the income statement, and the statement of cash flows. Using these statements, we then demonstrate how ratio analysis of financial statements can provide valuable information about a company's financial condition. Finally, the chapter explores current trends affecting the accounting profession.

Accounting Basics

Accounting is the process of collecting, recording, classifying, summarizing, reporting, and analyzing financial activities. It results in reports that describe the financial condition of an organization. All types of organizations—businesses, hospitals, schools, government agencies, and civic groups—use accounting procedures. Accounting provides a framework for looking at past performance, current financial health, and possible future performance. It also provides a framework for comparing the financial positions and financial performances of different firms. Understanding how to prepare and interpret financial reports will enable you to evaluate two companies and choose the one that is more likely to be a good investment.

The accounting system shown in **Exhibit 14.3** converts the details of financial transactions (sales, payments, purchases, and so on) into a form that people can use to evaluate the firm and make decisions. Data become information, which in turn becomes reports. These reports describe a firm's financial position at one point in time and its financial performance during a specified period. Financial reports include *financial statements,* such as balance sheets and income statements, and special reports, such as sales and expense breakdowns by product line.



Exhibit 14.3: **The Accounting System** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Who Uses Financial Reports?

The accounting system generates two types of financial reports, as shown in **Exhibit 14.4**: internal and external. Internal reports are used within the organization. As the term implies, **managerial accounting** provides financial information that managers inside the organization can use to evaluate and make decisions about current and future operations. For instance, the sales reports prepared by managerial accountants show how well marketing strategies are working, as well as the number of units sold in a specific period of time. This information can be used by a variety of managers within the company in operations as well as in production or manufacturing to plan future work based on current financial data. Production cost reports can help departments track and control costs, as well as zero in on the amount of labor needed to produce goods or services. In addition, managers may prepare very detailed financial reports for their own use and provide summary reports to top management, providing key executives with a "snapshot" of business operations in a specific timeframe.

Financial accounting focuses on preparing external financial reports that are used by outsiders; that is, people who have an interest in the business but are not part of the company's management. Although they provide useful information for managers, these reports are used primarily by lenders, suppliers, investors, government agencies, and others to assess the financial strength of a business.

To ensure accuracy and consistency in the way financial information is reported, accountants in the United States follow **generally accepted accounting principles (GAAP)** when preparing financial statements. The **Financial Accounting Standards Board (FASB)** is a private organization that is responsible for establishing financial accounting standards used in the United States.

Currently there are no international accounting standards. Because accounting practices vary from country to country, a multinational company must make sure that its financial statements conform to both its own country's accounting standards and those of the parent company's country. Often another country's standards are quite different from U.S. GAAP. In the past, the U.S. Financial Accounting Standards Board and the International Accounting Standards Board (IASB) worked together to develop global accounting standards that would make it easier to compare financial statements of foreign-based companies. However, as of this writing, the two organizations have not agreed on a global set of accounting standards.

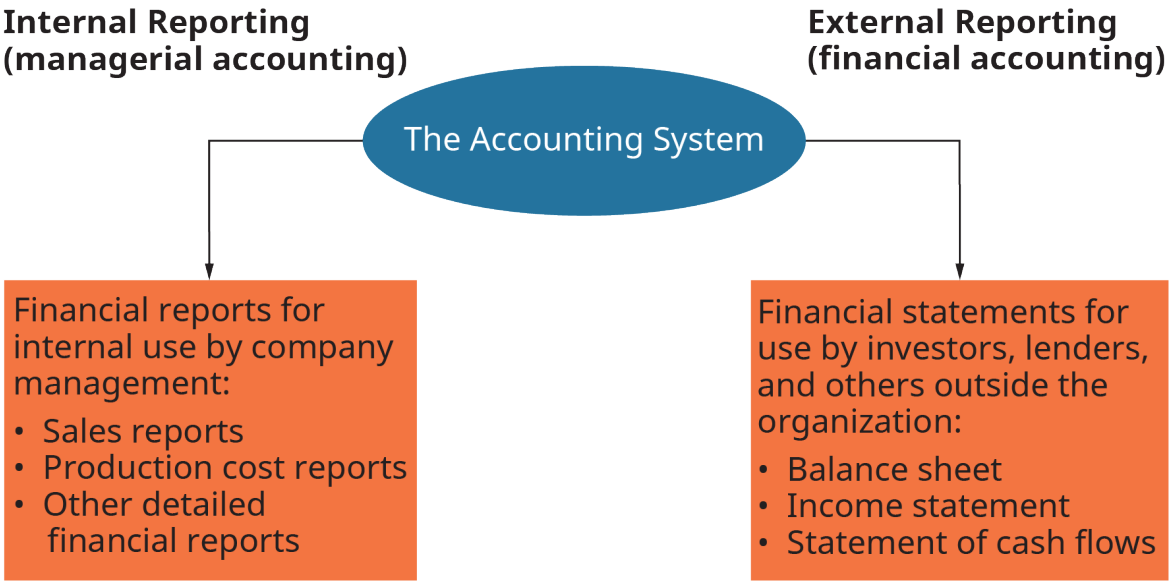


Exhibit 14.4: **Reports Provided by the Accounting System** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

EXPANDING AROUND THE GLOBE

Global Accounting Standards Unlikely to Happen

Imagine being a CFO of a major multinational company with significant operations in 10 other countries. Because the accounting rules in those countries don't conform to GAAP, your staff has to prepare nine sets of financial reports that comply with the host country's rules—and also translate the figures to GAAP for consolidation into the parent company's statements in the United States. It's a massive undertaking for anyone.

The U.S. FASB and the IASB have tried to make this task easier, but progress has been slow. These groups hoped to develop international accounting standards that remove disparities between national and international standards, improve the quality of financial information worldwide, and simplify comparisons of financial statements across borders for both corporations and investors. Unfortunately, it looks like this goal of convergence is slipping away.

More than a decade ago, the FASB and the IASB jointly published a memorandum of understanding (MOU) reaffirming the two organizations' desire to create uniform global accounting standards. "This document underscores our strong commitment to continue to work together with the IASB to bring about a common set of accounting standards that will enhance the quality, comparability, and consistency of global financial reporting, enabling the world's capital markets to operate more effectively," said Robert Herz, FASB's former chairman. Sir David Tweedie, then chairman of the IASB, agreed: "The pragmatic approach described in the MOU enables us to provide much-needed stability for companies using IFRS [the IASB's International Financial Reporting Standards] in the near term," he commented. (About 150 countries worldwide currently use IFRS.)

As they worked toward convergence, the board members decided to develop a new set of common standards rather than try to reconcile the two standards. These new standards had to be better than existing ones, not simply eliminate differences. Unfortunately, merging GAAP and IFRS into a consistent set of international accounting standards has proven to be very difficult because of different approaches used in the two sets. For example, because of frequent litigation surrounding financial information in the United States, preparers of financial statements demand very detailed rules in all areas of accounting, in contrast to the IASB's approach of setting accounting principles and leaving preparers to apply them to individual situations they encounter. In addition, many companies doing business in the United States fear that moving toward global accounting standards would be very costly and time-consuming in terms of changing accounting software, employee and vendor training, and other business-related practices.

For now, the two organizations agree to disagree on when and if they can "converge" GAAP and IFRS into a global set of standards. However, they continue to keep each other informed about upcoming changes in standards that may impact accounting practices worldwide.

Critical Thinking Questions

1. Is it important to have a single set of international accounting standards for at least publicly owned companies? Defend your answer.
2. Do you think the two organizations will ever come close to uniform global accounting standards? Use a search engine and the archives of *CFO* magazine, **http://www.cfo.com**, to research this topic, and summarize your findings.

Sources: "Who Uses IFRS Standards?" www.ifrs.org, accessed August 10, 2017; "FASB and IASB Reaffirm Commitment to Enhance Consistency, Comparability and Efficiency in Global Capital Markets," (press release), http://www.fasb.org, accessed August 10, 2017; Ken Tysiac, "Will Brexit, Trump Affect Global Accounting Standards?" http://www.journalofaccountancy.com, December 6, 2016; Bruce Cowie, "Insights: IFRS/US GAAP Convergence and Global Accounting Standards—Where Are We Now?" kaplan.co.uk, September 26, 2016; Michael Cohn, "IASB and FASB Look Beyond Convergence," https://www.accountingtoday.com, December 9, 2014; David M. Katz, "The Split over Convergence," *CFO,* http://ww2.cfo.com, October 17, 2014.

Financial statements are the chief element of the **annual report**, a yearly document that describes a firm's financial status. Annual reports usually discuss the firm's activities during the past year and its prospects for the future. Three primary financial statements included in the annual report are discussed and shown later in this chapter:

- The balance sheet
- The income statement
- The statement of cash flows

CONCEPT CHECK

1. Explain who uses financial information.
2. Differentiate between financial accounting and managerial accounting.
3. How do GAAP, the FASB, and the IASB influence the accounting industry?

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13.3: The Accounting Profession

What are the differences between public and private accountants, and how has federal legislation affected their work?

When you think of accountants, do you picture someone who works in a back room, hunched over a desk, wearing a green eye shade and scrutinizing pages and pages of numbers? Although today's accountants still must love working with numbers, they now work closely with their clients to not only prepare financial reports but also help them develop good financial practices. Advances in technology have taken the tedium out of the number-crunching and data-gathering parts of the job and now offer powerful analytical tools as well. Therefore, accountants must keep up with information technology trends. The accounting profession has grown due to the increased complexity, size, and number of businesses and the frequent changes in the tax laws. Accounting is now a $95 billion-plus industry. The more than 1.4 million accountants in the United States are classified as either public accountants or private (corporate) accountants. They work in public accounting firms, private industry, education, and government, and about 10 percent are self-employed. The job outlook for accountants over the next decade is positive; the Bureau of Labor Statistics projects that accounting and auditing jobs will increase 11 percent faster than many other industries in the U.S. economy.[2]

Public Accountants

Independent accountants who serve organizations and individuals on a fee basis are called **public accountants**. Public accountants offer a wide range of services, including preparation of financial statements and tax returns, independent auditing of financial records and accounting methods, and management consulting. **Auditing**, the process of reviewing the records used to prepare financial statements, is an important responsibility of public accountants. They issue a formal *auditor's opinion* indicating whether the statements have been prepared in accordance with accepted accounting rules. This written opinion is an important part of a company's annual report.

The largest public accounting firms, called the Big Four, operate worldwide and offer a variety of business consulting services in addition to accounting services. In order of size, they are Deloitte, PwC (PricewaterhouseCoopers), EY (Ernst & Young), and KPMG International.[3] A former member of this group, Arthur Andersen, disbanded in 2002 as a result of the Enron scandal.

To become a **certified public accountant (CPA)**, an accountant must complete an approved bachelor's degree program and pass a test prepared by the American Institute of CPAs (AICPA). Each state also has requirements for CPAs, such as several years' on-the-job experience and continuing education. Only CPAs can issue the auditor's opinion on a firm's financial statements. Most CPAs first work for public accounting firms and later may become private accountants or financial managers. Of the more than 418,000 accountants who belong to the AICPA, 47 percent work in public accounting firms and 39 percent in business and industry.[4]

Private Accountants

Accountants employed to serve one particular organization are **private accountants**. Their activities include preparing financial statements, auditing company records to be sure employees follow accounting policies and procedures, developing accounting systems, preparing tax returns, and providing financial information for management decision-making. Whereas some private accountants hold the CPA designation, managerial accountants also have a professional certification program. Requirements to become a **certified management accountant (CMA)** include passing an examination.

Reshaping the Accounting Environment

Although our attention was focused on big-name accounting scandals in the late 1990s and early 2000s, an epidemic of accounting irregularities was also taking place in the wider corporate arena. The number of companies restating annual financial statements grew at an alarming rate, tripling from 1997 to 2002. In the wake of the numerous corporate financial scandals, Congress and the accounting profession took major steps to prevent future accounting irregularities. These measures targeted

the basic ways, cited by a report from the AICPA, that companies massaged financial reports through creative, aggressive, or inappropriate accounting techniques, including:

- Committing fraudulent financial reporting
- Stretching accounting rules to significantly enhance financial results
- Following appropriate accounting rules but using loopholes to manage financial results

Why did companies willfully push accounting to the edge—and over it—to artificially pump up revenues and profits? Looking at the companies involved in the scandals, some basic similarities have emerged:

- A company culture of arrogance and above-average tolerance for risk
- Interpretation of accounting policies to their advantage and manipulation of the rules to get to a predetermined result and conceal negative financial information
- Compensation packages tied to financial or operating targets, making executives and managers greedy and pressuring them to find sometimes-questionable ways to meet what may have been overly optimistic goals
- Ineffective checks and balances, such as audit committees, boards of directors, and financial control procedures, that were not independent from management
- Centralized financial reporting that was tightly controlled by top management, increasing the opportunity for fraud
- Financial performance benchmarks that were often out of line with the companies' industry
- Complicated business structures that clouded how the company made its profits
- Cash flow from operations that seemed out of line with reported earnings (You'll learn about this important difference between cash and reported earnings in the sections on the income statement and statement of cash flows.)
- Acquisitions made quickly, often to show growth rather than for sound business reasons; management focused more on buying new companies than making the existing operations more profitable[5]

Companies focused on making themselves look good in the short term, doing whatever was necessary to top past performance and to meet the expectations of investment analysts, who project earnings, and investors, who panic when a company misses the analysts' forecasts. Executives who benefited when stock prices rose had no incentive to question the earnings increases that led to the price gains.

These number games raised serious concerns about the quality of earnings and questions about the validity of financial reports. Investors discovered to their dismay that they could neither assume that auditors were adequately monitoring their clients' accounting methods nor depend on the integrity of published financial information.

Better Numbers Ahead

Over the past 15 years, a number of accounting reforms have been put in place to set better standards for accounting, auditing, and financial reporting. Investors, now aware of the possibility of various accounting shenanigans, are avoiding companies that use complicated financial structures and off-the-books financing.

In 2002, the **Sarbanes-Oxley Act** (commonly referred to as SOX) went into effect. This law, one of the most extensive pieces of business legislation passed by Congress, was designed to address the investing public's lack of trust in corporate America. It redefines the public corporation–auditor relationship and restricts the types of services auditors can provide to clients. The Act clarifies auditor-independence issues, places increased accountability on a company's senior executives and management, strengthens disclosure of insider transactions (an employee selling stock based on information not known by the public), and prohibits loans to executives.

An independent five-member Public Company Accounting Oversight Board (PCAOB) was given the authority to set and amend auditing, quality control, ethics, independence, and other standards for audit reports. The Act specifies that all PCAOB members be financially literate. Two members must have their CPA designation, and the other three cannot be or have been CPAs. Appointed and overseen by the Securities and Exchange Commission (SEC), the PCAOB can also inspect accounting firms; investigate breaches of securities law, standards, competency, and conduct; and take disciplinary action. The corporate Board registers public accounting firms, as the Act now requires. Altering or destroying key audit documents now carries felony charges and increased penalties.

Other key provisions of the Act cover the following areas:

- *Auditing standards:* The Board must include in its standards several requirements, such as maintaining audit work papers

and other documentation for audit reports for seven years, the review and approval of audit reports by a second partner, and audit standards for quality control and review of internal control procedures.

- *Financial disclosure:* Companies must clearly disclose all transactions that may have a material current or future effect on their financial condition, including those that are off the books or with unconsolidated entities (related companies whose results the company is not required to combine with its own financial statements under current accounting rules). Management and major stockholders must disclose transactions such as sales of company stock within two days of the transaction. The company must disclose its code of ethics for senior financial executives. Any significant changes in a company's operations or financial condition must be disclosed "on a rapid and current basis."
- *Financial statement certification:* Chief executive officers and chief financial officers must certify company financial statements, with severe criminal and civil penalties for false certification. If securities fraud results in restatement of financial reports, these executives will lose any stock-related profits and bonuses they received prior to the restatement.
- *Internal controls:* Each company must have appropriate internal control procedures in place for financial reporting, and its annual report must include a report on implementation of those controls to assure the integrity of financial reports.
- *Consulting work:* The Act restricts the non-auditing work auditors may perform for a client. In the past, the large accounting firms had expanded their role to include a wide range of advisory services that went beyond their traditional task of validating a company's financial information. Conflicts of interest arose when the same firm earned lucrative fees for both audit and consulting work for the same client.[6]

Other regulatory organizations also took steps to prevent future abuses. In September 2002, the AICPA Auditing Standards Board(ASB) issued expanded guidelines to help auditors uncover fraud while conducting audits. The New York Stock Exchange stiffened its listing requirements so that the majority of directors at listed companies must be independent and not employees of the corporation. Nor can auditors serve on clients' boards for five years. Companies listed in the Nasdaq marketplace cannot hire former auditors at any level for three years.

In response to the passage of Sarbanes-Oxley and other regulations, companies implemented new control measures and improved existing ones. The burdens in both cost and time have been considerable. Many companies had to redesign and restructure financial systems to improve efficiency. Some finance executives believe that their investment in increased controls has improved shareholder perceptions of their company's ethics. Others, however, reported that costs depressed earnings and negatively affected stock prices. Despite the changes and costs associated with SOX compliance, 15 years after the law's implementation, many business executives believe that the process has helped them fine-tune financial activities and reporting while addressing dynamic changes in the market and other economic challenges.[7]

CONCEPT CHECK

1. Compare the responsibilities of public and private accountants. How are they certified?
2. Summarize the major changes affecting accounting and corporate reporting and the reasons for them.

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13.4: Basic Accounting Procedures

What are the six steps in the accounting cycle?

Using generally accepted accounting principles, accountants record and report financial data in similar ways for all firms. They report their findings in financial statements that summarize a company's business transactions over a specified time period. As mentioned earlier, the three major financial statements are the balance sheet, income statement, and statement of cash flows.

People sometimes confuse accounting with bookkeeping. Accounting is a much broader concept. *Bookkeeping,* the system used to record a firm's financial transactions, is a routine, clerical process. Accountants take bookkeepers' transactions, classify and summarize the financial information, and then prepare and analyze financial reports. Accountants also develop and manage financial systems and help plan the firm's financial strategy.

