



Article: 132

REVISION  
NOTES

# BUSINESS

9609

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# *A* **Level** **BUSINESS**

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**Shameel Khalid**

LGS 1A1, LGS Paragon, LGS 15 C, Beaconhouse JT,  
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## **PREFACE**

This is a comprehensive and carefully balanced compilation of all the relevant topics that need to be essentially covered and understood by any AS'/A' Level candidate who wishes to ace his Business paper. We have managed to adopt a purely focused and goal oriented approach in this context that would enable students not only to grasp the content but also assist them in analysing and evaluating individual components.

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## UNIT 1

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# Business and Its Environment

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A Level  
Business  
Teacher's Notes

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## Syllabus 2016 –18

- 1.1 Enterprise
  - The nature of business activity
  - The role of the entrepreneur
  - Social enterprise
- 1.2 Business structure
  - Economic sectors
  - Legal Structures
- 1.3 Size of business
  - Measurements of business size
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  -
- 1.4 Business objectives
  - Business objectives in the private & public sectors
  - Objectives and business decisions
- 1.5 Stakeholders in a business
- 1.6 external influences on business activity
  - Role of government (Economic constraints & enablers)
  - Consumer Protection

# UNIT 1 BUSINESS AND ITS ENVIRONMENT

## 1.1 ENTERPRISE

### The nature of business activity

An activity that produces an output in the shape of goods (tangible products) and services (intangible) with the ultimate objective of making profit is termed as a business activity. Business activities are required as we live in a world of great scarcity. Human needs include the basic requirements to be fulfilled such as food, shelter and clothing. Besides these, what a human desires for are wants. Human wants are unlimited and the resources used to fulfil these wants are limited. This phenomenon is referred to as the "basic economic problem". A particular business activity involves identifying the right product to be produced, considering the resources available.

### Opportunity Cost:

People are forced to make choices due to the presence of the basic economic problem mentioned above. Opportunity Cost is defined as the next best alternative forgone. In simpler terms, the sacrifice by an individual or organisation while giving preference to one product to the other is known as the opportunity cost of that particular decision.

### Factors of production:

The elements required to carry out a business activity are collectively known as the factors of production. These include:

#### Land:

It represents all the natural resources which are consumed during a business activity, e.g., plains, seas, mines etc.

#### Labour:

The term refers to any kind of physical or mental human effort, e.g., carpenters, doctors etc.

#### Capital:

All man-made resources fall in this category. It is further classified into fixed and working capital. The former includes machinery and equipment that can be used repeatedly during a production process over a period of time. The latter represents cash, raw material, semi finished and finished goods etc. that is in continuous circulation and utilised within a short span of time.

#### Entrepreneurship:

An entrepreneur is an individual responsible for managing all the other factors of production to an optimum or the best possible way.

#### Concept of Adding Value:

Adding value to a product means charging a higher price but keeping the cost of producing the good or providing the service the same. This can be achieved by establishing a better image for the product or by improving customers' perception of the quality of the product/service.

### The role of the entrepreneur

An entrepreneur organises land, labour and capital resulting in all kinds of business activities. People who have this role typically perform the following functions:

#### Innovation:

Generation and implementation of new ideas is a function one expects an entrepreneur to perform. In fact, a business activity usually commences with the entrepreneur having a business idea. Launch of Body Shop by Anita Roddick in 1976 is an impressive display of innovation. She created a business idea



of her own when she decided to offer toiletries and cosmetics for sale with a special emphasis on conservation, environment and animal rights.

### Organisation:

Land, labour and capital are hired by the entrepreneur and organised to produce goods or services. Decisions about the location of the premises, production methods, product design, prices, wages etc., are often made by the entrepreneur. If the firm grows, it is likely that some of these tasks are passed down to others.

### Assuming risk:

An entrepreneur assumes high risk as he decides to set up a business. Money has to be spent without any guarantee of return. There is every possibility of a loss in future since he might be unsuccessful in selling the goods or services he has produced.

### Social enterprise

It is a business that feels accountable towards stake holders other than shareholders also. Accepting these responsibilities towards customers, local residents, employees and the environment and acting accordingly can give firms a major competitive advantage. However, it may increase business costs, e.g., purchasing expensive but non-polluting capital equipment.

(Also see PEST Analysis in Section 6 for further details)

### Triple Bottom Line:

The triple bottom line is made up of the "social, environmental and economic" factors that must be considered seriously by all progressive business organisations. The social aspect pertains to fair and beneficial business practices towards the labour and community in which a corporation conducts its business. The term environment refers to sustainable environmental practices, indicating that a business needs to give due attention to issues such as pollution and recycling. Finally, the bottom line is economics, which basically highlights the significance of generating profit, an objective pursued by all business organisations, conscientious or not.

It is worth mentioning that almost a similar phrase was coined by "Shell" also, in which the terms 'people, planet and profit' replaced 'social, environment and economics' respectively.

### Ethical Issues:

Ethics can be defined as a system of morals or rules of behaviour. These are the values and beliefs which influence how individuals, groups and societies behave. To say that something is legal is not to say that it is ethical and vice versa. For example, advertising directed towards children might be legal but many see it as unethical. Similarly, in the past, the use of inside information in share dealing was considered unethical, but was nevertheless legal. The basic distinction to make is that the law concerns whether an action is allowed or not allowed whereas ethics concern whether an action is right or wrong, acceptable or unacceptable. It is advisable for a business to seriously look into various ethical issues and fulfil its CSR or "corporate social responsibility". The term "ethical" is used to refer to businesses which recognise the importance of social responsibility and the need to consider the effects of its actions upon stakeholders. For example, an electricity generating business may be operating within legal emissions limits. However, it may feel that it has to change its production methods to reduce emissions even further because it believes businesses should work towards a cleaner environment. A strong sense of corporate responsibility was displayed by Orange, the cell phone company, when it introduced tree shaped transmitters which blended in with the surrounding area. However, it is worth mentioning that despite the contribution of being ethical towards an improvement in the image and reputation of an organisation, the significance of profit making must not be undermined. The ultimate goal pursued by a firm has to be the reduction in costs that would eventually lead to an increase in profits. Therefore, the effort to act in an ethical way should be made without compromising the profit motive significantly.

## 1.2 BUSINESS STRUCTURE

### Economic sectors

#### Primary Sector:

This sector includes the extractive industries that acquire raw material from naturally available resources, e.g., agriculture, mining, etc.

#### Secondary Sector:

It comprises of the manufacturing industries that convert raw material into semi finished or finished goods, e.g., textile industry.

#### Tertiary Sector:

This represents all kinds of services such as banking, retailing, etc.

The significance of these three sectors varies from country to country, depending on factors such as availability of resources, size of the population, etc.

#### Public & Private Sectors:

The public sector comprises of businesses owned and controlled by the government. It operates for the welfare of the community and pursues profit as only a secondary motive. It means that a public sector organisation, often known as a Public Corporation, is responsible for providing certain essential facilities to the masses and it will continue to do so even if it does not prove to be profitable. Pakistan Railways is a relevant example in this context.

#### Comparison of Privatisation and Nationalisation:

**Privatisation** is a process in which state-owned assets are sold to the private sector, e.g., Pakistan Telecommunication Limited. The **advantages** of privatisation are:

- The sale of state-owned assets generates income for the government that would be used to provide public and merit goods to the masses.
- The company's primary motive becomes profit as compared to society's welfare. This leads to greater competition increasing the efficiency level.
- These businesses will be more responsive to consumers' needs and wants.
- Management will be freed from unnecessary political interference and can easily take decisions on purely commercial grounds.
- However, this system is said to have the following **drawbacks**:
- The private sector pursues profit as the primary motive and tends to ignore social welfare by not taking social costs into account.
- It leads to creation of private monopolies against which consumers have inadequate protection.
- When operated by private individuals, any parts of the business which make a loss will be closed down. This appears to have happened in case of public transport in numerous countries. Some bus services have been stopped as they were not that profitable. This leads to unemployment.
- Privatisation has promoted capitalism worldwide and the gap between the rich and the poor has widened.

### Legal Structures

#### Sole Proprietorship:

It is an unincorporated business owned by a single individual with unlimited liability. The term unlimited liability means that a sole trader is liable or fully responsible to pay off his debts, failing which, the creditors have the right to take over his personal assets or belongings in order to recover the amount. Sole Proprietorship is the oldest and the simplest form of business and is typical of small retail outlets.



**Advantages:**

The formation and dissolution of a sole proprietorship does not involve any major or complicated legal or technical formalities. The owner enjoys a high degree of flexibility in decision making and there is no profit sharing.

**Drawbacks:**

The sole proprietor may find it difficult to expand the business due to limited capital. There might be a lack of specialisation since he has to handle all aspects of business himself and is overworked. He has an unlimited liability and losses cannot be shared.

**Partnership:**

It is a form of business in which 2-20 individuals decide to run a business under unified control. Active partners participate in all business activities on a regular basis whereas a sleeping partner only makes a monetary investment in anticipation of a monetary return, and is not concerned with the day to day running of the business.

**Advantages:** There are additional funds available and workload as well as losses can be shared. This often leads to specialisation.

**Drawbacks:** A partnership may end up in conflicts and a disagreement due to the difference in opinion of partners on various issues. Under normal circumstances, partners have an unlimited liability. Profit sharing can also be regarded as a disadvantage.

**Joint Stock Company:**

This is an incorporated business in which a large number of individuals contribute towards a joint stock or a pool of money. The directors and shareholders have a limited liability. A JSC is further classified into public and private limited companies. A public limited company offers its shares on the stock exchange in order to raise funds whereas in case of a private limited company, the shares only change hands within a small group of close associates.

**Significance of limited liability:**

Limited liability signifies that the liability of the owner is limited to the extent of his investment. This prominent feature of limited companies attracts people to invest more in these companies. In case of liquidation (when the company is unable to pay off its debts), they are not liable to lose their personal possessions.

**Conversion of a Private Limited Company into a PLC: (Analysis):**

If the owners of a private limited company decide to go public, they wish to enjoy the following benefits:

- A substantial amount of money can be raised from the sale of shares to the general public.
- Production costs may be lower as firms will gain economies of scale due to expansion.
- PLCs are in a position to dominate the market because of their size.
- PLCs can raise finance easily also because banks are willing and keen to offer loans to such well established large scale business organisations (financial economies of scale).

**However, it is important not to overlook the following possible drawbacks:**

- The setting up costs can be very high; running into millions of pounds in certain cases.
- Since anyone can buy their shares, it is possible for an outside interest to take control of the company.
- All the company's accounts can be inspected by members of the public. Competitors may be able to use some of this information to their advantage. They have to publish more information than private limited companies.
- They are not able to deal with their customers at a personal level, owing to their size.
- There may be divorce of ownership and control which might lead to the interests of the owners being ignored to some extent.