The Accounting Equation

The accounting procedures used today are based on those developed in the late 15th century by an Italian monk, Brother Luca Pacioli. He defined the three main accounting elements as assets, liabilities, and owners' equity. **Assets** are things of value owned by a firm. They may be *tangible,* such as cash, equipment, and buildings, or *intangible,* such as a patent or trademarked name. **Liabilities**—also called *debts*—are what a firm owes to its creditors. **Owners' equity** is the total amount of investment in the firm minus any liabilities. Another term for owners' equity is *net worth*.

The relationship among these three elements is expressed in the accounting equation:

$$\text{Assets} - \text{Liabilities} = \text{Owners' equity}$$

The accounting equation must always be in balance (that is, the total of the elements on one side of the equals sign must equal the total on the other side).

Suppose you start a coffee shop and put $10,000 in cash into the business. At that point, the business has assets of $10,000 and no liabilities. This would be the accounting equation:

$$\begin{array}{rcl} \text{Assets} = \text{Liabilities} & + & \text{Owners' equity} \\ \$10,000 = \$0 & + & \$10,000 \end{array}$$

The liabilities are zero and owners' equity (the amount of your investment in the business) is $10,000. The equation balances.

To keep the accounting equation in balance, every transaction must be recorded as two entries. As each transaction is recorded, there is an equal and opposite event so that two accounts or records are changed. This method is called **double-entry bookkeeping**.

Suppose that after starting your business with $10,000 cash, you borrow another $10,000 from the bank. The accounting equation will change as follows:

$$\begin{array}{rcll} \text{Assets} = \text{Liabilities} & + & \text{Owners' equity} & \\ \$10,000 = \$0 & + & \$10,000 & \text{Initial Equation} \\ \$10,000 = \$10,00 & + & \$0 & \text{Borrowing transaction} \\ \$20,000 = \$10,00 & + & \$10,000 & \text{Equation after borrowing} \end{array}$$

Now you have $20,000 in assets—your $10,000 in cash and the $10,000 loan proceeds from the bank. The bank loan is also recorded as a liability of $10,000 because it's a debt you must repay. Making two entries keeps the equation in balance.

The Accounting Cycle

The *accounting cycle* refers to the process of generating financial statements, beginning with a business transaction and ending with the preparation of the report. **Exhibit 14.5** shows the six steps in the accounting cycle. The first step in the cycle is to analyze the data collected from many sources. All transactions that have a financial impact on the firm—sales, payments to employees and suppliers, interest and tax payments, purchases of inventory, and the like—must be documented. The accountant must review the documents to make sure they're complete.

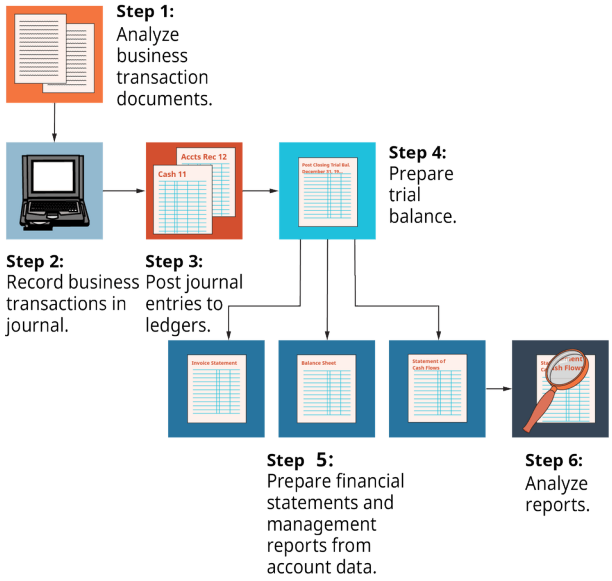


Exhibit 14.5: **The Accounting Cycle** (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Next, each transaction is recorded in a *journal,* a listing of financial transactions in chronological order. The journal entries are then recorded in *ledgers,* which show increases and decreases in specific asset, liability, and owners' equity accounts. The ledger totals for each account are summarized in a *trial balance,* which is used to confirm the accuracy of the figures. These values are used to prepare financial statements and management reports. Finally, individuals analyze these reports and make decisions based on the information in them.

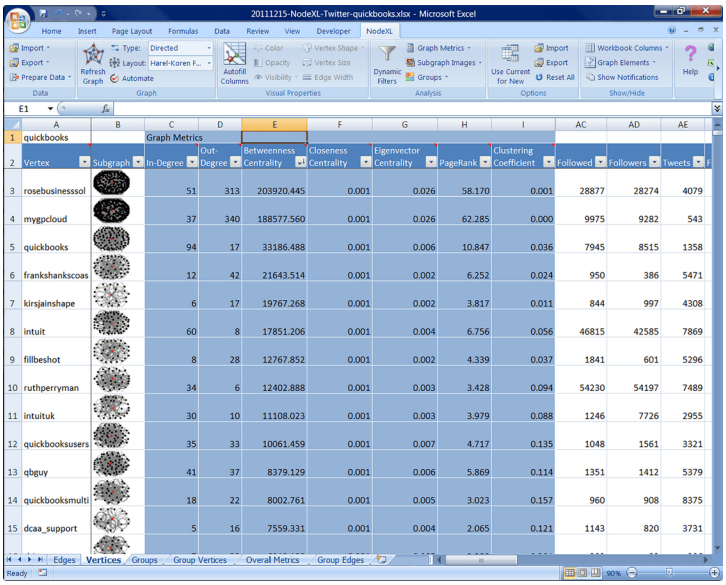


Exhibit 14.6: QuickBooks is a well-known software developer that provides business-management solutions to businesses of different sizes. The company's accounting software tools benefit professionals by automating a broad range of accounting and other business tasks. QuickBooks has become standard in the accounting and business fields, assisting in managerial decision-making and streamlining bookkeeping and accounting processes. *What accounting functions are typically incorporated into basic accounting software programs?*(Credit: Marc Smith/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Technological Advances

Over the past decade, technology has had a significant impact on the accounting industry. Computerized and online accounting programs now do many different things to make business operations and financial reporting more efficient. For example, most accounting packages offer basic modules that handle general ledger, sales order, accounts receivable, purchase order, accounts payable, and inventory control functions. Tax programs use accounting data to prepare tax returns and tax plans. Point-of-sale terminals used by many retail firms automatically record sales and do some of the bookkeeping. The Big Four and many other large public accounting firms develop accounting software for themselves and for clients.

Accounting and financial applications typically represent one of the largest portions of a company's software budget. Accounting software ranges from off-the-shelf programs for small businesses to full-scale customized enterprise resource planning systems for major corporations. Although these technological advances in accounting applications have made the financial aspects of running a small business much easier, entrepreneurs and other small-business owners should take to time to understand underlying accounting principles, which play an important role in evaluating just how financially sound a business enterprise really is.

MANAGING CHANGE

Data Analytics Become Effective CPA Tool

Knowledge is power, and understanding what your customers want and how your company can provide it often differentiates you from the competition. As the accounting field continues to take advantage of technological advances, it is important that data analytics become a key element of any accounting professional's toolbox.

Historically described as "paper pushers" who track financial information, today's accountants need to learn about big data and data analytics as part of their continuing education. Not long ago, an accountant's work finished when business financial statements were finalized and tax forms were ready to be filed with federal, state, and local governing bodies. Not anymore. With the revolution of computer technology, automation, and data collection from a myriad of sources, accountants can use data analytics to provide a clearer picture of the overall business environment for their companies and clients on an ongoing basis.

Data analytics can be defined as the process of examining numerous data sets (sometimes called big data) to draw conclusions about the information they contain, with the assistance of specialized systems and software. Using data analytics effectively can

help businesses increase revenue, expand operations, maximize customer service, and more. Accountants can use data analytics to make more accurate and detailed forecasts; help companies link diverse financial and nonfinancial data sets, which provides a more comprehensive reporting of their overall performance to shareholders and others; assess and manage risk across the entire organization; and identify possible fraud.

Data analytics can also improve and enhance the auditing process because more information will now be collected, which allows for analysis of *full* data sets in situations where only samples were audited previously. In addition, continuous monitoring will be easier to accomplish using data sets that are comprehensive.

Accounting professionals who can adapt to quickly changing technology such as data analytics will not only expand the scope of their expertise but also provide financial guidance that will give their companies and clients a strong strategic advantage over competitors.

Critical Thinking Questions

1. How can accountants use data analytics to enhance the services they provide to their clients?
2. Is the seismic shift in technology a good thing for professional accountants? Explain your reasoning.

Sources: "Data Analytics," http://searchdatamanagement.techtarget.com, accessed August 11, 2017; Jiali Tang and Khondkar E. Karim, "Big Data in Business Analytics: Implications for the Audit Profession," *The CPA Journal,*http://www.cpajournal.com, June 2017 issue; Clarence Goh, "Are You Ready? Data Analytics Is Reshaping the Work of Accountants," https://www.cfoinnovation.com, February 28, 2017; Norbert Tschakert, Julia Kokina, Stephen Kozlowski, and Miklos Vasarhelyi, "The Next Frontier in Data Analytics," *Journal of Accountancy,*http://www.journalofaccountancy.com, August 1, 2016.

CONCEPT CHECK

1. Explain the accounting equation.
2. Describe the six-step accounting cycle.
3. What role do computers and other technology play in accounting?

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13.5: The Balance Sheet

In what terms does the balance sheet describe the financial condition of an organization?

The **balance sheet**, one of three financial statements generated from the accounting system, summarizes a firm's financial position at a specific point in time. It reports the resources of a company (assets), the company's obligations (liabilities), and the difference between what is owned (assets) and what is owed (liabilities), or owners' equity.

The assets are listed in order of their **liquidity**, the speed with which they can be converted to cash. The most liquid assets come first, and the least liquid are last. Because cash is the most liquid asset, it is listed first. Buildings, on the other hand, have to be sold to be converted to cash, so they are listed after cash. Liabilities are arranged similarly: liabilities due in the short term are listed before those due in the long term.

The balance sheet as of December 31, 2018, for Delicious Desserts, Inc., a fictitious bakery, is illustrated in Table 14.1. The basic accounting equation is reflected in the three totals highlighted on the balance sheet: assets of $148,900 equal the sum of liabilities and owners' equity ($70,150 + $78,750). The three main categories of accounts on the balance sheet are explained below.

Table 14.1: Balance Sheet for Delicious Desserts

Delicious Desserts, Inc. **Balance Sheet as of December 31, 2018**			
Assets			
Current assets: Cash Marketable securities Accounts receivable Less: Allowance for doubtful accounts Notes receivable Inventory Total current assets	$45,000 1,300	$15,000 4,500 43,700 5,000 15,000	83,200
Fixed assets: Bakery equipment Less: Accumulated depreciation Furniture and fixtures Less: Accumulated depreciation Total fixed assets Intangible assets: Trademark Goodwill Total intangible assets Total assets	$56,000 16,000 $18,450 4,250	$40,000 14,200 $ 4,500 7,000	54,200 11,500 $148,900
Liabilities and owners' equity			
Current liabilities: Accounts payable Notes payable Accrued expenses Income taxes payable Current portion of long-term debt Total current liabilities	$30,650 15,000 4,500 5,000 5,000	$60,150	
Long-term liabilities: Bank loan for bakery equipment Total long-term liabilities Total liabilities	$10,000	10,000	$ 70,150
Owners' equity: Common stock (10,000 shares outstanding) Retained earnings Total owners' equity Total liabilities and owners' equity		$30,000 48,750	78,750 $148,900

Assets

Assets can be divided into three broad categories: current assets, fixed assets, and intangible assets. **Current assets** are assets that can or will be converted to cash within the next 12 months. They are important because they provide the funds used to pay the firm's current bills. They also represent the amount of money the firm can quickly raise. Current assets include:

- *Cash:* Funds on hand or in a bank
- *Marketable securities:* Temporary investments of excess cash that can readily be converted to cash
- *Accounts receivable:* Amounts owed to the firm by customers who bought goods or services on credit
- *Notes receivable:* Amounts owed to the firm by customers or others to whom it lent money

- *Inventory:* Stock of goods being held for production or for sale to customers

Fixed assets are long-term assets used by the firm for more than a year. They tend to be used in production and include land, buildings, machinery, equipment, furniture, and fixtures. Except for land, fixed assets wear out and become outdated over time. Thus, they decrease in value every year. This declining value is accounted for through depreciation. **Depreciation** is the allocation of the asset's original cost to the years in which it is expected to produce revenues. A portion of the cost of a depreciable asset—a building or piece of equipment, for instance—is charged to each of the years in which it is expected to provide benefits. This practice helps match the asset's cost against the revenues it provides. Because it is impossible to know exactly how long an asset will last, estimates are used. They are based on past experience with similar items or IRS guidelines for assets of that type. Notice that, through 2018, Delicious Desserts has taken a total of $16,000 in depreciation on its bakery equipment.

Intangible assets are long-term assets with no physical existence. Common examples are patents, copyrights, trademarks, and goodwill. *Patents* and *copyrights* shield the firm from direct competition, so their benefits are more protective than productive. For instance, no one can use more than a small amount of copyrighted material without permission from the copyright holder. *Trademarks* are registered names that can be sold or licensed to others. One of Delicious Desserts' intangible assets is a trademark valued at $4,500. *Goodwill* occurs when a company pays more for an acquired firm than the value of its tangible assets. Delicious Desserts' other tangible asset is goodwill of $7,000.

Liabilities

Liabilities are the amounts a firm owes to creditors. Those liabilities coming due sooner—current liabilities—are listed first on the balance sheet, followed by long-term liabilities.

Current liabilities are those due within a year of the date of the balance sheet. These short-term claims may strain the firm's current assets because they must be paid in the near future. Current liabilities include:

- *Accounts payable:* Amounts the firm owes for credit purchases due within a year. This account is the liability counterpart of accounts receivable.
- *Notes payable:* Short-term loans from banks, suppliers, or others that must be repaid within a year. For example, Delicious Desserts has a six-month, $15,000 loan from its bank that is a note payable.
- *Accrued expenses:* Expenses, typically for wages and taxes, that have accumulated and must be paid at a specified future date within the year although the firm has not received a bill
- *Income taxes payable:* Taxes owed for the current operating period but not yet paid. Taxes are often shown separately when they are a large amount.
- *Current portion of long-term debt:* Any repayment on long-term debt due within the year. Delicious Desserts is scheduled to repay $5,000 on its equipment loan in the coming year.

Long-term liabilities come due more than one year after the date of the balance sheet. They include bank loans (such as Delicious Desserts' $10,000 loan for bakery equipment), mortgages on buildings, and the company's bonds sold to others.

Owners' Equity

Owners' equity is the owners' total investment in the business after all liabilities have been paid. For sole proprietorships and partnerships, amounts put in by the owners are recorded as capital. In a corporation, the owners provide capital by buying the firm's common stock. For Delicious Desserts, the total common stock investment is $30,000. **Retained earnings** are the amounts left over from profitable operations since the firm's beginning. They are total profits minus all dividends (distributions of profits) paid to stockholders. Delicious Desserts has $48,750 in retained earnings.

CONCEPT CHECK

1. What is a balance sheet?
2. What are the three main categories of accounts on the balance sheet, and how do they relate to the accounting equation?
3. How do retained earnings relate to owners' equity?

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13.6: The Income Statement

How does the income statement report a firm's profitability?

The balance sheet shows the firm's financial position at a certain point in time. The **income statement** summarizes the firm's revenues and expenses and shows its total profit or loss over a period of time. Most companies prepare monthly income statements for management and quarterly and annual statements for use by investors, creditors, and other outsiders. The primary elements of the income statement are revenues, expenses, and net income (or net loss). The income statement for Delicious Desserts for the year ended December 31, 2018, is shown in Table 14.2.

Table 14.2: Income Statement for Delicious Desserts

Delicious Desserts, Inc. **Income Statement for the Year Ending December 31, 2018**			
Revenues			
Gross sales		$275,000	
Less: Sales discounts		2,500	
Less: Returns and allowances		2,000	
Net sales			$270,500
Cost of Goods Sold			
Beginning inventory, January 1		$ 18,000	
Cost of goods manufactured		109,500	
Total cost of goods available for sale		$127,500	
Less: Ending inventory December 31		15,000	
Cost of goods sold			112,500
Gross profit			**$158,000**
Operating Expenses			
Selling expenses			
Sales salaries	$31,000		
Advertising	16,000		
Other selling expenses	18,000		
Total selling expenses		$ 65,000	
General and administrative expenses			
Professional and office salaries	$20,500		
Utilities	5,000		
Office supplies	1,500		
Interest	3,600		
Insurance	2,500		
Rent	17,000		
Total general and administrative expenses		50,100	

Delicious Desserts, Inc. Income Statement for the Year Ending December 31, 2018			
Total operating expenses			115,100
Net profit before taxes			**$ 42,900**
Less: Income taxes			10,725
Net profit			**$ 32,175**

Revenues

Revenues are the dollar amount of sales plus any other income received from sources such as interest, dividends, and rents. The revenues of Delicious Desserts arise from sales of its bakery products. Revenues are determined starting with **gross sales**, the total dollar amount of a company's sales. Delicious Desserts had two deductions from gross sales. *Sales discounts* are price reductions given to customers that pay their bills early. For example, Delicious Desserts gives sales discounts to restaurants that buy in bulk and pay at delivery. *Returns and allowances* is the dollar amount of merchandise returned by customers because they didn't like a product or because it was damaged or defective. **Net sales** is the amount left after deducting sales discounts and returns and allowances from gross sales. Delicious Desserts' gross sales were reduced by $4,500, leaving net sales of $270,500.

Expenses

Expenses are the costs of generating revenues. Two types are recorded on the income statement: cost of goods sold and operating expenses.

The **cost of goods sold** is the total expense of buying or producing the firm's goods or services. For manufacturers, cost of goods sold includes all costs directly related to production: purchases of raw materials and parts, labor, and factory overhead (utilities, factory maintenance, machinery repair). For wholesalers and retailers, it is the cost of goods bought for resale. For all sellers, cost of goods sold includes all the expenses of preparing the goods for sale, such as shipping and packaging.