- It is argued that many of these companies are inflexible due to their size. They might find change difficult to cope with.

## MULTINATIONALS

Multinationals are large scale, well established businesses with their head quarter in one country and operating through a network of production plants and/or branches in different parts of the world, e.g., Unilever, Microsoft etc. These must not be confused with local or national businesses that operate on a limited scale catering to the needs of customers in a particular town or country respectively.

### Advantages to multinationals:

MNCs are in a position to enjoy a variety of economies of scale, including purchasing, financial, risk-bearing and technical economies, due to their rapid growth. They are fully aware of their importance to the economy of the where they are investing and can sometimes pressurize the government to show flexibility in its policies regarding key areas such as taxation, environment laws etc. Multinationals often exploit the resources of developing countries and have an access to cheap factors of production.

### Drawbacks to multinationals:

Management problems may arise for an MNC since they usually function on an exceptionally large scale. Nestle', for instance, has a workforce of almost half a million and deals in almost 1200 different products in over a hundred countries. Sometimes, the lack of sufficient amount of local knowledge can also create problems for such companies. It has also been observed that unfavourable political, national or global events may have a negative impact on the performance of certain MNCs, as seen in the case of the airline industry after the incident of 9/11.

### Advantages to the country:

Developed as well as developing countries encourage foreign investment since it usually accelerates the rate of economic growth. Countless employment opportunities are created as they offer jobs to the locals. These multinationals are responsible for introducing new technology in these countries which is not only in the interest of the customers but acts as a source of ideas for domestic industries also. Standard of living can be raised since these companies add a touch of comfort and convenience to the lifestyle of the masses. Moreover, the government generates a substantial amount of revenue through taxes paid by these multinationals. The operations of such companies in a particular region increase the confidence level of other foreign investors and they are also encouraged to explore new markets.

### Drawbacks to the country:

Multinational corporations, due to their financial and technological superiority, create serious problems for the local competing firms. Customers prefer products offered for sale by these reputable organisations, minimising the chances of success of the domestic industry. As discussed above, MNCs are also known for exploiting the natural and human resources of developing countries, in addition to exerting undue pressure on the government for relaxing rules and regulations especially for them. Moreover, some multinationals may show disregard towards the social, cultural or religious beliefs of the local residents and get involved in unsuitable or inappropriate production and marketing activities.

## FRANCHISE

It is a business in which exclusive rights are purchased for selling goods or services under a specific trade name and within a specified geographical area. The franchisor, who sells these rights, is entitled an initial fee coupled with a percentage royalty, to be paid by the franchisee, who has been authorised use the company's registered name and logo. The continuing growth of franchising has encouraged firms representing different industries to enter into such agreements, e.g., telecommunication (Telenor), clothing (Nike) and foodstuff (McDonald's).

### Advantages to franchisor:

The main advantage of franchising out a business is that it facilitates rapid expansion without incurring the high capital cost of direct ownership of businesses within the chain. A nationwide presence can



accomplished without heavy investment. The franchisor is also able to reduce the running costs, specially in the case of wages, raw material and administration. The franchisee will finance most of the expansion of the chain. The franchisor benefits from the efforts of committed, enthusiastic franchisees. They usually have local knowledge which proves to be beneficial in the expansion of the franchise.

### **Disadvantages to franchisor:**

Franchisees are self-employed and there may be problems in ensuring they all adhere to the operational methods which are designed to achieve uniformity. Failure by an individual franchisee will reflect badly on the whole franchise operation. The franchisee might have different objectives from those of the franchisor. In the long run, they may begin to resent the control exercised by the franchisor. As a result, a franchisee may resort to some unethical or illegal practices such as under-declaration of sales.

### **Advantages to the franchisee:**

The advantages to the franchisee are derived from the fact that the franchise involves the purchase of a tried and tested business format. He can benefit from the introduction and sale of ready-made product as well as a recognised name known to both customers and suppliers. Moreover, it is the responsibility of the franchisor to launch a promotional campaign for the product which will be in the interest of all the franchisees. The franchisee is entitled to advice, assistance and training services, to be rendered by the franchisor. Sometimes, loan facilities are also extended by the franchisor to the franchisee.

**Disadvantages to the franchisee:** The franchisor exerts considerable control over the franchisee. This limits the franchisee's freedom of action in terms of product, price, terms of sales, place and the termination of the business. Furthermore, the franchisee, in addition to the payment of initial fee and the royalty, is also supposed to buy inputs from the franchisor, which may place an extra burden on his financial resources.

## **1.3 SIZE OF BUSINESS**

### **MEASUREMENTS OF BUSINESS SIZE**

The size of businesses can be measured in the following ways:

#### **Number of employees:**

It is believed that higher the number of people employed, bigger would be the business in size as labour is not a cheap factor of production. However, this is applicable to labour intensive industries such as agriculture. It will not be a suitable gauge in case of firms that are highly capital intensive or mechanised in nature, e.g., car manufacturing.

#### **Sales turnover:**

This method is easy to implement for firms in the same industry. Higher the number of times the firm is able to sell its stock in a year, higher would be the sales volume, thus bigger the business would be in size. However, if the firms are not in the same industry, it might create problems as some firms are engaged in the production of luxury goods and services. For example, a firm selling consumer non durables such as foodstuff will be able to sell them much quickly than firms engaged in the production of air jets.

#### **Capital employed:**

This is used to measure the size of a business in terms of the investment in machinery. Needless to say, this method is particularly applicable in case of capital intensive industries.

#### **Market share:**

The term market share refers to the sales of a particular firm determined as a percentage of total market/industry sales.

$$\text{Market Share} = \frac{\text{totalsales of the firm}}{\text{totalsales of the industry}} \times 100$$



It is evident that there is no definite measure of comparing the size of different businesses. All the above mentioned factors as well as other indicators such as profit can provide useful guidance in this context.

## SIGNIFICANCE OF SMALL BUSINESSES

It is a general observation that small businesses not only survive but achieve success despite the presence of a large number of well established competitors in the market. The following factors make a major contribution towards the significance of small firms in today's competitive business world.

### Personal Services:

Small firms are in a better position to offer personalised services to their customers. Non standardised processes in which mass production does not serve the purpose can be handled in a more effective way if the firm is operating on a small scale due to the element of personal attention. The professions of hair dressing and tailoring fall in this category.

### Geographical limitations:

Large firms tend to overlook small towns, villages or remote areas due to geographical limitations and are more focused on major, metropolitan cities, finding them more profitable. This situation provides the smaller businesses with an opportunity to explore the market and serve the customers in these neglected areas. This is another reason why small firms manage to survive and flourish.

### Role of government:

Governments play a supportive role towards small firms and infant industries. Such firms can benefit from a variety of subsidies including tax exemption and availability of cheap raw material and are able to reduce their costs. Moreover, there are no major technical or legal formalities involved in the formation or dissolution of small firms. This allows them to find a foothold in the market and attain a steady growth rate with the passage of time even if the initial investment is small.

### Demand for variety:

Small firms do not rely significantly on advanced technology and are functionally flexible enough to adjust to the changing purchasing pattern of customers. It is a general observation that the workforce involved is multi-skilled and can perform a variety of functions as per requirement. In Pakistan, for example, almost the same group of people is found making bangles during Eid festivities and manufacturing kites when the kite flying season is on.

### Luxury items:

High income groups have the tendency of buying non standardised or customised products. Luxury items such as private jets or jewellery are usually made to order and the potential customers need individual attention. Small firms can fulfil this requirement more effectively and are quite successful in businesses involving production and sale of luxury items.

## INTERNAL GROWTH

The term internal growth is used in a situation in which an existing business expands without joining hands with any other firm. Usually, a profitable firm is able to finance expansion by reinvesting profits. Internal growth is a relatively slower process but there are examples of certain well known companies such as Hoover that grew to a very large size while growing internally.

## EXTERNAL GROWTH

This involves the acquisition of one firm by another. It could be done in the form of merger or takeover. The former implies a measure of voluntary agreement whereas the latter indicates that a predator firm swallows up another firm by buying its shares. Broadly speaking, external growth is classified into:



**Vertical Integration:**

When the merging firms are engaged in different stages of the same production process, it is called vertical integration. This could be further categorised into forward vertical integration, e.g., the owner of a cotton field taking over a textile mill or backward vertical integration, e.g., the owner of a petrol station taking over an oil refinery.

The significance of vertical integration is that it allows the concerned firms to enjoy economies of scale due to a reduction in average costs resulting from expansion. Moreover it is easier to keep a check on quality related issues since the manufacturer owns and controls the source of raw material also. The level of customer service can also be raised. Vertical integration proves to be profitable in the long run also because once the external links in the chain of production like the supplier of raw material are eliminated; the manufacturer is in a good position to keep the costs of production under control. However there is a possibility that the sudden increase in the scale of business leads to certain serious management problems, technically known as the diseconomies of scale.

**Horizontal Integration:**

This is a merger between firms that are dealing in similar products at the same stage of production. For example, if two car manufacturers join hands, it would be classified as horizontal integration. RBS & ABN AMRO, Walls & Polka, Mercedes & McLaren all represent horizontal integration.

Horizontal integration proves to be beneficial for the management of the concerned business since it results in a marked decrease in competition and therefore higher prices can be charged. There will be economies of scale also. The merged firms can share their respective expertise and come up with technologically superior and more useful products. However it has been observed that such a merger may lead to conflicts between the members of the workforce since they come from a different corporate culture and may find it difficult to get adjusted in the new environment and work closely as a unified force. Also, redundancy is caused due to duplication of jobs.

**Conglomerate/Lateral integration:**

A conglomerate is formed when two or more unrelated firms are involved in the merger or takeover. They deal in totally dissimilar products at different stages of production, e.g., a car manufacturer takes over a restaurant. Gillette, that took over Parker & Waterman pens, Braun Electronics and Duracell Batteries is one of the leading conglomerates of the world.

Firms involved in a lateral integration enjoy risk bearing economies of scale since they operate in totally different industries at the same time. However the lack of relevant experience may create hurdles for the management of a conglomerate.

**Friendly Merger:**

This takes place when a business is facing operational problems and might want to continue, but under the control of a stronger company.

**Hostile takeover:**

This comes into effect when a firm resists or does not want to merge with another business but is taken over by the other firm forcefully. In such a situation, almost all the company's shares quoted on the stock exchange are bought.

**Synergy:**

Synergy is a term used to describe a situation when two things are better operated being one. In business, this is applicable in case of two companies joining hands in order to operate together and proving to be more productive.

**Joint ventures/Strategic alliances:**

This is when two businesses decide to share costs and responsibilities pertaining to a business project. It is important as competition might decrease and each company can specialise in a particular aspect of the venture. A significant plus point of joint ventures is that such companies can enjoy certain advantages of mergers or takeovers without losing their identity. However, there might be cases when joint ventures are



unsuccessful in achieving their objectives. This is primarily due to disagreement between different managements as their views might conflict at times.