Delicious Desserts' cost of goods sold is based on the value of inventory on hand at the beginning of the accounting period, $18,000. During the year, the company spent $109,500 to produce its baked goods. This figure includes the cost of raw materials, labor costs for bakery workers, and the cost of operating the bakery area. Adding the cost of goods manufactured to the value of beginning inventory, we get the total cost of goods available for sale, $127,500. To determine the cost of goods sold for the year, we subtract the cost of inventory at the end of the period:

$127,500–$15,000=$112,500$127,500–$15,000=$112,500

The amount a company earns after paying to produce or buy its products but before deducting operating expenses is the **gross profit**. It is the difference between net sales and cost of goods sold. Because service firms do not produce goods, their gross profit equals net sales. Gross profit is a critical number for a company because it is the source of funds to cover all the firm's other expenses.

The other major expense category is **operating expenses**. These are the expenses of running the business that are not related directly to producing or buying its products. The two main types of operating expenses are selling expenses and general and administrative expenses. *Selling expenses* are those related to marketing and distributing the company's products. They include salaries and commissions paid to salespeople and the costs of advertising, sales supplies, delivery, and other items that can be linked to sales activity, such as insurance, telephone and other utilities, and postage. *General and administrative expenses* are the business expenses that cannot be linked to either cost of goods sold or sales. Examples of general and administrative expenses are salaries of top managers and office support staff; utilities; office supplies; interest expense; fees for accounting, consulting, and legal services; insurance; and rent. Delicious Desserts' operating expenses totaled $115,100.

Net Profit or Loss

The final figure—or bottom line—on an income statement is the **net profit** (or **net income**) or **net loss**. It is calculated by subtracting all expenses from revenues. If revenues are more than expenses, the result is a net profit. If expenses exceed

revenues, a net loss results.

Several steps are involved in finding net profit or loss. (These are shown in the right-hand column of Table 14.2.) First, cost of goods sold is deducted from net sales to get the gross profit. Then total operating expenses are subtracted from gross profit to get the net profit before taxes. Finally, income taxes are deducted to get the net profit. As shown in Table 14.2, Delicious Desserts earned a net profit of $32,175 in 2018.

It is very important to recognize that profit does not represent cash. The income statement is a summary of the firm's operating results during some time period. It does not present the firm's actual cash flows during the period. Those are summarized in the statement of cash flows, which is discussed briefly in the next section.

CONCEPT CHECK

1. What is an income statement? How does it differ from the balance sheet?
2. Describe the key parts of the income statement. Distinguish between gross sales and net sales.
3. How is net profit or loss calculated?

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13.7: The Statement of Cash Flows

Why is the statement of cash flows an important source of information?

Net profit or loss is one measure of a company's financial performance. However, creditors and investors are also keenly interested in how much cash a business generates and how it is used. The **statement of cash flows**, a summary of the money flowing into and out of a firm, is the financial statement used to assess the sources and uses of cash during a certain period, typically one year. All publicly traded firms must include a statement of cash flows in their financial reports to shareholders. The statement of cash flows tracks the firm's cash receipts and cash payments. It gives financial managers and analysts a way to identify cash flow problems and assess the firm's financial viability.



Exhibit 14.7: Coinstar is a cash cow—literally. The company established a niche counting loose change at the exits of supermarkets and other retailers everywhere. For a small fee, Coinstar's coin-counting machines turn penny jars and piggy banks into cash vouchers, a no-fee eGift card, or a charity donation. Recently Coinstar's parent company, Outerwall, was acquired by a private equity firm in a $1.6 billion deal to take the holding company private. *What does the statement of cash flows indicate about a company's financial status?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Using income statement and balance sheet data, the statement of cash flows divides the firm's cash flows into three groups:

- *Cash flow from operating activities:* Those related to the production of the firm's goods or services
- *Cash flow from investment activities:* Those related to the purchase and sale of fixed assets
- *Cash flow from financing activities:* Those related to debt and equity financing

Delicious Desserts' statement of cash flows for 2018 is presented in Table 14.3. It shows that the company's cash and marketable securities have increased over the last year. And during the year the company generated enough cash flow to increase inventory and fixed assets and to reduce accounts payable, accruals, notes payable, and long-term debt.

Table 14.3: Statement of Cash Flows for Delicious Desserts

Delicious Desserts, Inc. **Statement of Cash Flows for 2018**		
Cash Flow from Operating Activities		
Net profit after taxes	$32,175	
Depreciation	1,500	

Delicious Desserts, Inc. Statement of Cash Flows for 2018		
Decrease in accounts receivable	3,140	
Increase in inventory	(4,500)	
Decrease in accounts payable	(2,065)	
Decrease in accruals	(1,035)	
Cash provided by operating activities		$29,215
Cash Flow from Investment Activities		
Increase in gross fixed assets	($ 5,000)	
Cash used in investment activities		($5,000)
Cash Flow from Financing Activities		
Decrease in notes payable	($ 3,000)	
Decrease in long-term debt	(1,000)	
Cash used by financing activities		($4,000)
Net increase in cash and marketable securities		**$20,215**

CONCEPT CHECK

1. What is the purpose of the statement of cash flows?
2. Why has cash flow become such an important measure of a firm's financial condition?
3. What situations can you cite from the chapter that support your answer?

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13.8: Analyzing Financial Statements

How can ratio analysis be used to identify a firm's financial strengths and weaknesses?

Individually, the balance sheet, income statement, and statement of cash flows provide insight into the firm's operations, profitability, and overall financial condition. By studying the relationships among the financial statements, however, one can gain even more insight into a firm's financial condition and performance. A good way to think about analyzing financial statements is to compare it a fitness trainer putting clients through various well-established assessments and metrics to determine whether a specialized fitness program is paying dividends for the person in terms of better strength, endurance, and overall health. Financial statements at any given time can provide a snapshot of a company's overall health. Company management must use certain standards and measurements to determine whether they need to implement additional strategies to keep the company fit and making a profit.

Ratio analysis involves calculating and interpreting financial ratios using data taken from the firm's financial statements in order to assess its condition and performance. A financial ratio states the relationship between financial data on a percentage basis. For instance, current assets might be viewed relative to current liabilities or sales relative to assets. The ratios can then be compared over time, typically three to five years. A firm's ratios can also be compared to industry averages or to those of another company in the same industry. Period-to-period and industry ratios provide a meaningful basis for comparison, so that we can answer questions such as, "Is this particular ratio good or bad?"

It's important to remember that ratio analysis is based on historical data and may not indicate future financial performance. Ratio analysis merely highlights potential problems; it does not prove that they exist. However, ratios can help managers monitor the firm's performance from period to period to understand operations better and identify trouble spots.

Ratios are also important to a firm's present and prospective creditors (lenders), who want to see if the firm can repay what it borrows and assess the firm's financial health. Often loan agreements require firms to maintain minimum levels of specific ratios. Both present and prospective shareholders use ratio analysis to look at the company's historical performance and trends over time.

Ratios can be classified by what they measure: liquidity, profitability, activity, and debt. Using Delicious Desserts' 2018 balance sheet and income statement (**Table 14.1** and **Table 14.2**), we can calculate and interpret the key ratios in each group. Table 14.4summarizes the calculations of these ratios for Delicious Desserts. We'll now discuss how to calculate the ratios and, more important, how to interpret the ratio value.

Liquidity Ratios

Liquidity ratios measure the firm's ability to pay its short-term debts as they come due. These ratios are of special interest to the firm's creditors. The three main measures of liquidity are the current ratio, the acid-test (quick) ratio, and net working capital.

The **current ratio** is the ratio of total current assets to total current liabilities. Traditionally, a current ratio of 2 ($2 of current assets for every $1 of current liabilities) has been considered good. Whether it is sufficient depends on the industry in which the firm operates. Public utilities, which have a very steady cash flow, operate quite well with a current ratio well below 2. A current ratio of 2 might not be adequate for manufacturers and merchandisers that carry high inventories and have lots of receivables. The current ratio for Delicious Desserts for 2018, as shown in Table 14.4, is 1.4. This means little without a basis for comparison. If the analyst found that the industry average for small bakeries was 2.4, Delicious Desserts would appear to have low liquidity.

The **acid-test (quick) ratio** is like the current ratio except that it excludes inventory, which is the least-liquid current asset. The acid-test ratio is used to measure the firm's ability to pay its current liabilities without selling inventory. The name *acid-test* implies that this ratio is a crucial test of the firm's liquidity. An acid-test ratio of at least 1 is preferred. But again, what is an acceptable value varies by industry. The acid-test ratio is a good measure of liquidity when inventory cannot easily be converted to cash (for instance, if it consists of very specialized goods with a limited market). If inventory is liquid, the current ratio is better. Delicious Desserts' acid-test ratio for 2018 is 1.1. Because the bakery's products are perishable, it does not carry large inventories. Thus, the values of its acid-test and current ratios are fairly close. At a manufacturing company, however, inventory typically makes

up a large portion of current assets, so the acid-test ratio will be lower than the current ratio.

Table 14.4: Ratio Analysis for Delicious Desserts at Year-End 2018

Ratio	Formula	Calculation	Result
Liquidity Ratios			
Current ratio	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$	$\frac{\$83,200}{\$60,150}$	1.4
Acid-test (quick) ratio	$\frac{\text{Total current assets-inventory}}{\text{Total current liabilities}}$	$\frac{\$83,200 - \$15,000}{\$60,150}$	1.1
Net working capital	Total current assets- Total current liabilities	$\$83,200 - \$60,150$	$23,050
Profitability Ratios			
Net profit margin	$\frac{\text{Net profit}}{\text{Net sales}}$	$\frac{\$32,175}{\$270,500}$	11.9%
Return on equity	$\frac{\text{Net profit}}{\text{Total owners' equity}}$	$\frac{\$32,175}{\$78,750}$	40.9%
Earnings per share	$\frac{\text{Net profit}}{\text{Number of shares of common stock outstanding}}$	$\frac{\$32,175}{10,000}$	$3.22
Activity Ratio			
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$		
	$\frac{\text{Cost of goods sold}}{(\text{ Beginning inventory } + \text{ Ending inventory })/2}$	$\frac{\$112,500}{(\$18,000 + \$15,000)/2}$	
		$\frac{\$112,500}{\$16,500}$	6.8 times
Debt Ratio			
Debt-to-equity ratio	$\frac{\text{Total liabilities}}{\text{Owners' equity}}$	$\frac{\$70,150}{\$78,750}$	89.1%

Net working capital, though not really a ratio, is often used to measure a firm's overall liquidity. It is calculated by subtracting total current liabilities from total current assets. Delicious Desserts' net working capital for 2018 is $23,050. Comparisons of net working capital over time often help in assessing a firm's liquidity.

Profitability Ratios

To measure profitability, a firm's profits can be related to its sales, equity, or stock value. **Profitability ratios** measure how well the firm is using its resources to generate profit and how efficiently it is being managed. The main profitability ratios are net profit margin, return on equity, and earnings per share.

The ratio of net profit to net sales is the **net profit margin**, also called *return on sales*. It measures the percentage of each sales dollar remaining after all expenses, including taxes, have been deducted. Higher net profit margins are better than lower ones. The net profit margin is often used to measure the firm's earning power. "Good" net profit margins differ quite a bit from industry to industry. A grocery store usually has a very low net profit margin, perhaps below 1 percent, whereas a jewelry store's net profit margin would probably exceed 10 percent. Delicious Desserts' net profit margin for 2018 is 11.9 percent. In other words, Delicious Desserts is earning 11.9 cents on each dollar of sales.



Exhibit 14.8: For giant retailers such as Macy's, the high expense of operating a brick-and-mortar store counters the elevated markup on merchandise, resulting in slim profit margins. Because competition forces marketers to keep prices low, it is often a retailer's cost-cutting strategy, not initial markup or sales volume, that determines whether a business will be profitable. *What expenses other than payroll and the cost of merchandise affect a retailer's net profit margin?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

The ratio of net profit to total owners' equity is called **return on equity (ROE)**. It measures the return that owners receive on their investment in the firm, a major reason for investing in a company's stock. Delicious Desserts has a 40.9 percent ROE for 2018. On the surface, a 40.9 percent ROE seems quite good. But the level of risk in the business and the ROE of other firms in the same industry must also be considered. The higher the risk, the greater the ROE investors look for. A firm's ROE can also be compared to past values to see how the company is performing over time.

Earnings per share (EPS) is the ratio of net profit to the number of shares of common stock outstanding. It measures the number of dollars earned by each share of stock. EPS values are closely watched by investors and are considered an important sign of success. EPS also indicates a firm's ability to pay dividends. Note that EPS is the dollar amount earned by each share, not the actual amount given to stockholders in the form of dividends. Some earnings may be put back into the firm. Delicious Desserts' EPS for 2018 is $3.22.

Activity Ratios

Activity ratios measure how well a firm uses its assets. They reflect the speed with which resources are converted to cash or sales. A frequently used activity ratio is inventory turnover. The **inventory turnover ratio** measures the speed with which inventory moves through the firm and is turned into sales. It is calculated by dividing cost of goods sold by the average inventory. (Average inventory is estimated by adding the beginning and ending inventories for the year and dividing by 2.) Based on its 2018 financial data, Delicious Desserts' inventory, on average, is turned into sales 6.8 times each year, or about once every 54 days (365 days ÷ 6.8). The acceptable turnover ratio depends on the line of business. A grocery store would have a high turnover ratio, maybe 20 times a year, whereas the turnover for a heavy equipment manufacturer might be only three times a year.

Debt Ratios

Debt ratios measure the degree and effect of the firm's use of borrowed funds (debt) to finance its operations. These ratios are especially important to lenders and investors. They want to make sure the firm has a healthy mix of debt and equity. If the firm relies too much on debt, it may have trouble meeting interest payments and repaying loans. The most important debt ratio is the debt-to-equity ratio.

The **debt-to-equity ratio** measures the relationship between the amount of debt financing (borrowing) and the amount of equity financing (owners' funds). It is calculated by dividing total liabilities by owners' equity. In general, the lower the ratio, the better. But it is important to assess the debt-to-equity ratio against both past values and industry averages. Delicious Desserts' ratio for 2018 is 89.1 percent. The ratio indicates that the company has 89 cents of debt for every dollar the owners have provided. A ratio

above 100 percent means the firm has more debt than equity. In such a case, the lenders are providing more financing than the owners.

CONCEPT CHECK

1. How can ratio analysis be used to interpret financial statements?
2. Name the main liquidity and profitability ratios, and explain what they indicate.
3. What kinds of information do activity ratios give? Why are debt ratios of concern to lenders and investors?

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13.9: Trends in Accounting

What major trends affect the accounting industry today?

The post-SOX business environment has brought many changes to the accounting profession. When the public accounting industry could no longer regulate itself back in the late 1990s and early 2000s, it became subject to formal regulation for the first time. This regulatory environment set higher standards for audit procedures, which actually helped public companies fine-tune their financial reporting procedures, despite the added costs and labor hours needed to comply with SOX. Once again the core auditing business, rather than financial advisory and management consulting services, became the primary focus of public accounting firms. The relationship between accountants and their clients has also changed, and the role of chief audit executive has taken on more visibility in many large organizations. In addition, the FASB has made slow but steady progress in making changes related to GAAP, including a separate decision-making framework for users and preparers of private company financial statements.[8] There are several other important trends that may affect the accounting industry over the next several years, including cloud computing services, automation, and staffing challenges.

Cloud-Based Services

The internet and cloud technology continue to disrupt many industries, including accounting, and clients expect their accountants to be up to speed on how financial data and other accounting information can be entered, accessed, and discussed in a very short period of time. For the most part, gone are the days when accountants and their support staff spend hours manually inputting data that gets "re-hydrated" into standardized accounting and financial statements, and reams of paper generate a company's weekly, monthly, or yearly reports.

According to recent research, cloud-based accounting firms add five times more clients than traditional accounting firms because businesses expect their accountants to be able to use technology to create the company's financial picture in real time, while assisting them in decision-making about where to go next in terms of profitability, sales, expansion, etc. In addition, it is estimated that more than 90 percent of small and medium-sized companies use cloud-based accounting software, which helps them synthesize the information they collect for their many important financial statements. This use of computerized accounting programs offers many opportunities to accountants to shift their focus when it comes to attracting and retaining business clients.[9]

Automation

In addition to cloud-based services, automation will continue to play an important role in the accounting industry, particularly in auditing services, where the manual gathering and inputting of information can be an inefficient and sometimes inaccurate process. Being able to automate this process will help generate complete sets of data that will improve the overall details of the auditing process. In addition, accountants who can use a client's data files from their business operations and import this information into a tax or accounting software package will streamline the overall accounting process and lessen the tedious work of data entry.[10]

Staffing Challenges

As these and other disruptive technologies change the focus of accounting work, the challenge of hiring the right staff to use these new tools intensifies. With accounting processes becoming automated and less time-intensive, some accounting firms are becoming more connected to their clients and increasing their advisory services when it comes to daily business operations. This change in approach will likely have an impact on the type of experienced employees accountants hire in the future. In addition, because most services are now cloud-based and financial data is available rather quickly, businesses are apt to change accounting firms faster than in the past if they are unsatisfied with the services they receive. Accountants have a great opportunity to expand their business portfolios and increase their client list by leveraging technology as part of their overall corporate strategies.[11]

MANAGING CHANGE

Attracting and Retaining Millennial CPAs

Much has been written about millennials, the population segment born between 1980 and 2000. As the older baby boomer generation continues to retire, millennials now make up the largest group in the U.S. labor force. This group will continue to shape the workplace over the next few decades.

Businesses and other organizations cannot ignore this group and their expectations about employment. To be successful, today's accounting firms—whether Big 4 firms or small and mid-sized businesses—need to understand what makes millennials tick, what is important to them, what makes them look for new opportunities both within and outside the organization—and how to retain them.

Global accounting services company PwC recently partnered with several other institutions to conduct a two-year generational study about the attitudes of millennial employees. Key findings suggest that millennials want flexibility in their work lives that leads to an enjoyable work-life balance, appreciation for the work they accomplish, challenges that will help them grow in their careers, and continued support from employers. As a result of this study, PwC made several changes to its own work environment to attract and retain millennial workers, including flexible schedules, relaxed dress codes, greater communication at all levels of the company, and a renewed commitment to transparency within the organization.