### **Economies of scale:**

The term refers to a situation in which an increase in the scale of business leads to a reduction in average or per unit costs. Internal economies are the ones that are enjoyed by a single growing firm irrespective of what is happening to other firms in the industry. If the entire industry (collection of similar firms) starts to grow in size, the resulting advantages are called external economies of scale.

#### **Internal economies of scale:**

##### **Purchasing economies:**

A large firm requires raw material in bulk which encourages suppliers to offer discounts. This factor is pivotal in reducing costs and improving profit margin for growing firms.

##### **Risk bearing economies:**

Large firms always make an effort to widen the range of their products. This minimizes the element of risk since if one of the products fails, the company still has a chance of recovering the amount by selling other items in the product mix.

##### **Financial economies:**

Financial institutions are keen on offering assistance to large and established businesses. That is why it is easy for the management of such firms to get a loan application approved.

##### **Managerial economies:**

Large firms benefit from the services of specialist functional managers. The expertise of these specialists proves to be in the greatest interest of the business as it expands.

##### **Marketing economies:**

The cost of advertising and distribution rises at a lower rate than increase in the output and sales. Thus, in proportion to sales, large firms can advertise more cheaply and effectively than their smaller rivals.

##### **Technical economies:**

Established firms can specialise in terms of workforce as well as machinery. Moreover, following the law of increased dimensions, a slight increase in investment may enable a growing firm to enjoy more than proportionately high returns.

#### **External economies of scale:**

##### **Ancillary services:**

An expanding industry is often assisted by other supporting industries that provide ancillary services such as maintaining an uninterrupted supply of raw material, e.g., leather for footwear industry. In this way, the manufacturers can focus on the production process without worrying about the availability of high quality low cost raw material.

##### **Commercial facilities:**

Industries in the tertiary sector offer commercial facilities to growing businesses and support them in achieving their short and long term goals. Such commercial facilities include insurance, transportation, advertising, etc.

##### **Availability of labour:**

Large industries are usually concentrated in particular areas, e.g., Sialkot in Pakistan is known for the sports goods industry. This leads to the creation of a huge skilled workforce that can prove to be equally useful for all the firms in the industry.

##### **Cooperation:**

Firms that constitute a particular industry compete against each other for the same target market. However, these rivals may decide to cooperate with each other in situations where certain common interests have to be safeguarded. For instance, the firms in an industry will act as a unified force against



unfavorable government policies. Similarly, they may contribute towards a pool of money that can be used for establishing Research & Development centres or publishing journals that will be highly useful to all the firms in the industry.

**Disintegration:**

Whenever a production process becomes too lengthy or time consuming, it is divided or disintegrated into numerous simpler processes. Each process or phase is controlled by a separate group of firms or industry, e.g., production of cotton cloth is divided into ginning, weaving, spinning, dyeing, etc. This specialisation of resources not only leads to sharing of workload but a definite improvement in quality as well.

**DISECONOMIES OF SCALE:**

The increase in average costs as a business grows beyond the optimum size is technically known as diseconomies of scale. This can be classified into:

**a) Management problems:** In case of large businesses, managers find it difficult to perform the functions of control, communication, coordination and morale maintenance. They are unable to pay undivided attention to various aspects of business such as human resource management and quality control. Powers have to be delegated to others and this lack of personal attention may lead to deterioration in performance.

**b) Rising prices of inputs:** As discussed earlier, an increase in the scale of business results in the advantages of bulk buying or purchasing economies of scale. However, there are situations that can be exploited by the supplier. Realising that he has a monopoly or that the manufacturer is largely or totally dependent on him for acquiring raw material, he may start charging higher prices. Similarly, the workforce can also adopt a similar strategy and demand higher wages for the extra effort that they are making since the business is expanding.

**1.4 BUSINESS OBJECTIVES****BUSINESS OBJECTIVES IN THE PRIVATE & PUBLIC SECTORS**

All businesses pursue a variety of short and long-term goals or objectives. Stakeholders in a business play a key role in shaping up the objectives of a business organisation. For instance, if the owners are the most dominant stakeholders, then profit making is likely to be an important goal. Similarly, if employees are influential enough, then issues like job security and good working conditions could be the primary objective. In this context, businesses often issue a mission statement which is a description of the overall aims of the business.

**Survival:**

Survival is considered to be an important initial business objective, specially in case of newly established small businesses. Firms may encounter a number of problems when they first begin trading including a lack of experience and resources as well as threats posed by the already established competitors. As a result of this uncertainty, the most important business objective might be to survive in the initial stages of trading.

**Profit maximization:**

There are many who are of the opinion that the main aim of private sector businesses is to maximise profits. This is achieved when the difference between the total revenue and the total costs is the greatest.

**Growth:**

Many businesses pursue growth as their primary objective. In fact there are businesspeople who believe that growth is a pre-requisite to survival. Failure to grow might result in a loss of competitiveness, a decline in demand and eventual closure. If a firm is able to grow and dominate the market, it may be able to enjoy some monopoly power in future and raise its price. Moreover, growth allows a firm to diversify and reduce the risk factor.



**Sales revenue maximisation:**

Social scientists such as William Baumol argue that an objective of firms may be to gain the highest possible sales revenue. Needless to say, this objective will be strongly favoured by those employees whose salaries are linked to sales.

**Image and social responsibility:**

In the last couple of decades, firms all around the world have shown a major tendency towards establishing and enhancing their image as socially responsible organisations. Promoting environment friendly products, donating substantial amount of funds to charitable institutions etc. are steps taken by businesses with the objective of improving their image in the eyes of different stakeholders.