PwC is not alone in shifting its organizational culture to address some of the issues millennials say are important factors for them within the work environment. For example, Baker Tilly, another top accounting firm, recognizes that more than half its workforce consists of millennials who have helped shape the company's approach to work. The themes of flexibility and trust permeate the company's culture, which reinforces employees' motivation to be engaged in work that is meaningful, satisfying, and helps them develop as individuals.

Here are some other strategies accounting firms might employ to keep their 30-something employees from jumping ship:

- *Initiate onboarding activities quickly:* Although training accounting professionals takes time, companies should engage and train new employees quickly to immerse them in organizational culture and assign them work they view as meaningful.
- *Assign mentors from the start:* Millennials want to know their work makes a difference, so what better way to get them involved right from the start than to make sure they are connected to mentors who can guide their work and career path.
- *Support a flexible approach to work:* Some millennials are in the prime of their career, and many may also be juggling a family life that requires a lot of their time. Companies need to remember that millennials like being productive, although they may not think a long workday equates to a productive one. The use of cloud-based technology encourages employees to do their work in a productive atmosphere that may not take place in the office.

Recognizing generational traits of millennials not only demonstrates commitment on the part of the company, but also helps keep these employees engaged and involved in their work.

Critical Thinking Questions

1. Do you think a shift in thinking when it comes to managing millennials is a smart strategy? Why or why not?
2. Will accounting firms be required to rethink their billing strategies to address millennials' insistence on a more flexible approach to work? Explain your reasoning.

Sources: "Workforce of the Future: The Competing Forces Shaping 2030," https://www.pwc.com, accessed August 11, 2017; Hitendra Patil, "The 7 Experiences Millennials Want from Your Firm," http://www.cpatrendlines.com, accessed August 11, 2017; "Millennial Accountants Don't Want a Corner Office with a View," https://www.rogercpareview.com, April 24, 2017; David Isaacs, "Voices: Confessions of a Millennial CPA: The Most Productive Generation," https://www.accountingtoday.com, April 20, 2017; Teri Saylor, "How CPA Firms Are Evolving to Meet Millennials' Desires," http://www.journalofaccountancy.com, March 6, 2017.

CONCEPT CHECK

1. How has the relationship between public accounting firms and their clients changed since SOX became law?
2. Describe how cloud computing and automation are changing the accounting industry.
3. What are some of the challenges encountered by accounting firms when introducing new technologies into their workflow

process?

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14: GLOBAL ENVIRONMENT

14.1: Why It Matters- Global Environment
14.2: Globalization
14.3: Measuring Global Trade
14.4: Global Buisness Strategies
14.5: Global Trade Forces
14.6: Global Trade Agreements and Organizations
14.7: Ethical Challenges in the Global Environment
14.8: Putting it Together- Global Environment

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14.1: Why It Matters- Global Environment

Why describe the characteristics, opportunities, and challenges of the global business environment?

 Grab your book bag, backpack, briefcase or whatever you carry your school supplies in, and open it up. Sort the contents into two piles: items made in the United States and items made anywhere else. Now, how large is the stack of things made in the United States compared to the imported items? Some may be labeled with the store brand and say something like “Manufactured in China for Company X.” Others may simply have a tag that reads “Made in the Philippines.” How many different countries are represented by the contents of your book bag? Do you realize that you just identified a small sample of countries that are United States trading partners?

You should now have two stacks of items (made in the United States and made elsewhere). Now, take everything that is **not** made in the United States and put it aside. From this point forward all you have access to are the things left in the “100 percent made in the U.S.A.” stack. What do you have left? You will be lucky if you have a pencil and an eraser. It is global business and global trade that gives you access to everything else in your backpack.

Understanding the global business environment is critical to everyone who consumes any good, service or resource. Until we understand how the global business environment operates, why businesses and nations trade, and the forces at work in the global marketplace, we are naive consumers. You need to be informed so that you can make decisions about where you will work, who you will work for, who you will vote for, and what foreign policies you will either support or oppose. Without understanding the global business environment, you might find yourself facing daily life with nothing more than a pencil and an eraser.

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14.2: Globalization

What you'll learn to do: explain why nations and U.S. firms engage in global business

In this section you'll learn about the drivers of the global economy and how companies and countries evaluate whether or not to pursue global opportunities.

Learning Objectives

- Differentiate between comparative and absolute advantage
- Explain the roles of absolute and comparative advantage in global business

Globalization and Business

Globalization



There was a time when consumers only had access to goods and services that were available locally. Their choices were limited by what they could access on foot, by horse, or by carriage. This is still the case for many people around the world, and in rural and remote parts of the U.S., it's still necessary for families to make weekly trips to town to stock up on food, household items and other necessities. However, with the rise of Internet-based business (think Amazon), there's been an explosion of international trade, and more and more consumers essentially have the world at their door. Of course international trade isn't just a twentieth-century phenomenon. Trade across borders and between cultures has been a feature of human civilization for centuries—there's evidence of this dating back as far as the nineteenth century BCE. The Silk Road, one of the best-known and most enduring "international" trade routes, began sometime around 200 BCE and for centuries was central to cultural interaction from China through regions of the Asian continent all the way to the Mediterranean Sea.

So, if cultures and nations have been trading with one other for four thousand years, what makes today's business landscape different? The answer lies in the distinction between *international business* and *globalization*.

International business refers to commerce in which goods, services, or resources cross the borders of two or more nations. This is what the Egyptians were doing when they sent goods across the Red Sea to Assyria. **Globalization** is broader than international business and describes a shift toward a more integrated world economy in which culture, ideas, and beliefs are exchanged in addition to goods, services, and resources. Globalization implies that the world is "getting smaller": As a result of new transportation and communication technologies, people around the world can more readily connect with one another—both virtually and geographically.

The following video provides a good introduction to the causes and consequences of globalization.

Impact of Globalization on Global Business

The video, above, provides a good bird's eye view of the affect of globalization on business—from opening up new markets to increasing the level of competition within markets and industries. Let's take a look at particular example, though, to think through the various implications of conducting business on a global scale. Consider McDonald's, which was started by two brothers in San Bernadino, California, sixty-eight years ago. As a result of globalization, nearly 69 *million* people in 118 different countries eat at McDonald's every day. The first McDonald's outside the U.S. and Canada was established in Costa Rica in 1970, and since the 1990s, most of the company's growth has taken place in foreign countries. The process of building a global presence, entering new markets, and capitalizing on growing international demand for American fast food has enabled McDonald's to expand from a single location to a global corporation with revenues in excess of U.S. $25.4 billion in 2015. [1] However, entering new markets—whether at home or abroad—means contending with increased competition in those markets, including competition with other globally minded companies. In 2010, Subway surpassed McDonald's to become the largest single-brand restaurant chain and the largest restaurant operator globally.

What is it like for companies that decide to take advantage of global opportunities as McDonald's and Subway have? Return to the discussion of "external forces" in module 1, but now consider them from a global business perspective. Globalization certainly means that businesses can reach consumers around the word more rapidly and efficiently—thanks to cell phones, airplanes, and the Internet, we are all so much more interconnected and "accessible" now. But globalization also means incredible complexity. The list below sketches out just a few of the complexities and challenges that an American fast-food company like McDonald's faces when it takes on the global business environment.

The Global Economic Environment

McDonald's is a corporation based in the United States, where all business transactions are conducted using the U.S. dollar, but there are 167 official national currencies in the world, each with a different value and purchasing power. Imagine trying to balance the corporate checkbook at McDonald's when your deposits have been made in more than a hundred different currencies.

The Global Legal Environment

In Greece, there is a $650 fine for eating ice cream at certain historic, artistic, and culturally important sites. If you are the operator of a McDonald's near the Parthenon, should you remove the ice cream cones and McFlurries from your menu to protect your customers against being fined, or not?

The Global Competitive Environment



McKebab, a fast-food restaurant in Slovakia whose name and golden "M" bear a striking resemblance to McDonald's.

How does McDonald's recapture the number-one position it lost to Subway in 2010? The company may need to make substantial changes to its operations, menu offerings, and/or marketing tactics. This is a steep, uphill climb in the United States alone, but consider trying to accomplish it in 118 different countries in 188 different markets—where you are competing not only with other global U.S. fast-food companies like Subway and KFC but with local ones, like "McKebab," as well!

The Global Technological Environment

What does technology have to do with fast food or McDonald's? Consider the company's presence in China, where there are nearly 1.3 billion mobile users, and say hello to "McDonald's Next," a "modern and progressive" version of the restaurant that first opened in Hong Kong, featuring mobile-phone-charging platforms, free Wi-Fi, and self-ordering kiosks. This next generation of McDonald's is a response to increased expectations around speed, service, economy, and availability across established and developing economies, mostly fueled by consumers' growing access to affordable technology. As global businesses respond to demands created *by* technology, they must also leverage technology to move products, people, and supplies around the globe in a cost-effective and efficient manner.

The Global Social Environment



McDonald's Maharaja Mac

McDonald's has had to adapt in countless ways to meet the demands of its customers around the world. While it prides itself on offering a consistent, internationally recognizable menu and brand, the company has also had to cater to local dining preferences and customs. In 1995, for example, the first kosher McDonald's opened in a Jerusalem suburb. In Arab countries, the restaurant chain offers "halal" menus, which comply with Islamic laws governing the preparation of meat. In 1996, McDonald's entered India for the first time, where it offered a Big Mac made with lamb called the Maharaja Mac.[2]

McDonald's is not a complex business—after all, it sells inexpensive burgers and fries, not automobiles or airplanes or pharmaceuticals—but clearly the global environment presents challenges even for them. You may be wondering why nations and businesses decide to take on such challenges, given the ongoing difficulty, risk, and uncertainty. We'll investigate this question throughout the remainder of this module.

Absolute and Comparative Advantage



Consider the humble banana. Even if you're not a big fan of this yellow fruit, you've surely seen them in the grocery store or in a market somewhere. If you walked through a US city with a banana and asked people to identify it, it's unlikely you would encounter anyone who had no idea what it was. What if you did the same thing with a picture of a *banana tree*? How many people could identify it? Maybe some, but not all. Why is that? In the United States, bananas are grown in Hawaii, and not everyone has been to Hawaii. In fact, most of the bananas in the world are grown in Ecuador. If we Americans love bananas and don't live in Hawaii and can't get to Ecuador regularly, without global trade, we're out of luck: no bananas for cereal in the morning or as snacks during the day and, worse, no banana splits at the local ice cream parlor. Why do Ecuador and Hawaii trade away their bananas instead of keeping them all to themselves? Probably because, although bananas are delicious and nutritious, it's hard to build houses out of them. Instead, the state of Hawaii and nation of Ecuador choose to trade their bananas for things they lack, while considering the cost and profitability of exporting their product.

Ecuador and Hawaii offer an example of comparative advantage. Because bananas are not grown or readily available everywhere in the world, Ecuador and Hawaii can profitably export theirs to banana-less places like Iowa and Canada. At the same time, Ecuador may need computer systems to keep track of all of those bananas they are selling, but Ecuador is not a technologically advanced economy like the United States. The United States has a comparative advantage in computers, so we sell our computers to Ecuador and let them concentrate on selling us bananas.

The Concept of Advantage

In order to understand why businesses are willing to operate in a complex global environment, we must first understand two fundamental concepts that drive almost all business decisions: absolute and comparative advantage. Countries and companies are willing to assume the risk of engaging in global trade because they believe that they have an advantage over the competition that they can turn into profits. Not all countries have the same natural resources, infrastructure, labor force, or technology. These differences create advantages that can be exploited in global trade, to a country's (or company's) benefit.

Absolute Advantage

An entity (country, region, company, or individual) is considered to have an **absolute advantage** if either of the following conditions exists:

1. It is the only source of a particular product, good, or service. This kind of absolute advantage is very rare and usually depends on a particular natural resource being available only within a certain region or country. An example might be the coveted edible red bird's nests found only in the caves of Thailand (and prized in Chinese cooking as the main ingredient in bird's nest soup). Similarly, if Ecuador were the only place in the world where bananas could be grown, it would have an absolute advantage. However, suppose some sneaky banana spy goes to Ecuador and pilfers some banana tree seedlings and takes them back to her home country and begins growing and exporting bananas. At that point Ecuador no longer has an absolute advantage on the basis of the "only-source" condition.
2. An entity is also considered to have an absolute advantage if it is able to produce *more* of something than another entity while using the same amount of resources (factors of production). When the sneaky banana spy started growing bananas in

her home country, she didn't actually take away Ecuador's absolute advantage, because Ecuador can produce *more* bananas using the same amount of resources (labor, land, water, equipment, etc.). Put another way, Ecuador's direct cost of producing bananas is lower than the banana spy's. Assuming that the bananas can be grown in the new country, it will take that country a very long time to match Ecuador's skill, efficiency, and output level, and until it does, Ecuador will retain its absolute advantage.

Comparative Advantage

An entity (country, region, company, or individual) is considered to have a **comparative advantage** over another in producing a particular good or service if it can produce the good or service at a lower relative opportunity cost.

You'll recall from the economic environment module that opportunity cost is the value of the *next best alternative*. (The video, below, also includes a refresher on this concept.) Since countries and businesses have limited resources, they are forced to make choices about how they allocate those resources. As a student, you understand opportunity cost better than you think. You have a limited amount of time, and you must choose between reading this module and going out with your friends, because you can't do both. If you choose to go out with your friends, then the opportunity cost might be failure on your next exam because you did not use the time to prepare.

Ecuador has a comparative advantage in bananas over a long list of countries, including the United States. This comparative advantage is even better understood when you consider that their *next best alternative* product is oil. The Middle Eastern countries have been pumping oil from the ground for as long as Ecuador has been growing bananas. It makes as much sense for Kuwait to attempt to export bananas as it does for Ecuador to export oil. It's the reality of comparative advantage that encourages countries and businesses to do what they do best—leaving the production of other goods and services to other countries or companies—and in so doing, focusing on producing goods and services where they have advantage, thus maximizing their opportunities in a global environment.

The following video provides an excellent illustration of comparative and absolute advantage and explains why they are such important considerations in how countries decide to specialize and trade.

practice question 14.2.1

Consider an economy that has an absolute advantage in producing a given product, then it _____ have a comparative advantage in producing that same product.

a. must
b. might or might not
c. definitely

Answer available at the end of this section.

practice question 14.2.2

If Kate can make more tacos in an hour than Bill, but Bill can make more tacos at a lower opportunity cost then Bill has a(n) _____.

a. absolute advantage in making tacos.
b. both an absolute and comparative advantage in making tacos.
c. comparative advantage in making tacos.

Answer available at the end of this section.

Game: Absolute and Comparative Advantage

It's one thing to talk and read about global business and another to actually engage in global trade. The following interactive provides a brief introduction to doing just that, with a focus on just how countries behave to create a more productive global economy.

learn more

Now that you've learned about specialization, you can try playing this trade game to explore trade in a fictional world: Play the Trade Ruler Game. Note that this game is Flash-based, so you'll need to enable Flash in your browser in order to see it.

Global Markets

Global Markets and Business Opportunity



Increasingly nations and business use their comparative or absolute advantages to enter global markets driven by the same factor: the immense *size* of these markets.



Let's return to the banana for a moment. In 2015, Ecuador exported 6.55 *million metric tons* of bananas. Without a large global demand for bananas, every man, woman, and child in Ecuador would have to eat 834 pounds of them per year to consume all of the production. Of course that wouldn't happen: Instead, the country would simply cut back on the production of bananas—but, in so doing, it would lose an export that now accounts for more than 10 percent of its gross domestic product (GDP). Ecuador needs a large and vibrant global market to keep up with its tremendous supply of bananas, and it relies on the revenue from those bananas to purchase the other things it needs (in the same way that you traded cell phones for blue jeans in the island trader simulation).

Later in this module we'll discuss how nations like Ecuador enter foreign markets, but for now let's look more closely at the size

of the world's largest markets. The following table shows population and GDP data for the top five economies in the world as of 2015.[3] You'll recall from the economic environment module that GDP, or gross domestic product, is a monetary measure of the market value of all final goods and services produced in a period, and the GDP growth rate is the increase or decrease in GDP over a period of time, expressed as a percentage.

Country	GDP	Population	GDP Growth Rate
China	$19,390,000,000,000	1,367,485,388	6.90%
European Union	$19,180,000,000,000	513,949,445	2.20%
United States	$17,950,000,000,000	321,368,864	2.40%
India	$7,965,000,000,000	1,251,695,584	7.30%
Japan	$4,830,000,000,000	126,919,659	0.50%

Looking at the figures in this table, it isn't hard to imagine that a country or company would like to have a foothold in one or all of these markets. Taken together, these five economies represent a lot of people, a lot of purchasing power, and a lot of economic growth. However, the immensity of the global market offers more than just new target customers. Consider some of the following benefits nations and firms realize by entering foreign markets.

Access to Factors of Production

You will recall that the factors of production required for a successful business venture are natural resources, capital, human capital, and entrepreneurship. Access to global markets enables countries and companies to acquire these factors of production when they are nonexistent, scarce, or just too costly at home. For example, India is one of the largest providers of telephone-based customer service (labor) worldwide, which makes sense given that its population is second only to China and almost four times that of the United States. In addition, labor costs in India are significantly lower than in the U.S.

Innovation and Ideas

Many companies enter global markets and, once there, discover unmet needs or unique products and services. They are then able to use their discoveries to expand an existing product line or introduce new products in other markets or at home. For example, many people credit the United Kingdom with inspiring the development of the craft beer industry in the United States.

Risk Reduction

Given the complexity of operating a business globally, it may seem like a contradiction that risk reduction is one of the benefits of a large global market, but it's actually true. If a country or a company trades or does business with multiple foreign partners, they are less dependent on the success of any single partnership. Likewise, if a nation or business has *multiple* global sources for factors of production, then if one source "dries up," they will still have access to what they need. For example, in 2010 China halted its export of rare earth minerals to Japan after the two countries were unable to resolve a territory dispute. Japan used these minerals in the production of everything from cars to computer chips, and to say that the Japanese were in a state of distress is an understatement. As a result of this albeit brief reduction in Chinese supply, Japan established a trade agreement with India for the import of the needed materials. They will no longer be totally dependent upon the Chinese for these important resources.

In summary, globalization makes business on a global scale possible, and the size of the global market makes it attractive. By using their absolute and comparative advantages, countries and companies can leverage their resources to produce and trade the things that benefit them the most.

The following video provides a recap of the main reasons why countries and businesses engage in global trade.

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1. https://en.Wikipedia.org/wiki/McDonald%27s ↩
2. en.Wikipedia.org/wiki/History_of_McDonald ↩
3. CIA World FactBook https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html#ch ↩

Answers

practice question 14.2.1

b. Absolute advantage means the economy can produce a given product with a lower resource cost and comparative advantage means the economy can product a given product with a lower opportunity cost. Absolute advantage meaning being better at something relative to something else. Specialization allows for everyone benefiting from producing under comparative advantage and then trading.

practice question 14.2.2

c. Kate has an absolute advantage because she can make more tacos and Bill has a comparative advantage because he can make more tacos at a lower opportunity cost.

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14.3: Measuring Global Trade

What you'll learn to do: describe how nations measure global trade

In the same way that nations measure their own economic productivity, they use specific tools to measure their trade with other nations. In this section you'll learn what some of those tools are and how they're used.

Learning Objectives

- Differentiate between trade deficits and trade surpluses
- Explain how countertrade contributes to the measure of global trade

Balance of Trade and Balance of Payments



Nations and businesses that trade back and forth, buy and sell companies, loan one another money, and invest in real estate around the globe need to have a way to evaluate the impact of these transactions on the economy. They need to make decisions about trade policies, regulations, and trade agreements, and until they can get a snapshot of what global trade is doing to hurt or help its economy, they can't make these decisions. It's a lot like your own finances, just on a much larger scale. At the end of the month have you spent more than you earned? Do you have a large positive balance in your bank account as a result of receiving a financial aid check? Did you need to borrow money from your parents to buy books or clothes? Until you really examine where your money is coming from and balance your checkbook, it's hard to make long-term financial plans—like, say, deciding whether or not to buy a new car or purchase a home. This is very similar to what countries do when they measure the impact of trade on their economy.

In this section we'll look at two key measurements of trade: balance of trade and balance of payments.

Balance of Trade

One of the ways that a country measures global trade is by calculating its **balance of trade**. Balance of trade is the difference between the value of a country's imports and its exports, as follows:

value of exports – value of imports = balance of trade

Note

It's important to use this formula just as it's presented, without altering the sequence of values.

The calculation of the balance of trade yields one of two outcomes: a trade deficit or a trade surplus. A **trade deficit** occurs when a nation imports more than it exports. Since 1976, the United States has consistently run trade deficits due to high imports of oil and consumer products. In recent years, the biggest trade deficits were recorded with China, Japan, Germany, and Mexico. This shouldn't come as a surprise to you if you emptied your backpack and counted up all the items *not* made in the United States. In contrast, a **trade surplus** occurs when a nation exports more than it imports. Although the United States has run an overall trade deficit since 1976, it doesn't mean that we import more from *every* country than we export. On the contrary, the United States records trade surpluses with Hong Kong, the Netherlands, the United Arab Emirates, and Australia. Because the balance of trade is calculated using **all** imports and exports, it's possible for the United States to run a surplus with some nations and a deficit with others. As with your checkbook, the balance reflects the difference between *total* exports ("deposits") and *total* imports ("withdrawals").

candyland's balance of trade

 Let's look at the balance of trade for "Candyland."

Candyland is located in a region that lacks phosphate as a natural resource. However, it does have an abundance of sugarcane. As a result of its comparative advantages, Candyland imports phosphate from Christmas Island (it's a real place in Australia—look it up!) to fertilize the sugarcane it grows, and it uses the sugarcane to manufacture saltwater taffy, which it exports to Christmas Island. The following table shows Candyland's imports and exports with Christmas Island in 2014.

	Imports (phosphate)	**Exports (taffy)**
2014	$45,000,000	$75,000,000

Using these figures, we can easily calculate Candyland's balance of trade in 2014:

$75,000,000 (exports) – $45,000,000 (imports) = $30,000,000

This means that Candyland had a trade surplus of $30,000,00 with Christmas Island, since exports exceeded imports. We can also say that Candyland was a "net exporter," meaning they exported more than they imported.

However, the picture changed in 2015 when the Australian government closed the phosphate mine on Christmas Island. Candyland had to import phosphate from Morocco, instead, and was not able to get the same favorable pricing as before.

Consequently, sugarcane farmers paid more for fertilizer, the price of sugarcane went up, and Candyland had to raise the price on its saltwater taffy. Sadly, the people of Morocco aren't really big fans of saltwater taffy, so exports fell. The following table shows Candyland's imports and exports with Morocco in 2015.

	Imports (phosphates)	Exports (Taffy)
2015	$65,000,000	$55,000,000

We can use the figures to calculate Candyland's balance of trade:

$55,000,000 (exports) – $65,000,000 (imports) = –$10,000,000

The negative number indicates a trade deficit of $10,000, showing that Candyland's imported more from Morocco than it exported. We would say that Candyland became a "net importer"—importing more than it was exporting.

Obviously this is a simple example. A country's global business doesn't amount to just trading phosphate and taffy or cell phones and blue jeans. It includes all kinds of financial transactions: goods and services imported and exported, foreign investments, loans, transfers, and so on. Tracking all these payments provides another way to measure the size of a country's international trade: the balance of payments.

Balance of Payments

Balance of Payments is the difference between the total flow of money coming into a country and the total flow of money going out of a country during a period of time. Although related to the balance of trade, balance of payments is the record of **all** economic transactions between individuals, firms, and the government and the rest of the world in a particular period. Thus the balance of payments includes **all** external transactions of a country, including payments for the country's exports and imports of goods, services, foreign investments, loans and foreign aid, financial capital, and financial transfers.

- For instance, if a US company buys land or a factory in another country, that investment is included in the US balance of payments as an *outflow*. Likewise, if a US company is sold to a foreign company, it's included in the balance of payments. Just recently, Didi Chuxing, the Chinese ride-hailing service, bought Uber's subsidiary in China in a deal valued at $35 billion. This sale will create a *cash inflow* to the United States, but over the long term it will decrease the revenue flowing in from China through Uber.
- If a nation receives foreign aid or borrows money from another country, this amount is also reflected in its balance of payments as a *cash inflow*. For example, the bailout Greece received from the Eurozone and IMF in 2010 to help stabilize its failing economy affected the balance of payments for all of the nations involved. Greece recorded the €110 billion loan as an *inflow* in its balance of payments, while the Eurozone members recorded it as an *outflow* in their balance of payments.

A country's balance of payments is calculated as follows:

total money coming into a country (inflow)– total money going out (outflow) = balance of payments

Note

It's important to use this formula just as it's presented, without altering the sequence of values.

Candyland's balance of payments

Let's examine Candyland's balance of payments in 2015. The following table shows all of its external transactions during the year.

	Imports (phosphates)	Exports (taffy)	Foreign aid (loan) from Hooperland	Purchase of Wandaland assets
2015	$65,000,000	$55,000,000	$25,000,000	$30,000,000

When we calculated Candyland's balance of trade in 2015, we *did not* take into account the following two transactions:

1. Candyland invested in a factory in Wandaland and purchased the factory from the government for $30,000,000. This *outflow* of funds will affect Candyland's balance of payments.

When we calculate Candyland's 2015 balance of payments, by taking the inflows (revenue from exports and foreign aid) and subtracting the outflows (payments for imports and purchase of foreign assets), the balance is negative, as shown below:

($55,000,000 + $25,000,000) (total inflow) – ($65,000,000 + $30,000,000) (total outflow) = –$15,000,000

What effect will this have on Candyland? Well, when Candyland's leader is briefed by her council of international economic advisers, they will inform her that the country currently has an "unfavorable balance of payments." That is, less money is coming into the country than is going out. If, on the other hand, the balance of payments were a positive number (inflow exceeded outflow), Candyland could say that it has a "favorable balance of payments."

At this point it's tempting to make judgments about these different types of trade measurements and conclude that trade surpluses and favorable balance of payments are always indicators of a strong economy, but unfortunately it's not so cut and dried. Balance of trade and balance of payments are starting points—much in the way that an individual's credit rating might be a starting point for seeking a loan. How the numbers are interpreted and viewed by the country's leaders, other countries, and the world depends on many factors, such as where a country is in its economic development, the factors contributing to the balance of trade or payments, the health of the overall global economy, what the country is doing with its imports, and so on. As you might guess, assessments of these factors can be intensely political. You'll learn more about these considerations later in this module when we discuss how nations attempt to restrict or control trade.

Countertrade



So far we have discussed global trade measured in dollars, euros, or other traditional currency, which is the way that everyone assumes business is conducted today. For example, here in the United States, we express the size of the global market, or Global World Product (GWP), as U.S. $107.5 trillion. If we lived in Japan, we'd measure GWP using Japanese currency, yen (¥).

However, when we measure global trade *only* in terms of currency-based transactions, we omit a portion of the market known as countertrade. **Countertrade** is a system of exchange in which goods and services are used as payment rather than money. There are many types of countertrading. Some of the most common types are described below:

1. **Barter**: Exchange of goods or services directly for other goods or services without the use of money as means of purchase or payment. Example: One party trades salt for sugar from another party.
2. **Switch trading**: Practice in which one company sells to another its obligation to make a purchase in a given country. Example: Party A and Party B are countertrading salt for sugar. Party A may switch its obligation to pay Party B to a third party, known as the switch trader. The switch trader gets the sugar from Party B at a discount and sells it for money. The money is used as Party A's payment to Party B.
3. **Counterpurchase**: Sale of goods and services to one company in another country by a company that promises to make a future purchase of a specific product from the same company in that country. Party A sells salt to Party B. Party A promises to make a future purchase of sugar from Party B.
4. **Buyback**: This occurs when a firm builds a plant in a country, or supplies technology, equipment, training, or other services to the country, and agrees to take a certain percentage of the plant's output as partial payment for the contract. Example: Party A builds a salt-processing plant in Country B, providing capital to this developing nation. In return, Country B pays Party A with salt from the plant.
5. **Offset:** Agreement that a company will offset a hard-currency purchase of an unspecified product from that nation in the future. Agreement by one nation to buy a product from another, subject to the purchase of some or all of the components and raw materials from the buyer of the finished product, or the assembly of such product in the buyer nation. Example: Party A and Country B enter a contract where Party A agrees to buy sugar from Country B to manufacture candy. Country B then buys that candy.

Countertrading is common among countries that lack sufficient hard currency (i.e., cash) or where other types of market trade are impossible. In developing countries, whose currency may be weak or devalued relative to another country's currency, bartering may be the only way to trade. For example, if the value of Venezuela's currency, the *bolívar fuerte*, falls relative to the U.S. dollar (as it has in recent years), the exchange rate makes it unfavorable for Venezuela to sell its oil to the United States. Countertrade may be a much more financially beneficial arrangement.

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14.4: Global Buisness Strategies

What you'll learn to do: evaluate common strategies used to reach global markets

Globalization introduces a number of challenges that are unique to operating simultaneously in different countries and global markets. What is the best way to enter or take advantage of a global market? When should you adjust a product's features to customize it to consumer needs in a different global market? How do you manage the costs and complexities of producing and/or promoting products in different locations, with different languages, cultural sensitivities, and consumer expectations?

While this next section doesn't attempt to answer all of these questions, it explains common strategies and approaches used by multinational corporations to take advantage of global business opportunities.

Learning Objectives

- Explain how firms use licensing and franchising to reach global markets
- Explain how firms use joint ventures and foreign strategic alliances to reach global markets

Global Business Strategies

In today's economy, once a nation or business has developed an advantage—either comparative or absolute—it's likely to look beyond its own borders or storefront to seek greater economic opportunity. But how do you enter a global market? It's certainly not as simple as loading up your products in a van, driving to the next town, and knocking on doors. Below are some of the common strategies companies and countries use to get their goods and services into global markets.

Exporting/Importing


Figure 14.4.1. Shipping Containers

Exporting is the easiest and most straightforward way to engage with the global market. **Exporting** is taking goods that were produced within a company's home country and shipping them to another country. The party sending the good is called an *exporter*. It is impossible to discuss exporting without mentioning its complement, importing. **Importing** is the process by which a good is brought into a jurisdiction, especially across a national border, from an external source. The party bringing in the good is called an *importer*. Simply put, one country's exports become another country's imports. Examples of U.S. imports are everywhere: Take a look at the labels in your clothes or the contents of your backpack. From our vantage point, U.S. exports may be a little harder to see, but they exist all the same and are plenty visible in other countries. According to *World's Top Exports*, the following export product groups represent the highest dollar value in American global shipments during 2015. In parentheses is the percentage share each export category represents in terms of overall U.S. exports:

1. Machines, engines, pumps: US$205.8 billion (13.7% of total exports)

2. Electronic equipment: $169.8 billion (11.3%)
3. Aircraft, spacecraft: $131.1 billion (8.7%)
4. Vehicles: $127.1 billion (8.4%)
5. Oil: $106.1 billion (7.1%)
6. Medical, technical equipment: $83.4 billion (5.5%)
7. Plastics: $60.3 billion (4%)
8. Gems, precious metals, coins: $58.7 billion (3.9%)
9. Pharmaceuticals: $47.3 billion (3.1%)
10. Organic chemicals: $38.8 billion (2.6%)[1]

Advantages and Disadvantages

Since exporting doesn't require a company to manufacture its products in the target country, the company doesn't have to invest in factories, equipment, or other production facilities located halfway around the globe. Most of the costs involved in exporting are associated with finding a buyer or distributor in the destination market. For these reasons, exporting is considered to be the quickest and least expensive means to enter the global market. However, there are disadvantages, too.

Once products arrive in the destination market, the business loses control of them, which can result in products being misrepresented, copied by other manufacturers, or even sold on a black market. In addition, because the business isn't active in the new market, it can't gain insight into or experience with local consumer preferences and demand. This lack of information can create uncertainty and potentially cost the company opportunities down the road. As you will learn later in this module, businesses operating in other countries may find themselves subject to taxes, regulations, and/or restrictions that can substantially affect the profitability of the entire export venture.

Outsourcing/Offshoring



Figure 14.4.2. Garment factory, Jiaxing, China

Outsourcing and offshoring are two additional strategies that a business can use in order to take advantage of the global market. **Outsourcing** *contracts out* a business process to another party and may include either or both foreign and domestic contracting. You may be familiar with outsourcing if your college has outsourced the bookstore to a national chain such as Barnes & Noble, or the food services are provided by a company such as Starbucks or Aramark. Although the employees work on your college campus, they are not college employees. **Offshoring**, on the other hand, is the actual *relocation* of a business process from one country to another—typically it's an operational process, such as manufacturing, or sometimes a supporting process, such as accounting. In the case of offshoring, the employees still work for the company that's offshoring its operations, but instead of working in a facility within the United States, they are located in a foreign country. In general, outsourcing and offshoring are strategies that companies use to try to lower their costs.

If a business chooses outsourcing as a way to engage with the global market, it might have a single component part manufactured in, say, Tibet and then shipped back to Iowa, where the factory workers in Iowa would use the outsourced part in the assembly of the final product. The business would have a contract with the company making the component part at an agreed-upon price, but it would not have an employer-employee relationship with the workers in Tibet. On the other hand, if the business wants to take advantage of offshoring, it would move the entire plant from Iowa to Tibet and hire workers in Tibet who would work directly for the business.

The following video is an example of how a small business is outsourcing its manufacturing to China. Especially for small start-up companies, using established manufacturing facilities located outside of the U.S. allows them to enter the global marketplace. Cost, logistics, finances, and speed are just some of the things that this type of arrangement can bring to businesses looking to take advantage of the growing global demand for U.S.-branded products.

Advantages and Disadvantages

Offshoring and outsourcing are both the subject of ongoing heated public debate—both in the U.S. and in other countries. Those in favor assert that these strategies benefit both sides of the arrangement: Free trade is enhanced, the destination country gains jobs, and the origin country gets cheaper goods and services. Some supporters go further and assert that outsourcing and offshoring raise the gross domestic product (GDP) and increase the total number of jobs domestically, too. This claim is based on the idea that workers who lose their jobs will move to higher-paying jobs in industries where the origin country has a comparative advantage.

On the other hand, job losses and wage erosion "at home" have sparked opposition to offshoring and outsourcing. Many argue that the jobs that are shipped overseas are not replaced by better, higher-paying ones. And it's not just low-skilled workers who are feeling the pain. Increasingly, critics say, even highly trained workers (such as software engineers) with high-paying jobs are finding themselves replaced by cheaper workers in India and China. Some firms, while realizing financial gains from lowering their production costs, are finding that offshoring and outsourcing are very costly in terms of lack of control over product quality, working conditions, and labor relations. For example, companies like Nike and Apple have come under fire by human rights organizations and consumers over reports of worker abuse, dangerous working conditions, and ridiculously low wages. It was recently reported that apparel workers in Bangladesh are sometimes paid as little as $0.21 per hour. We will explore some of the ethical issues raised by offshoring and outsourcing later in the course in the business ethics module.

Licensing and Franchising

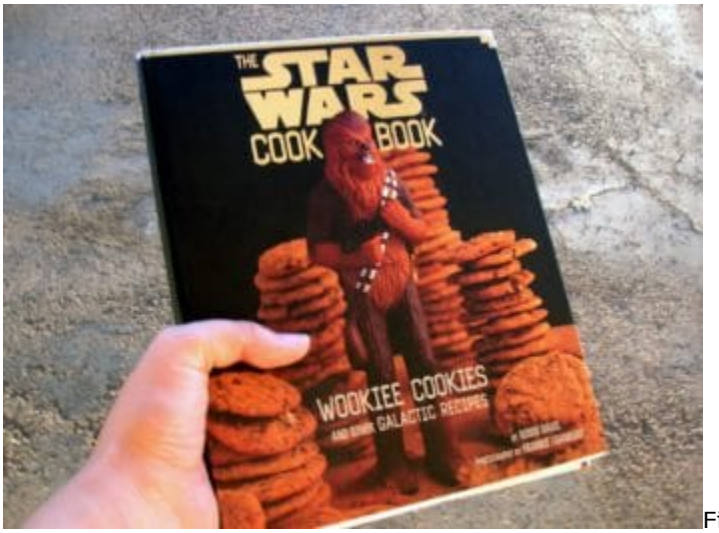


Figure 14.4.3. The Star Wars Cookbook

Increasingly, businesses are getting their products and services into global markets via licensing and franchise agreements. Under a **licensing agreement**, the licensor agrees to let someone else (the licensee) *use* the property of the licensor in exchange for a fee. License agreements usually cover property that is intangible, such as trademarks, images, patents, or production techniques. Since its debut in the late 1970s, *Star Wars* remains the most lucrative source of licensing in the entertainment business, generating more than $42 billion from the sale of licensed merchandise.