**Providing services:**

Primarily, the public sector has always been responsible for achieving the goal of providing essential services to the masses at subsidised rates even if it proves to be unprofitable. However there has been a change lately in the methods adopted by the government authorities pertaining to the management of these public sector organisations. Public service is obviously still the ultimate objective but now the public sector is being handled in a more business-like manner. These organisations directly compete against the private sector firms and carry out a host of business activities such as marketing and budgeting. They make a serious effort to earn profit without compromising quality, cost effectiveness and well being of the public. This trend can be observed easily in case of industries such as telecommunication, transportation and banking.

**OBJECTIVES AND BUSINESS DECISIONS****Management by objectives:**

"Management by objectives" or MBO is a theory which is regarded as the brainchild of Peter Drucker. He was of the opinion that a business can achieve long term success only if it has an objective-oriented approach. MBO revolves around the following four factors:

- a) A business should define all its objectives in a quantitative manner. It means that the goals pursued by a firm have to be described in terms of figures or numbers, e.g., the manager sets a target of selling 25000 units for his sales team.
  - b) Short as well as long-term objectives have to be arranged in a certain hierarchy. Most important goals should be pursued first followed by the less important ones.
  - c) MBO requires that managers ought to set targets for their subordinates in such a way that proves to be challenging but is realistic also. This approach will keep the employees motivated and they will be encouraged to utilise all their potential and skills in order to accomplish a given task.
  - d) The management should make an effort to maintain consistency while setting objectives. One goal must support and strengthen the other. This would guarantee that the organisation moves forward satisfactorily and the available resources are utilised efficiently.
- The **benefits** claimed for MBO are that it leads to better managers. It forces managers to plan for results and to clarify organisational roles and structures. It also provides a means of appraising performance and rewarding managers, and acts as an effective control over different parts of the organisation. However, there are dangers and **problems** associated with MBO. It is time consuming and, if handled badly, can cause resentment from staff. It may contribute to inflexibility in the face of a changing environment. However, it can be safely stated that MBO provides a means of coordinating and integrating human contributions towards organisational success by setting out individual objectives designed to complement the overall corporate objective.

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## 1.5 STAKEHOLDERS IN A BUSINESS

Stakeholders are individuals or groups of individuals who have an interest in a business. They influence and are influenced by the performance of the business. These can be classified as internal stakeholders such as owners, directors, managers and employees and external stakeholders including customers, community, government, suppliers and competitors. It is strongly recommended that a firm honours its responsibility to its internal stakeholders but also accepts the need to act responsibly towards external stakeholders. This means acting in a fair way towards customers, financiers, suppliers and the community. It requires prompt payment of bills, manufacturing quality products, honest dealing and reliability. It is important for a business to act in socially responsible manner. Socially responsible behaviour clearly requires obeying the law and paying taxes, but it also means operating in an ethical way. Showing concern for the environment and the undertaking of philanthropic activity on behalf of the disadvantaged are examples of such behaviour.

### Workers:

The labour is the backbone for any business. They directly get affected by business decisions. They are paid salaries or wages. They should always be motivated as it will always increase their efficiency raising productivity levels. Their jobs are protected through contract of employment so that they feel secured. In case of growth of business, workers might be affected positively or negatively. The employees enjoy being part of a business that is huge and successful. However, it is equally true that workers tend to show resistance to change as they have got used to a certain kind of environment and find it difficult to get adjusted in the new set up. This is what the employees experience when a firm merges with another business organisation.

### Owners:

Owners combine all the factors of production in order to operate a business. They are the risk bearers and the profit seekers. Their ultimate goal is to maximise profit by accelerating the growth of business and enjoying economies of scale. They want the image of their company to be enhanced and brand loyalty established. There are a growing number of businessmen who attach a lot of importance to ethical issues and want their firm to be recognised as a socially responsible organisation.

### Customers:

There is a well known saying in business, "Customer is the king." Customers are extremely important to any business. In fact, they are the driving force. In today's competitive business world, a firm has to be market oriented in order to be successful. Therefore, it is imperative that a business organisation has sufficient amount of knowledge regarding the target audience habits so that their requirements can be fulfilled. A typical customer wants the highest possible quality at the lowest possible price. Needless to say, this may prove to be an uphill task for any manufacturer or seller.

### Government:

In a mixed economy, it is essential to strike a balance between the authority of the government and the independence enjoyed by the private sector. The government affects business activity by accelerating the growth of firms through a variety of subsidies or retarding it through taxation. The government authorities pursue numerous objectives such as safeguarding consumers through consumer protection laws, protecting the rights of employees through labour laws, keeping a check on inflation and unemployment rates, ensuring social welfare and equal distribution of wealth, etc. Their ability to achieve all these objectives effectively is determined to a great extent by the performance of business organisations. For example, the amount generated in form of taxes will definitely increase as the business grows. This is especially true in case the government enforces a system based on progressive taxation in which the tax rate rises with an increase in income. Similarly, if the government decides to raise the minimum wage level, the cost of production for manufacturers is going to rise.

### Community:

Business activity has a significant impact on the community. The pollution caused by production plants could affect everyone negatively and damage the reputation of the business organisation as well. On the other hand, jobs created by businesses help raise the general standard of living. Technologically superior



and socially helpful products such as electronics and medicines make a positive contribution towards the well being of the community.

Other stakeholder groups such as financial institutions, suppliers and managers also actively interact with business organisations in their respective capacities.