A longer-term and more comprehensive way to access the global market is through franchising. Under the terms of a franchise agreement, a party (franchisee) acquires access to the knowledge, processes, and trademarks of a business (the franchisor) in order to sell a product or service under the business's (franchise's) name. In exchange for the franchise, the franchisee usually pays the franchisor both initial and annual fees. McDonald's, Holiday Inn, Hertz Car Rental, and Dunkin' Donuts have all expanded into foreign markets through franchising.

Advantages and Disadvantages

Licensing and franchising both offer advantages for the involved parties: The licensee and franchisee both gain a competitive

advantage in the market. The licensee/franchisee gets immediate brand recognition and may quickly overtake the competition by offering a product or service for which there is existing unmet demand. For example, a local sandwich shop may have a hard time competing when a Subway franchise opens because the brand is so well known. Also, because franchises are usually “turnkey” operations in which processes, supply chains, training, and products are already in place, the new business can quickly begin efficient and profitable operations. For the franchisor, this arrangement enables them to gain inexpensive access to a new market, since the initial cost of the franchise is borne by the franchisee. Under a licensing agreement, all of the costs of production, sales, and distribution are the responsibility of the licensee. If financial capital is scarce, both approaches allow companies to have a global presence without heavy investments.

These methods do contain some risks and disadvantages, however. They are typically the least profitable way of entering a foreign market, since the profits go to the franchisee or licensee. Although the licensor or franchisor receives up-front money and/or a small percentage of future sales, the majority of the revenue remains in the destination country with the licensee or franchisee. Franchising entails a long-term commitment on the part of the franchisor to provide ongoing support in the form of training, logistics, product development, and brand marketing. Once a business begins to establish a global franchise presence, the pressure to maintain brand integrity and fiscal responsibility becomes more intense as the failure of the franchise now has global consequences. For companies selling licensing rights there is a risk that their intellectual property may be misrepresented or used in a manner that could tarnish the brand’s image. Also, once a license to use an image or other intellectual property has been granted to a company in another country, the probability that knock-off products will enter the market goes up. For both franchisors and licensors, maintaining quality standards on a global scale is a massive undertaking, and for this reason many companies are choosing to exert a higher degree of control over their products, brands, and intellectual property than they have in the past.

Joint Ventures/Strategic Alliances


Figure 14.4.4. Honey Nut Cheerios

There are times when businesses have opportunities within the global market that are better undertaken with a partner. Sometimes these projects are extremely large and capital-intensive or are so comprehensive that it makes sense to include multiple businesses or even governments. These large-scale, global projects usually take one of two forms: strategic alliances or joint ventures.

A **joint venture** establishes a new business that is jointly owned by two or more otherwise independent businesses. The most common joint ventures involve two companies that are equal partners in the new firm, investing money and resources while sharing control of the newly formed firm. Often, the foreign partner provides expertise on the new market, business connections and networks, and access to other in-country aspects of business such as real estate and regulatory compliance. For example, in 2015 Fiat Chrysler entered into a joint venture with Tata Motors of India to expand the production of Jeeps in India. The company created in this joint venture is Fiat India Automobiles Private Limited.

Joint ventures require a greater commitment from firms than other global strategies, because they are riskier and less flexible. Joint ventures may afford tax advantages in many countries, particularly where foreign-owned businesses are taxed at higher rates than locally owned businesses. Some countries require all business ventures to be at least partially owned by domestic business partners.

A less permanent, but equally effective way to enter the global market is through a **strategic alliance**. A strategic alliance is

formed between two or more corporations, each based in their home country, for a specified period of time. Unlike a joint venture, a new company is not formed. Generally, strategic alliances are pursued when businesses find that they have gained all they can from exporting and want to expand into a new geographic market or a related business. This approach can be particularly useful when a government prohibits imports in order to protect domestic industry. The cost of a strategic alliance is usually shared equitably among the corporations involved, and it's generally the least expensive way for all concerned to form a partnership. An example of this is the alliance between General Mills and Nestlé: Honey Nut Cheerios are manufactured in bulk by General Mills in the United States and then shipped to Nestlé Europe, where they are packaged and shipped to France, Spain, and Portugal.

Advantages and Disadvantages

The greatest advantage of joint ventures and strategic alliances is the knowledge and experience of the market offered by the local partner—on everything from consumer preferences to cultural differences, language, and political/economic systems. Another advantage is that the risk of entering the market with a new product is shared by more than one firm, thereby reducing each company's exposure to potential losses.

However, these types of partnerships also have their drawbacks. When companies share their technology and industry know-how, they run the risk that the partner firm will take that technology or innovation and use it to become a competitor in the future. This was a primary concern when Boeing collaborated with Mitsubishi (it was ultimately resolved in the legal details of the partnership agreement, which both companies signed). Conflicts over control of these partnerships can also arise if the owners of the partner firms do not agree on key business decisions.



Figure 5. BMW US Manufacturing Company, South Carolina

Of all of the ways that a business can reach the global market, the most intensive approach is through foreign direct investment or FDI. **Foreign direct investment** is an investment in the form of a controlling ownership in a business enterprise in one country by an entity based in another country. FDI can take one of two forms: Greenfield ventures or mergers/acquisitions.

In a Greenfield venture, the company enters a foreign market and establishes a new subsidiary as a start-up business. A good example of this is the BMW US Manufacturing Company, a vehicle-assembly facility located in Greer, South Carolina, that is part of the BMW Group. Although it's BMW's only assembly plant in the United States, it represents a direct investment inside the United States by the German manufacturer, and it's one of the most successful Greenfield ventures in the U.S.

Businesses that are not ready to take on the challenge of establishing a new facility or subsidiary in a foreign country will usually choose either a merger or acquisition as a means of expanding their global reach. Mergers and acquisitions represent the vast majority of FDI and range from 50 percent to 80 percent of all FDI in some industries. According to *Forbes*,

> "U.S. companies completed 116 emerging market acquisitions in the first half of 2013, up from 110 in the second half of 2012. . . . The most popular geographic targets for U.S. companies in the first half of 2013 were Brazil (25 deals), India (18 deals), South American countries excluding Brazil (15), South and East Asia (15), and Central America and Caribbean (14).[2]"

Mergers and acquisitions aren't just carried out by U.S. companies, either—it's an incredibly pervasive global business strategy, and ownership of many well-known products and brands has long been separated from the country of origin. For example, the

Chinese just bought Smithfield Foods, Stolichnaya ("Stoli") Russian vodka is actually owned by a company in the United Kingdom, Anheuser-Busch is owned by Belgian-Brazilian conglomerate InBev, and 7-Eleven is owned by the Japanese.[3]

Advantages and Disadvantages

Because the level of commitment and investment associated with FDI is so high, companies expend a great deal of time and effort scrutinizing potential opportunities. With Greenfield ventures, the amount of time it takes to build a presence in the foreign country is substantial. If a business is not already established in other global locations and lacks experience with FDI, it may be in for a series of unpleasant surprises in the form of regulations, licensing, taxes, and other "red tape"—much of which we will look at later in this module.

On the other hand, mergers and acquisitions are faster to execute than Greenfield ventures, and by merging with or acquiring an existing foreign company already in the market, outside companies can quickly take advantage of that presence. Another benefit is that a merger or acquisition involves the purchase of assets such as property, plants, and equipment that are already producing a product with a known revenue stream. The key to a successful merger or acquisition is paying the right price for the company, because, no matter how successful the business was before it was acquired (or merged), overpaying can turn a formerly profitable operation into a money pit.

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1. United States Top 10 Exports. (2016). Retrieved August 17, 2016, from http://www.worldstopexports.com/united-states-top-10-exports/ ↩
2. Rapoza, K. (2013, September 13). U.S. Companies Buying up Foreign Competition. Retrieved August 18, 2016, from http://www.forbes.com/sites/kenrapoza/2013/09/15/u-s-companies-buying-up-foreign-competition/#7a6b71ef2177 ↩
3. Frohlich, T. C., & Sauter, M. B. (n.d.). Ten Classic American Brands That Are Foreign-Owned. Retrieved August 19, 2016, from http://247wallst.com/special-report/...foreign-owned/ ↩

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14.5: Global Trade Forces

What you'll learn to do: identify and describe forces that affect global trade

In this section you'll learn about the range of forces that affect global trade. These forces include everything from culture and politics to the natural environment.

Learning Objectives

- Describe the impact of political and economic forces on global trade
- Describe the impact of physical and environmental forces on global trade
- Describe the impact of tariff and nontariff restrictions on global trade

Sociocultural Differences



Culture refers to the influence of religious, family, educational, and social systems on people, how they live their lives, and the choices they make. Business always exists in an environment shaped by culture. Organizations that intend to sell products and services in different countries must be sensitive to the cultural factors at work in their target markets. Even cultural differences between different countries—or between different regions in the same country—can seem small, but businesses that ignore them risk failure in their ventures.

Culture is complex, and fully appreciating its influence takes significant time, effort, and expertise. Certain features of a culture can create an illusion of similarity, but businesses need to delve deeply to make sure they truly understand the people and environments in which they work. Even a common language does not guarantee similarity of interpretation. For example, in the U.S. we purchase "cans" of various grocery products, but the British purchase "tins." In India, where English is one of a number of officially recognized languages, "matrimonial" is used as a noun in casual conversation, referring to personal ads in newspapers seeking marriage partners.

Several dimensions of culture that require particular attention from global businesses are listed below.

Language

The importance of language differences can't be overemphasized, and there are nearly three thousand languages in the world. Language differences can be a challenge for businesses designing international marketing campaigns, product labels, brand and product names, tag lines, and so on. Finding a single brand name that works universally in terms of pronunciation, meaning, and "ownability" is a monumental challenge. Of course, correct and grammatical use of language in business communication is essential for a product, brand, or company to be viewed as credible, trustworthy, and of high quality.

The language issue becomes more complicated when a country has more than one officially recognized language. To illustrate, in

Canada, national law requires that labels include both English and French. In India and China, more than two hundred different dialects are spoken. India has more than twenty officially recognized languages. Mainland China's official spoken language is Standard Chinese, and several autonomous regions have designated other additional official languages. Meanwhile in Hong Kong and Macau, Cantonese Chinese, English, and Portuguese are the official languages. Clearly language can quickly become a very challenging issue for businesses!

Finally, businesses should be attuned to what they communicate when they choose which languages to use—or not use. In Eastern Europe, for example, the long history of Soviet occupation during the Cold War has left many inhabitants with a negative perception of the Russian language. Products that carry Russian labeling may suffer accordingly.

Customs and Taboos

All cultures have their own unique sets of customs and taboos. It's important for businesses to learn about these customs and taboos so they'll know what is acceptable and unacceptable for their foreign operations. For example, in Japan, the number four is considered unlucky, and products packages containing four items are avoided by many consumers. In Middle Eastern countries where Islamic law is strictly observed, images displaying the uncovered arms or legs of the female body are considered offensive. Meanwhile in Egypt, where many women wear the headscarf or hijab in public, an increasing number of younger women are in work and educational settings where gender segregation does not exist. Businesses struggle with whether to portray women with or without the hijab, knowing that they risk offending some of their target audience with either choice. Businesses should seek guidance from native experts familiar with local culture and customers.

Values

The role of values in society is to dictate what is acceptable or unacceptable. Values are part of the societal fabric of a culture, and they can also be expressed individually, arising from the influence of family, education, moral, and religious beliefs. Values are also learned through experiences. As a result, values can influence consumer perceptions and purchasing behavior. For example, consumers in some countries, such as the United States, tend to be individualistic and make many purchasing decisions based on their own personal preferences. In other countries, such as Japan, the well-being of the group is more highly valued, and buying decisions are more influenced by the well-being of the group, such as the family. Based on these differences in values, it is not surprising that ads featuring individuals tend to do better in countries where individualism is an important value, and ads featuring groups do better in countries where the group's well-being is a higher value.

Time and Punctuality

Different cultures have different sensitivities around time and punctuality. In some countries, being slightly late to a meeting is acceptable, whereas in other countries it's very insulting. For cultures that highly value punctuality, being on time is a sign of good planning, organization, and respect. In cultures where precise punctuality is less important, there is often a greater emphasis on relationships. The fact that a meeting happens is more important than when it happens.

While there are cultural stereotypes about time management (such as the laid-back "island time" many residents of island nations refer to), the best rule of thumb in business is to be punctual and meet deadlines as promised. You will not insult people by following this rule. Also, it's wise not to apply popular stereotypes to individual people for whom the cultural stereotype may or may not be true. You should let a person's behavior speak for itself, and always treat others with the same level of courtesy you would expect from them.

Business Norms

Business norms vary from one country to the next and may present challenges to foreigners not used to operating according to the particular norms of the host country. In business meetings in Japan, for example, it's expected that the most senior person representing an organization will lead the discussion, and more junior-level colleagues may not speak at all. The role of alcohol in business meetings varies widely by culture: In Middle Eastern cultures where alcohol is forbidden, it may be insulting to serve or even offer an alcoholic beverage. In China, many rounds of toasts are customary as part of formal dinner meetings.

Likewise, business norms around greetings and physical contact also vary. American-style handshakes have become accepted as a business norm in many cultures, but this custom is not universal. In Japan and some other Asian cultures, a respectful bow is the traditional business greeting, although the handshake is becoming more common. In Islamic cultures, contact between men and women is a sensitive issue, even in business settings. In those regions and cultures, it's best to shake hands with a woman only if she extends her hand first. Similarly, Western women may avoid causing embarrassment by shaking hands only if a hand is extended to her. In India, the namaste (a slight bow with hands brought together on the chest) remains a respectful, if traditional,

business greeting particularly when interacting with women and older people.

Always seek guidance from a trusted colleague or friend who has experience in the local customs and can offer coaching on proper etiquette.

Religious Beliefs and Celebrations

As discussed earlier in this module, religious beliefs and practice can strongly influence what consumers buy (or don't buy), when and where they shop, and how they conduct business. It's important for companies to understand the influence of religion on consumer culture in the markets where they operate, so that their business activities can be appropriately sensitive. Failing to respect religious beliefs or cultures can seriously undermine the reputation of a company or brand. At the same time, businesses that are attuned to the impact of religion on culture can more easily integrate their operations and employees into the local culture.

For example, all the major world religions observe holidays that include feasting and gift giving. These festival seasons tend to be prime shopping seasons as well. Holidays originating from the prominent religion of a country or region create sensitivities about certain products: in the Hindu religion, cows are considered sacred and people refrain from eating beef. Observant Jews and Muslims consider pork unclean, and they consume only kosher or halal meats, respectively. Many religions eschew alcohol: for example, devout Sikhs, Muslims, Mormons, Buddhists, and conservative Southern Baptists all refrain from drinking.

Religious beliefs may cause sensitivities around revealing images or sexually suggestive material. Religious beliefs associated with the symbolism of different colors may create either preferences for or rejection of certain products. The link between religious practice and gender roles may affect which members of the family influence which types of buying decisions. It is important, however, for businesses not to oversimplify how decision making happens in these settings. Even if a woman, for example, is not the primary buyer, she may exercise strong influence of many consumer decisions. Here, as in other areas of cultural impact, is it crucial for businesses to educate themselves about the people and cultures they are targeting for business in order to use cultural knowledge to their advantage.

Political and Economic Differences

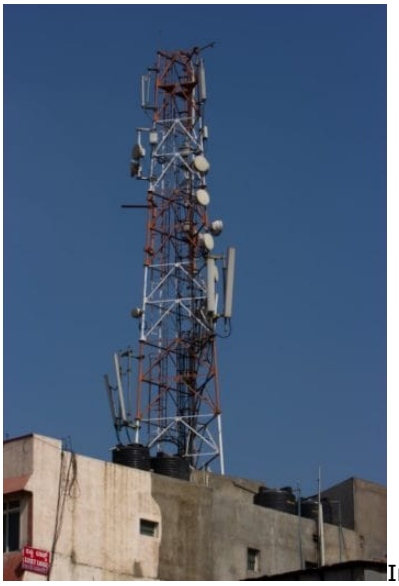


The **political economy** of a country refers to its political and economic systems, together. The political system includes the set of formal and informal legal institutions and structures that comprise the government or state and its sovereignty over a territory or people. As you know, political systems can differ in the way they view the role of government and the rights of citizens (compare, for example, the democratic political system of Canada with the communist system of North Korea). As you'll recall, the economic system refers to the way in which a country organizes its economy: most are command, market, or mixed economies.

The nature of a country's political economy plays a big role in whether it is attractive to foreign business and entrepreneurship. Historically, there has been a direct relationship between the degree of economic freedom in a country and its economic growth—the more freedom, the more growth, and vice versa. For decades, the Chinese government maintained an ironclad grip on all business enterprise, which effectively prevented foreign businesses from fully engaging with the Chinese market. That climate has tempered, however, and now the political economy of China is much more open to foreign investment, though it is still not as open as Europe or the U.S.

Businesses seeking global opportunities must consider other economic factors beyond a country's political economy. For one thing, they will want to target the markets and countries where people have the highest incomes and the most disposable income. The world map below shows just how much variation there is in the gross national income (GNI) per person among the nations of the world.

However, often those markets are not where *new* opportunity exists, so businesses have to pursue what economists refer to as "emerging markets." The four largest emerging and developing economies are the BRIC countries (Brazil, Russia, India, and China). One means of measuring a country's level of economic development is by its purchasing power parity (PPP), which enables economists to compare countries with very different standards of living. The PPP for a given country is determined by adjusting up or down as compared to the cost of living in the United States.


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

However, there is often more to a country's economic story than its PPP or GNI. Consider India: As an emerging market, India is attracting significant attention from businesses all around the globe. It has the second-fastest-growing automotive industry in the world. According to a 2011 report, India's GDP at purchasing power parity could overtake that of the United States by 2045. During the next four decades, Indian GDP is expected to grow at an annualized average of 8 percent, making it potentially the world's fastest-growing major economy until 2050. The report highlights key growth factors: a young and rapidly growing working-age population; growth in the manufacturing sector because of rising education and engineering skill levels; and sustained growth of the consumer market driven by a rapidly growing middle class.

At the same time, surveys continue to emphasize the chasm between two contrasting pictures of India—on one side, an urban India, which boasts of large-scale space and nuclear programs, billionaires, and information technology expertise, and a rural India on the other, in which 92 million households (51 percent) earn their living by manual labor. In 2014, a report by the Indian Government Planning Commission estimated that 363 million Indians, or 29.5 percent of the total population, were living below the poverty line.

Another aspect of a country's political economy is the stability of its current government. Business activity tends to grow and thrive when a country is politically stable. When a country is politically unstable, multinational firms can still conduct business profitably, but there are higher risks and often higher costs associated with business operations. Political instability makes a country less attractive from a business investment perspective, so foreign and domestic companies doing business there must often pay higher insurance rates, higher interest rates on business loans, and higher costs to protect the security of their employees and operations. Alternatively, in countries with stable political environments, the market and consumer behavior are more predictable, and organizations can rely on governments to enforce the rule of law.

As you can see, the desirability of a country as a potential market or investment site depends on a host of complex, interrelated factors. To further complicate matters, once a business arrives in a foreign market, it must also contend with the uncertainty of exchange rates. An **exchange rate** is the value of one country's currency relative to the value of another country's currency. For example, an exchange rate of 119 Japanese yen (JPY, ¥) to the United States dollar (US$) means that ¥119 will be exchanged for each US$1, or US$1 will be exchanged for ¥119.

Each country, using various mechanisms, manages the value of its currency. A market-based exchange rate will change whenever the value of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than the available supply (this does not mean that people no longer want money, only that they prefer to hang on to their wealth in some other form, possibly another currency).

The video below will provide a complete picture of exchange rates and how they impact trade:

Clearly, exchanges rates are an important consideration for companies wanting to take their business global, since they will likely have to buy and sell even the most mundane commodities once they arrive in the foreign market. Local labor wants to be paid in its nation's currency, and if the exchange rate of that currency changes in a way that makes it more valuable, then the business's costs rise unexpectedly. Although businesses try to anticipate and plan for fluctuations in exchange rates, currency values are determined by supply and demand, and businesses are at the mercy of market forces beyond their control.

Legal Differences



Governments around the world maintain laws that regulate business practices. In some countries, these laws are more heavy-handed, and in others, the business climate is less regulated and structured. Some laws and regulations, such ones governing property rights and contracts, are designed to create a stable environment for business (both domestic and international)—by establishing the establishment and enforcement of property rights and contracts, for example. Others are designed to protect consumers and the environment, requiring businesses to adhere to responsible, safe, and ethical practices. Still other laws and regulations privilege domestic businesses and protect or partially shield them from foreign competition. There are even laws and regulations that affect what marketers are allowed to include in marketing communications, although these are more strict in some countries than in others. And of course, some laws and regulations deal with taxation and other costs of conducting business.

Businesses must understand and conform to the legal and regulatory environments of the countries and regions in which they operate. The following is a short list of common regulatory areas that affect businesses globally:

- **Contract law** governing agreements about the supply and delivery of goods and services
- **Trademark** registration and enforcement for brand names, logos, tag lines, and so forth
- **Labeling** requirements for consumer safety, protection, and transparency
- **Patents** to enforce intellectual property rights and business rights associated with unique inventions and "ownable" business ideas
- **Decency, censorship, and freedom-of-expression** laws to which marketing communications are subject
- **Price floors, ceilings, and other regulations** regarding the prices organizations can charge for certain types of goods and services
- **Product safety**, testing, and quality-control
- **Environmental protection** and conservation regulations and permits governing acceptable and responsible business practices
- **Privacy**, including laws governing data collection, storage, use, and permissions associated with consumers and their digital identities

- **Financial reporting** and disclosure to ensure that organizations provide transparency around sound business and financial practices

In some cases, international laws and regulations designed to simplify these issues among regional allies and economic partners may also apply.

Physical and Environmental Differences



Physical and environmental factors can have a significant impact on a company's ability to do business in a foreign country. Some developing countries lack the infrastructure such as roads, railways, and port systems needed to transport goods, or they may not have adequate storage facilities. You can imagine that this would be a major barrier for businesses trying to sell fresh food or perishable goods. Add to that the limited access to electricity, clean water, and sanitation in many parts of the world, and you begin to understand some of the practical and logistical challenges of doing business globally.

A country's natural environment and the surrounding regulations aimed at protecting it may pose additional challenges. Many governments require foreign companies to undergo a complex permitting process if any of their planned activities will adversely affect the environment. Even in developing countries, minimum standards for air emissions, waste disposal, and hazardous-material handling are becoming the norm, and in places where such regulations are weak or lacking, companies often face considerable pressure from local residents and consumer groups to clean up their act or leave. While all of these challenges can make companies think twice about setting up shop in a foreign country, the growing trend of corporate social responsibility shows that more companies are devising creative, collaborative solutions to doing global business more sustainably.

Tariff and Nontariff Trade Restrictions



Although many people find it hard to imagine, not every nation welcomes the expansion of businesses into their country. When a nation seeks to restrict the flow of incoming foreign goods and services, economists refer to this as trade protectionism. Protectionism is the economic policy of restraining trade between

countries through methods such as tariffs on imported goods, restrictive quotas, and a variety of other government regulations designed to foster fair competition between imports and domestically produced goods and services.

According to proponents, protectionist policies protect the businesses and workers within a country by restricting or regulating trade with foreign nations. The doctrine of protectionism contrasts with the doctrine of free trade, according to which governments reduce the barriers to trade as much as possible. There is a broad consensus among economists that the impact of protectionism on economic growth and prosperity is largely negative.

Let's take a closer look at several of the most common tools used by nations hoping to protect local industry through trade restrictions.

Import Tariffs

Import tariffs are are simply a type of tax that is levied on goods and services coming into a country. They increase the price of imported goods and services, since the businesses pass the cost of the tariff on to consumers. Tariffs benefit local producers of goods and services while generating revenue for the government. They are one of the oldest form of trade protectionism, one of the easiest to implement, and the most common subject in trade-agreement negotiations.

Nontariff Restrictions

Import quotas are another means of restricting the flow of foreign goods into a local economy. An import quota is exactly what its name implies: a limit on the amount or quantity of a particular good or service that can be imported into a country. Although not as common today as they have been historically, import quotas seek to protect local businesses from a flood of cheap foreign imports. Many countries have passed "antidumping" laws aimed at foreign imports that they believe are priced below fair market value. Dumping is when a company exports a product at a price lower than the price it normally charges in its own home market. The economic impact of an import quota is similar to that of a tariff, except that the tax revenue generated by a tariff is instead paid to those who possess import licenses.

When a country is reluctant to impose quotas and tariffs, another way it can protect domestic markets is with local content requirements. **Local content requirements** are set by the government and require foreign businesses to use a certain quantity of local labor, resources, and/or suppliers in their operations. This kind of trade restriction has been a point of contention in recent trade negotiations between the United States and India. India's government has been aggressive about using local content requirements to its "Made in India" program, which it hopes will establish India as an international manufacturing hub. The United States and other countries argue that India's policies are detrimental to foreign competition. The situation is currently under review by the World Trade Organization, and given the size of the Indian economy, the rest of the world is watching.

The most extreme form of trade restriction is the **embargo**. An embargo is an official ban on trade or other commercial activity with a particular country. The reasons for a country to place an embargo on another country range from human rights violations to ideological differences to national security interests. Embargoes are considered strong diplomatic measures imposed in an effort, by the imposing country, to elicit a given national-interest result from the country on which it is imposed. Although trade and commercial activities are barred under an embargo, medical and humanitarian supplies are usually exempt. The most enduring of all trade embargoes is the United States' embargo against Cuba, which, after fifty-five years, appears to be coming to an end.

As you can see, global trade restrictions can be as narrow as a tariff on a particular imported good or as broad as an embargo, which stops the flow of goods and services between countries altogether. Since these types of restrictions are imposed by governments, businesses have no choice but to follow their rules—even when it means walking away from a lucrative opportunity.

The following video discusses the effects of different kinds of trade restrictions.

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14.6: Global Trade Agreements and Organizations

What you'll learn to do: describe global trade agreements and economic organizations that regulate and promote global trade

In this section, you'll learn about the organizations that oversee global economic cooperation and help facilitate global trade agreements.

Learning Objectives

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

The World Trade Organization (WTO)

In the post–World War II environment, countries came to realize that a major component of achieving any degree of global peace was global cooperation—politically, economically, and socially. The intent was to level the trade playing field and reduce economic areas of disagreement, since inequality in these areas could lead to more serious conflicts. Nations agreed to work together to promote free trade and, with the help of key international organizations like the World Trade Organizations, they entered into bilateral and multilateral agreements.



GATT: How the World Trade Organization Got Its Start

Before you begin your reading on the World Trade Organization (WTO), take a few minutes to watch the following video that will give you some background on **General Agreement on Tariffs and Trade (GATT)** and explain how it grew into the WTO we know today. Remember, the world is much smaller today than when your parents and grandparents were growing up, and international trade hasn't always been the norm. After watching the video, consider how impossible world trade would be without some type of agreement among nations.

Enjoy!

As you saw in the video, what began with one agreement (GATT) eventually evolved into the WTO. In fact, GATT was the only multilateral instrument governing global trade from 1946 until 1995. Given the difficulty of trying to regulate trade among more than one hundred nations according to a single document, it's easy to see why the WTO came into existence. It became clear to

the participating nations that GATT was incapable of adapting to an increasingly globalized world economy. Moreover, when the Uruguay Round of GATT negotiations was launched in September 1986, it marked the largest global effort to structure trade in history. Today, GATT still exists as the WTO's umbrella treaty for trade in goods, but it's no longer the only legally binding global-trade agreement.

What does the WTO actually do? Among its various functions, the most important are the following:

- Oversees the implementation and administration of the agreements between nations that fall under the WTO's scope of authority
- Provides a forum for negotiations and settling disputes among nations.

In recent years, the WTO has also made it a priority to assist developing nations as they come under WTO regulation. Many developing countries and emerging markets lack the experience and technical expertise needed to deal with large and very comprehensive trade agreements. The WTO provides them with critical training and support, thereby ensuring that the WTO is inclusive and equitable toward both the wealthiest and the poorest nations in the world.

Part of the nondiscrimination mandate of the WTO is most-favored-nation (MFN) status. Most-favored-nation status requires that a WTO member must apply the same terms and conditions to trade with any and all other WTO members. In other words if a country grants another country (even a non-WTO member) a special favor, then every other WTO member must get the same treatment. You probably experienced a version of most-favored-nation status as a child, when an adult told you that if you were going to take gum or candy to class, you had to bring enough for everyone. In other words you couldn't just give gum or candy to your best friends, and if you didn't have enough for everyone in the class, then nobody got any. That, in effect, is how most-favored-nation status works.

One of the other key elements to the success of the WTO is its transparency requirement. WTO members are required to publish their trade regulations and follow a system that allows external parties to review and evaluate any administrative decisions and their impact on trade regulations. When a WTO nation changes its trade policies, those changes must be reported to the WTO.

Overall, the WTO's mission is to improve the stability and predictability of global trade. As a result, it tends to support free-trade, as opposed to protectionist, policies, and strongly discourages the use of quotas and other such restrictions on imports.

Whether or not the WTO is doing its duty and accomplishing its mission is a matter of ongoing debate. Nonetheless, the WTO currently has 104 members and twenty observer governments. WTO member states account for almost 97 percent of global trade and 98 percent of global GDP. Once the twenty observer governments become members, it is possible that the WTO will oversee the entire world economy. What began in 1947 in Geneva, with twenty-three nations focused solely on tariff reduction, has grown into a truly global organization that deals with agriculture, labor standards, environmental issues, competition, and intellectual property rights.

The World Bank


World Bank Group president Jim Yong Kim visits an integrated child development services and skills center in Delhi, India.

Created in 1944 at the Bretton Woods Conference in New Hampshire, the **World Bank** is an international financial institution

that provides loans for capital programs to developing countries. It comprises two institutions: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA). Originally, the IBRD was tasked with supporting post-war reconstruction, but it has evolved to include the present-day mandate to alleviate poverty worldwide. The World Bank is a component of the World Bank Group, which is part of the United Nations system. The World Bank is comprised of 189 member countries represented by a board of governors. Although headquartered in Washington DC, the World Bank has a presence in almost every nation in the world.

The World Bank has set two goals to achieve by 2030:

1. End extreme poverty by decreasing the percentage of the world's population that live on less than US$1.90 per day to no more than 3 percent
2. Promote shared prosperity by fostering the income growth of the bottom 40 percent in every country

The World Bank's primary function is providing low-interest loans and grants to developing countries. It tends to fund projects focused on education, infrastructure, natural-resource management, and public health. In many instances, the World Bank provides technical assistance as well as research and policy advice to developing nations. One of the projects currently underway is the Education Sector Support Project for the Republic of the Congo. The primary objective of this project is to improve education outcomes for primary- and secondary-school children by providing quality education in an appropriate teaching and learning environment. Other World Bank projects are aimed at improving basic infrastructure, such as building and maintaining safe water supplies and sanitary sewer systems in Africa and parts of Asia. For developing nations, many of these improvements would be impossible without the World Bank's help. Although the World Bank has come under fire in the past for budget overruns and poor project oversight, its role in promoting economic development has been undeniable.

The following video shows how a World Bank project works:

The International Monetary Fund (IMF)



The **International Monetary Fund (IMF)** is an international organization headquartered in Washington, D.C., comprised of 189 member countries. The IMF works to foster global growth and economic stability by providing policy, advice, and financing to its members. It also works with developing nations to help them reduce poverty and achieve macroeconomic stability. Formed in 1944 at the Bretton Woods Conference in New Hampshire, it came into formal existence in 1945 with twenty-nine member countries and the goal of reconstructing the international payment system. It now plays a central role in the management of balance-of-payments difficulties and international financial crises.

IMF member countries contribute funds to a pool, from which they can borrow if they are experiencing balance-of-payments problems. The rationale for this arrangement is that private international capital markets function imperfectly, and many countries have limited access to financial markets. Without access to IMF financing, many countries can only correct large external payment imbalances through drastic measures that can have adverse effects on their own economies and the world's. The IMF provides alternate sources of financing to countries in need that would not otherwise be available to them.

When the IMF was founded, its primary functions were to provide short-term capital to aid the balance of payments and to oversee fixed-exchange-rate arrangements between countries, thus helping national governments manage their exchange rates and prioritize economic growth. This assistance was meant to prevent the spread of international economic crises. The IMF was

also formed to help put the pieces of the international economy back together after the Great Depression and World War II. In addition, it also sought to provide capital investments for economic growth and infrastructure projects.

The IMF's role was fundamentally altered by floating exchange rates post-1971. At that point the organization began examining the economic policies of its loan recipients to determine whether a shortage of capital was due to economic fluctuations or economic policy. The IMF also researched what types of government policy would ensure economic recovery. The current challenge is to help countries implement economic policies that reduce the frequency of crises among the emerging-market countries, especially the middle-income countries that are vulnerable to massive capital outflows. In order to meet this challenge, the IMF's activities have expanded beyond the oversight of exchange rates to surveillance of the overall macroeconomic performance of its member countries. Today it plays an active role in shaping and managing economic policy around the world.

The following video gives a good overview of the IMF and its role in promoting global trade.

Trade Agreements



So far you have seen how international organizations such as the WTO, IMF, and World Bank support global trade, but this is only part of the story. Where global trade really gets a boost is from trade agreements (also called trade blocs). This where the term "global economic integration" gets its legs— from the process of modifying barriers among and between nations to create a more fully integrated global economy. Trade agreements vary in the amount of free trade they allow among members and with nonmembers; each has a unique level of economic integration. We will look at four: regional trade agreement (RTA) (also called a "free trade area"), customs unions, common markets, and economic unions.

Regional trade agreements are reciprocal trade agreements between two or more partners (nations). Almost all countries are part of at least one RTA. Under an RTA, countries "huddle together," forming an international community that facilitates the movement of goods and services between them. For example, the North American Free Trade Agreement (NAFTA) enacted between Canada, the U.S., and Mexico facilitates trade among these countries through tariff reductions and elimination. The Association of Southeast Asian Nations (ASEAN), shown below, provides for the free exchange of trade, service, labor, and capital across ten independent member nations to provide a balance of power to China and Japan. The Central American Free Trade Agreement (CAFTA) (Costa Rica, Dominican Republic, Guatemala, Honduras, Nicaragua, and El Salvador) eliminated tariffs on more than 80 percent of U.S. exports and opened U.S. trade restrictions for Central American sugar, textiles, and apparel imports, thereby reducing costs on these products for American consumers[1].



The Association of Southeast Asian Nations (ASEAN) as of 2015.

Customs unions are arrangements among countries whereby the parties agree to allow free trade on products *within* the customs union, and they agree to a *common external tariff* (CET) on imports from the rest of the world. It is this CET that distinguishes a customs union from a regional trade agreement. It is important to note that although *trade* is unrestricted within the union, customs unions do not allow free movement of capital and labor among member countries. An example is the customs union of Russia, Belarus, and Kazakhstan, which was formed in 2010. These countries eliminated trade barriers among themselves but have also agreed to some common policies for dealing with nonmember countries.

Common markets are similar to customs unions in that they eliminate internal barriers between members and adopt common external barriers against nonmembers. This difference is that common markets also allow free movement of resources (e.g., labor) among member countries. An example of a common market is the Economic Community of West African States (ECOWAS), comprised of Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, guinea-Bissau, Ivory Coast, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

An even more economically integrated arrangement is the **economic union**. Economic unions eliminate internal barriers, adopt common external barriers, permit free movement of resources (e.g., labor), AND adopt a common set of economic policies. The best-known example of an economic union is the European Union (EU). EU members all use the same currency, follow one monetary policy, and trade with one another without paying tariffs.