### CONFLICT OF OBJECTIVES:

The aims of different stakeholders might be in conflict with each other since they are all seeking what is beneficial for them. That is why business organisations often find it challenging to satisfy all the stakeholders simultaneously. The owners want to maximise profits by keeping their costs low and enjoying economies of scale. The workers, on the other hand, might demand an increase in their pay level, obviously meaning a rise in costs for the owners. Businessmen usually pass these high costs to the customers by charging higher prices. This leads to another unavoidable conflict since a customer seeks highest possible quality at the lowest possible price. This situation puts the owners in a difficult spot as they would not like to disappoint the customers or the workers. Similarly, if maximisation of profit is the ultimate objective, the business might not be able to give due importance to social costs arising in terms of pollution and other related issues. The government wishes to charge high taxes in order to generate revenue for arranging public and merit goods. However, high tax rates, particularly in case of progressive taxation, are known to have a disincentive effect on owners of businesses.

## 1.6 EXTERNAL INFLUENCES ON BUSINESS ACTIVITY

### Role of government (Economic constraints & enablers)

The government plays a significant role in determining the performance of small and large business enterprises. It enforces a variety of policies in the country having a direct impact on the ability of a business to achieve its goals. Two of the most important such policies are the fiscal and monetary policies that are instrumental in regulating the economy of the country.

The **Fiscal Policy** primarily revolves around taxation and public expenditure. The government generates revenue through direct and indirect taxes. A direct tax is levied directly on the income of an individual commonly known as the income tax whereas an indirect tax is imposed on goods and services, usually charged as a part of the final price. It is commonly known as the VAT (value added tax) or GST (general sales tax). There are three different taxation policies in practice in different parts of the world. Progressive taxation is the one in which the tax rate increases with a rise in income. This method is supported and implemented by countries all over the world since the government can generate a substantial amount of revenue by taxing the higher income groups leading to a reduction in the gap between the rich and the poor. However it is an established fact that progressive taxes have a disincentive effect on investors since it discourages growth. Proportional taxation is based on a flat tax rate for all income groups. In case of Regressive taxation, the tax rate declines with an increase in income. This strategy proves to be effective in encouraging growth but obviously could be disastrous in case of the lower income groups. The amount raised through taxation has to be spent on development oriented projects for the welfare and betterment of the masses. This is technically known as Public Expenditure or government spending and performs the following major functions:

- Providing public and merit goods, e.g., street lights and subsidized health facilities respectively
- Social security benefits, e.g., unemployment benefits and pension
- Accelerating the rate of economic growth through subsidies
- Strengthening strategic industries such as Defence and Agriculture

The **Monetary Policy** is formulated with the purpose of regulating the supply of money in the economy primarily with the objective of keeping a check on inflation. Inflation, which is a persistent and general increase in prices, is categorised into Hyper, Suppressed and Creeping inflation. Hyper inflation, being experienced in Zimbabwe these days, is the worst form of inflation since it represents a situation in which the currency loses its value to such an extent that it becomes unacceptable as a medium of exchange. People in the country are forced to start using the barter system (goods exchanged for other goods) in order to meet their needs. There is no short term solution to this and, in order to resolve the crisis, all the currency notes in circulation have to be replaced by newly printed notes with a different value. Suppressed inflation, also known as demand-pull inflation is experienced when the demand exceeds



supply and the resulting shortage often leads to a sharp increase in prices. This can be countered by raising the level of production through better utilisation of the available resources. The third form of inflation is creeping (cost-push) inflation in which the final prices are increased since the cost of production has risen. Usually the annual increase in price is 1%-6% and this is something commonly observed since wage rates, cost of raw material, transportation costs etc. always increase with the passage of time. It is an established fact that an excessive supply of money in the economy, without being backed up by a specific amount of gold, leads to a decline in its value. Therefore, the government authorities adopt a variety of methods to keep a check on the supply of money. Broadly speaking, the government either uses an approach in which the printing of new notes is controlled or a tighter credit policy is enforced in order to discourage banks from lending too much money. In this context, the following instruments of monetary policy are commonly applied by the government authorities.

### **Central Bank's Discount Rate:**

This is the rate at which the central bank of the country lends money to the commercial banks. In order to control the supply of money, and subsequently inflation, the discount rate is often increased. It discourages the commercial banks from borrowing large amounts of money from the central bank and hence they will not be in a position to offer credit facilities to consumers at low interest rates.

### **Special Deposits:**

The government may instruct the commercial banks to deposit a specific amount of money with the central bank in order to control the supply of money. This amount, often termed as frozen assets, is not released unless there is a definite improvement in the situation regarding inflation.

### **Open Market Operations:**

Bonds are issued and publicised so that the masses are encouraged to invest in this sector. The amount collected by the government through the launch of bonds and other similar instruments helps control the circulation of money and hence inflation. People spend substantial sums of money, considering it to be a safe investment, once the bonds mature after a certain period of time.

### **Funding:**

This instrument of monetary policy is similar to the above mentioned open market operations with the only difference that Funding is a long term measure since the bonds mature after a longer period of time. It is recommended when the inflation rates are critically high.

### **Qualitative & Quantitative Control:**

Qualitative control is exercised when the government instructs commercial banks to be more selective while approving loan applications. Credit should be offered purely on merit, keeping in mind the contribution of the applicant towards the economic growth of the country. For instance, exporters should be favoured in this connection.

Similarly, the government sets a limit to the maximum amount of money that can be offered as loan within a given period of time. This measure, just like qualitative control, proves to be useful in controlling the supply of money in the economy.