The following video further explains and compares the different types of trade agreements:

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

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14.7: Ethical Challenges in the Global Environment

What you'll learn to do: describe ethical challenges that businesses face in a global environment

The ethical landscape of international business is cloudy, and the diverse nature of cultural, political, and legal systems around the world often makes the line between ethical and unethical business practices difficult to negotiate. In this section you will learn about some of the ethical challenges and issues that businesses face in global markets.

Learning Objectives

- Explain why forms of corruption such as bribery are so widespread and difficult to regulate
- Summarize the key parts of the Foreign Corrupt Practices Act

Labor Abuses

The term **sweatshop** refers to a factory that is guilty of some sort of labor abuse or violation, such as unsafe working conditions, employment of children, mandatory overtime, payment of less than the minimum wage, unsafe working conditions, abusive discipline, sexual harassment, or violation of labor laws and regulations. The U.S. Government Accounting Office has chosen to define a sweatshop as any manufacturing facility that is guilty of two or more of the above types of labor abuses. However, it is important to understand that the term sweatshop is not just a legally defined term but a word that is used broadly and has entered the general lexicon.

Rana Plaza


Garment factory collapse, Rana Plaza, Bangladesh.

On April 24, 2013, at Rana Plaza on the outskirts of Dhaka, Bangladesh, a building containing apparel factories collapsed, trapping and killing more than 1,100 employees. It was not only the worst industrial disaster in the history of the garment industry, it was also the world's most fatal industrial building collapse. News reports soon emerged that the factory owners had ignored ominous warning signs, such as visible cracks in the wall, and had illegally added several stories to the top of the building, creating a weight the building could not bear. Many of the factories operating in the building were producing apparel for well-known Western brands, such as Walmart, Joe Fresh, and Mango.

Rescue workers struggled for more than a week to reach trapped survivors, while hospitals tended to the more than 2,500 workers who had escaped, many with severe injuries. Survivors told heart-rending tales of having lost mothers and sisters who had worked in the same factories. The deaths of so many innocent workers created a firestorm of controversy in Bangladesh and around the world. Accusations and recriminations were leveled at corporations and government officials. A period of intense and profound soul-searching ensued for the global fashion companies that relied on outsourced factory labor in Bangladesh. Within a few months, two major initiatives were announced, one American and one European, to increase safety and accountability in

Bangladeshi factories.

How did this situation arise?

Thanks to international efforts to lower import tariffs, such as those instituted by GATT in 1947 and by the WTO in 1995, an outsourcing movement was born, and many companies saw the opportunity to lower their production costs by moving them overseas. Fashion and apparel companies were among the first to take advantage of the benefits of outsourcing—namely, gaining access to cheap foreign labor markets. Throughout the period from 1970 to the present, employment in American apparel factories dropped sharply as companies moved production to countries like Indonesia, Vietnam, China, Mexico, and the Dominican Republic.

The outsourcing movement was accompanied by increasing reports of sweatshop abuses. As a result, a number of nongovernmental organizations (NGOs), such as the National Labor Committee, became involved in anti-sweatshop activities. Throughout the 1990s, a number of sweatshop-related abuses came to light in factories used by American brands. Several of these involved the island of Saipan, a small American protectorate in the Pacific. A number of factory owners discovered that since Saipan is technically American territory, clothing produced in Saipan could enter the United States duty-free and carry the label "Made in America." Since Saipan is much closer to Vietnam and the Philippines than to the United States, a number of these factories recruited Vietnamese and Filipino natives as factory workers. Upon their arrival in Saipan, however, some of these workers were exposed to flagrant human rights abuses and, in the worst of cases, outright slavery. In one notorious case, workers were literally imprisoned in the factory and forced to work without pay. Eventually, these abuses were revealed and U.S. prosecutors filed charges against factory owners, some of whom were sentenced to substantial prison sentences.

In the early 1990s, one of America's most prominent footwear brands, Nike, also came under attack as reports emerged from Indonesia and Vietnam of worker abuse. In Vietnam, a young female factory employee was working on basketball shoes when her machine exploded and sent a bolt through her heart. At first, Nike refused to accept responsibility, pointing out that Nike had never manufactured its own footwear and apparel. Nike's contracts with its sourcing factories required the factories to obey labor regulations and, in Nike's view, this meant that any abuses were the factories' responsibility. However, by 1998, the continuing negative publicity obliged Nike to reverse its course by instituting a strict code of conduct for its factories.

By 2000, as a result of continued scrutiny from various watchdog organizations like the Worker Rights Consortium, the National Labor Committee, and other international groups such as the Clean Clothes Campaign, most large apparel brands developed and publicized their own internal codes of conduct for suppliers. Such codes of conduct were contractually imposed on all suppliers and required that factories comply with all local labor laws, refrain from employing children, and maintain safety programs. In addition, most brands began to require that factories make themselves available for inspections to make sure that they were complying with the standards set forth in the codes of conduct. A number of inspection companies sprang up to service the needs of the corporations and groups of young inspectors soon scanned the globe, moving from factory to factory, checking them for fire violations, reviewing records to make sure that rules on overtime were respected, and so forth.

Despite all these efforts, reports of violations continued to be heard. The American consumer seemed to have wearied of the sweatshop issue to some extent, and companies like Walmart and Nike, which had often been accused of sweatshop abuses, saw their sales and stock valuations continue to rise. Many companies began to focus more on environmentalism and anti–global-warming issues, and a number of brands began to require that their supply factories obtain some sort of environmental certification, such as the Bluesign certification that was established in Germany under the auspices of SGS S.A., the world's largest inspection company. Then, in 2012 and 2013, a horrific series of accidents reminded the world's consumers that the sweatshop issue was still with us.

In 2012, a fire broke out at an apparel factory in Pakistan, killing some 270 Pakistani workers. Among the Western companies sourcing from that factory were the UK retailer Tesco and the German apparel brand Kik. Kik's offer to compensate the victims' families $2,000 per fatality was viewed by many Pakistanis as insulting. Then, just a few months later, at the Tazreen Fashions factory in Dhaka, Bangladesh, another 112 factory workers perished in a fire. Again, it was discovered that well-known Western brands such as Walmart, Disney, and the Gap had sourced products from the factory. The world's attention was squarely focused on Pakistan and Bangladesh when the building collapse at Rana Plaza in Bangladesh became the worst industrial catastrophe in the history of apparel manufacturing.

Corruption

In the following video, Joseph R. DesJardins discusses the concept of ethics and asks whether international standards of behavior are possible. What do you think?

When a large corporation decides to enter a foreign market, it must usually secure a number of licenses, permits, registrations, or other government approvals. Certain types of business may be even be impossible or illegal unless the corporation is first able to obtain a change or adjustment to the nation's laws or regulations. Since the power to authorize the foreign corporation's activities is vested in the hands of local politicians and officials, and since corporations have access to large financial resources, it should not be surprising that some corporate executives resort to financial incentives to influence foreign officials. While certain financial incentives, such as promises to invest in local infrastructure, may be legitimate, any form of direct payment to the foreign official that is intended to influence that official's public decisions will cross the line into *bribery*.



Bribery is one of the archetypal examples of a corporation engaged in unethical behavior. A number of problems can be attributed to business bribery. First, it is obviously illegal—all countries have laws that prohibit the bribery of government officials—so the foreign company engaging in bribery exposes its directors, executives, and employees to grave legal risks. Second, the rules and regulations that are circumvented by bribery often have a legitimate public purpose, so the corporation may be subverting local social interests and/or harming local competitors. Third, the giving of bribes may foment a culture of corruption in the foreign country, which can prove difficult to eradicate. Fourth, in light of laws such as the U.S. Foreign Corrupt Practices Act (FCPA) and the Organization of Economic Cooperation and Development (OECD) Convention on Anti-Bribery (discussed in greater detail below), bribery is illegal not only in the target country, but also in the corporation's home country. Fifth, a corporation that is formally accused or convicted of illicit behavior may suffer a serious public relations backlash.

Despite these considerable disincentives, experts report that worldwide business corruption shows little signs of abating. Transparency International (TI), a leading anticorruption organization based in Berlin, estimates that one in four people worldwide paid a bribe in 2009. It appears that the total number of bribes continues to increase annually. The World Economic Forum calculated the cost of corruption in 2011 at more than five percent of global GDP (US$2.6 trillion) with more than $1 trillion paid in bribes each year.

Governments and intergovernmental organizations have redoubled their efforts to combat the perceived increase in international business corruption. Globalization, which accelerated in the final decades of the twentieth century, is often cited by specialists as contributing to the spread of corruption. Corporations and businesses in every nation have become increasingly dependent on global networks of suppliers, partners, customers, and governments. The increased interaction between parties in different countries has multiplied the opportunities for parties to seek advantage from illicit incentives and payoffs. Although outright bribery is clearly unethical and illegal, there is great deal of behavior that falls into a gray zone that can be difficult to analyze according to a single global standard. When does a business gift become a bribe? What level of business entertainment is "right" or "wrong"? Over the past two decades, governments and regulators have sought to clearly define the types of behavior that are considered unethical and illegal.

Another factor that has heightened the sense of urgency among regulators is the magnitude of recent cases of corruption (several of which are described in greater detail below). The cost to shareholders as well as stakeholders and society has proven enormous. Governments and international organizations have ramped up their enforcement of anticorruption laws and sought increasingly severe penalties, sometimes imposing fines amounting to hundreds of millions of dollars. Largely as a result of these efforts, most multinational corporations have developed internal policies to ensure compliance with anticorruption legislation.

The following are recent examples of large-scale corruption in international business.

Walmart in mexico

According to a report issued by the Mexican Employers Association in 2011, companies operating in Mexico spend more than 10 percent of their revenue on corrupt acts. One of the most well-known cases was the Walmart scandal that came to light in September 2005 and resulted in the company's stock value dropping by as much as $4.5 billion. Evidence unearthed by internal and external investigations revealed a widespread use of bribes, alleged to total more than $24 million. The bribes were paid to facilitate the construction of Walmart stores throughout Mexico. The country is a huge market for Walmart—one in every five Walmart stores is in Mexico. As of October 2014, the investigation continued, having implicated Walmart senior level management of complicity or awareness.

glaxosmithkline in china

In September 2013, China's Xinhua news agency reported that a police investigation into bribes paid by drug manufacturer GlaxoSmithKline (GSK) indicated that the bribes were organized and paid by GSK China and not by individuals operating on their own prerogative as had been reported by the company initially. Police also alleged that the corporate parent merely went through the motions of an internal audit process, indicating a knowledge and acceptance of the bribery. This very recent case suggests that the Chinese government's widely publicized arrests and convictions for bribery have not yet served as a sufficient deterrent to corrupt practices by foreign corporations.

alcatel in costa rica

In January 2010, mobile-device manufacturer Alcatel agreed to pay Costa Rica $10 million in reparations for social damage caused by Alcatel's payment of $2.5 million in bribes to get a contract to provide mobile phone services in that country. This case is notable for its application of the concept of social damage and the resulting order of compensation to the citizens of Costa Rica.

Anticorruption Laws and Regulations

The first major international anticorruption law was the United States' **Foreign Corrupt Practices Act (FCPA)**, adopted in 1977. The FCPA criminalized bribery of foreign public officials by American business enterprises. Initially, the FCPA was not well received. Few other countries followed suit and US companies complained that the FCPA shut them out of the competition for billions of dollars' worth of overseas business contracts. Slowly, however, the push for concerted anticorruption measures gathered momentum, and intergovernmental institutions such as the OECD, the African Union, and the United Nations eventually adopted anticorruption conventions. Further support for a global anticorruption agenda was provided by lending institutions such as the World Bank, by NGOs such as Transparency International, and by the rapidly evolving corporate social responsibility movement. Notable among these efforts was the Communist Party of China's promulgation of a code of ethics to fight the widespread corruption within the Communist Party of China.

The FCPA applies only to bribes paid (or offered) to foreign government officials to obtain or retain business or to develop an unfair competitive advantage. The concepts of *bribe* and *foreign government official* can be interpreted broadly. While companies and executives charged with FCPA violations have often sought to characterize their payments as business "gifts," this has not shielded them from liability when there was evidence that the payments were intended as a means of obtaining illicit objectives. However, where payments have been characterized as "facilitation" or "lubrication" payments, meaning that they merely created an incentive for an official to promptly execute legal actions, such as mandatory customs inspections, the payments have been allowed. In numerous countries, the state owns all or part of commercial enterprises, so a great number of business executives could be classified as foreign government officials.

In 1997, the **Organization for Economic Cooperation and Development (OECD)** established legally binding standards for defining bribery in international business transactions. Similar to the FCPA, the OECD Anti-Bribery Convention focuses on the bribery of public officials. Like the FCPA, the OECD also potentially creates the opportunity for companies to circumvent the regulations by hiring consultants or agents. Notably excluded from the scope of the OECD Convention is a prohibition against bribing private parties. Despite such loopholes, the OECD Convention was an important step in the right direction. By 2012, forty-three countries had ratified the agreement and begun its implementation.

Corruption from a Cross-Cultural Perspective

Compliance with anticorruption legislation raises complex ethical dilemmas for corporations. It remains difficult to regulate ethical behavior when social and cultural norms vary significantly from country to country. Acts that are considered unethical in one country may represent a traditional way of doing business in another. One legal scholar explains the difference as follows:

> "A common misconception, held in both Western and developing countries, and even among many researchers on corruption, is to confuse what is corrupt with what is legal. Laws are defined by values, as are ethical norms, but the two are not equivalent.[1]"

The West tends to be universalist in its outlook: That is, every society works, or should work, essentially the same way. Its business practices, for example, should be based on a market system that is characterized by transparency and regulated by laws that apply to everyone. A country that fails to conform to this model is seen as underdeveloped or dysfunctional. It follows from this view that that corruption is basically the same in Sweden as in Sudan.

The reality, however, is that different cultures use radically different systems to get things done. Whereas Western cultures are primarily rule based, most of the world's cultures are relationship based. Westerners tend to trust the system, while non-Westerners are cemented by personal honor, filial duty, friendship, or long-term mutual obligation. Loyalty to cronies is suspect behavior in the West but represents high moral character in much of the world.

What is corrupt in the West may be acceptable elsewhere. The classic example of the purchasing agent illustrates this point. The Western purchasing agent is expected to award contracts based on the quality of bids and transparently available financial information about the bidders. An agent who favors personal friends is viewed as corrupt, because cronyism subverts this transparency-based system. It creates a conflict of interest: A choice that is good for the agent and his or her cronies may not be good for the company.

In much of the world, however, cronyism is a foundation for trust. A purchasing agent does business with friends because friends can be trusted. He or she may not even ask to see the company financials, since this could insult the other's honor. It is assumed that cronies will follow through on the deal, not because they fear a lawsuit, but because they do not wish to sacrifice a valuable relationship in an economy where relationships are the key to business. In such a system it is in the company's interest for the agent to do business with friends, and cronyism may therefore present no conflict of interest.

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1. Sharon Eiher, "Corruption in International Business: The Challenge of Cultural and Legal Diversity," Wichita, KS: Friends University, accessed October 29, 2013, www.ashgate.com/pdf/SamplePag...siness_Ch1.pdf. ↩

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14.8: Putting it Together- Global Environment

Synthesis



Remember the humble banana we talked about at the start of this module? Now you know at least some of what it takes to get bananas from Brazil to your local grocery store: trade agreements, currency exchange rates, compliance with federal laws, bribery and possible corruption, national comparative advantages, tariffs, trade restrictions, cultural differences, and more. Those are just a few of the things that had to fall into place to get those bananas into your local market and ultimately into a banana split served at the local ice cream shop!

What is the future of globalization? Take a look at the following video for some ideas . . .

Summary

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

Globalization

Why do countries trade? Shouldn't a strong country such as the United States produce all of the computers, television sets, automobiles, cameras, and VCRs it wants rather than import such products from Japan? Why do the Japanese and other countries buy wheat, corn, chemical products, aircraft, manufactured goods, and informational services from the United States? Because countries have different natural, human, and capital resources and different ways of combining these resources, they are not equally efficient at producing the goods and services that their residents demand. The decision to produce any good or service has an **opportunity cost**, which is the amount of another good or service that might otherwise have been produced. Given a choice of producing one good or another, it is more efficient to produce the good with the lower opportunity cost, using the increased production of that good to trade for the good with the higher opportunity cost.

Measuring Global Trade

A nation has a comparative advantage at producing something if it can produce it at a lower cost than another. A competitive advantage is a term describing attributes that allows a nation to outperform competing nations. These attributes may include access to natural resources, such as high-grade ores or inexpensive power, highly skilled personnel, geographic location, high entry barriers, etc.

Global Business Strategies

The main strategies that companies use to enter the global market are exporting/importing, outsourcing/offshoring, licensing and franchising, joint ventures/strategic alliances, and foreign direct investment (FDI). Each has different advantages and disadvantages that must be weighed carefully.

Global Trade Forces

Firms desiring to enter international business many forces and barriers. Common barriers to effective global business are cultural, social, and political barriers, and tariffs and trade restrictions.

Ethical Challenges in the Global Environment

Culture plays a big role in shaping and defining ethical behavior. As a result, what may be considered ethical in one country may be seen as unethical in another. In a global business context, such ethical challenges often arise in the form of corruption and labor abuse.

Global Trade Agreements and Organizations

The goal of the GATT is to make trade freer, and thus the promises countries make must involve reductions in trade barriers. The WTO's main purpose is to monitor the trade liberalization agreements reached by GATT-member countries in the Uruguay Round. The most important "power" of the WTO is its ability to adjudicate disputes between member countries regarding compliance with the agreements. The IMF's key roles are the following: promote international monetary cooperation; facilitate the expansion and balanced growth of international trade; promote exchange stability; and assist in the establishment of a multilateral system of payments. The World Bank has one central purpose: to promote economic and social progress in developing countries by helping raise productivity so that their people can live a better and fuller life.

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