### **Regulating Hire Purchase Contracts:**

If the government has a relaxed policy in context of hire purchase contracts, consumers tend to spend beyond their means which may cause inflation. Therefore, governments are known for tightening up their hire purchase policies with the objective of keeping a check on rising inflation rates. By taking steps such as increasing the rate of interest, they discourage consumers from availing hire purchase facilities.

### **Consumer Protection**

The government adopts numerous measures for safeguarding the interests of consumers. It makes sure that the producers and suppliers do not misrepresent the facts. They are required to convey information to customers that is based on realistic figures. The government implements a wide range of rules and regulations in order to guarantee that high quality standards must be maintained and sub-standard goods and services are not offered for sale to the masses. For example, the Price Control Act keeps a check on



the prices of necessities such as staple foodstuff. The Food & Drug Ordinance is important in enforcing high quality standards in the production and distribution of food items and medicines. The Weights & Measures Act is responsible for removing any discrepancies regarding the information printed on the package and the actual contents inside. Departments such as the Advertising Standards Authority can play a significant role in improving the quality of advertising and making it more useful for the consumers. There are many other steps taken by the government authorities also in addition to the ones mentioned above with the objective of protecting the rights of consumers.

**Labour Protection:**

It is the responsibility of the government to look into the problems and issues relating to the workforce. In this context, various laws have been passed to ensure that the workers are not exploited by the business owners. The Minimum Wage Rate is considered to be the most important in this regard since it makes the employers legally bound to pay a certain minimum amount to the employees in return for their services. Moreover, there are labour laws pertaining to the working conditions, working hours, safety, discriminatory behaviour of the employers, fringe benefits etc. All the labour laws aim at ensuring the well being of the work force and increasing their productivity also.

**Economic systems:**

The term represents the rules, regulations and practices that govern and mould the economy of a country. It is categorised into:

**Planned economy:**

A planned or command economy is characterised by maximum possible authority and control exercised by the government. This system is typical of countries with a communist set up as in the case of former USSR. The government dictates its terms to the producers as well as the consumers regarding decisions pertaining to quantity, quality, consumption etc. The advocates of planned economy claim that the gap between the rich and the poor can be narrowed down if this system is implemented properly. Resources and wealth will be evenly distributed and producers not permitted to exploit the consumers in their pursuit for profit. However, the command economic system failed, as shown by the disintegration of USSR, since the rulers seemed to be its only beneficiaries. There are serious drawbacks such as a lack of variety, innovation and competition which are essential ingredients in the recipe for success.

**Free market economy:**

In this hypothetical system, the private sector enjoys the maximum possible freedom to take decisions regarding all aspects of business. The consumers are also in a position to make purchases at will without being subjected to any kind of rationing laws. There is high degree of competition leading to the production and distribution of a variety of goods and services. Prices are also adjusted in accordance with the principle of demand and supply. There is a definite improvement in quality and innovation but since the profit motive is the ultimate, producers sometimes tend to compromise the well being of the masses. Low quality and over priced products may be offered for sale in order to satisfy the profit motive. The role of the government is minimised and there are no significant consumer protection Laws. That is why it is said that a free market economy nurtures capitalism which, simply put, is the accumulation of wealth in the hands of a few.

**Mixed economy:**

A mixed economy is a blend of planned and free market economic systems. This is undoubtedly the most popular, and arguably the ideal, economic system adopted in countries all over the world. The private sector is free to take its own decisions but the government authorities play a supervisory role. There is no unnecessary interference with the production, pricing or distribution decisions and the privately owned companies can adjust their policies in accordance with the ongoing trends and the purchasing pattern of customers. However, the government is actively involved in measures that regulate the economy. It enforces a variety of policies in connection with taxation, subsidies, consumer and labour protection laws etc. This system leads to the creation of a competitive market in which a variety of goods and services are available for sale. There is a consensus that a mixed economy is slightly more inclined towards a free market but it is worth mentioning that any business engaged in illegal, immoral or inappropriate activities is severely dealt with.



**International T:****Rade:**

The exchange of goods and services across international boundaries is technically termed as international trade. In simple terms, it is the import and export of goods and services. Resources are unevenly distributed and it is inevitable for a country to avoid participation in international trade. There is a set of rules and regulations that govern international trade, often known as the restrictions on international trade. The major restrictions or barriers are discussed below.

**Tariff:**

It is an import duty or tax levied on imported items. A tariff acts as a useful source of revenue for the government and also protects the domestic industry against foreign competitors. Tariff is categorised into "Ad Valorem" and "Specific" tariff. The former is calculated as a percentage of the monetary value of an imported item whereas the latter is determined in accordance with the weight or quantity.

**Quota:**

It is a physical limitation on the maximum amount of goods that could be imported or exported within a given period of time. An import quota creates demand in the country that can be met if the domestic industry raises the level of production and uses the available resources in a more effective manner. Similarly an export quota ensures that the domestic requirements are fulfilled before a product is exported.

**Foreign Exchange Control:**

In case the government feels that the country is passing through a severe economic crisis, it may impose a foreign exchange control. This restriction requires everyone in the country to surrender foreign currency to the government authorities and, in return, receive payment in local currency at a rate decided by the government. By doing so, the level of foreign reserves in the central bank can be raised and some financial stability can be brought back to the economy. However, it is important to note that this particular restriction is undesirable since it has a disincentive effect on the exporters.

**Embargo:**

This is the most severe form of restriction since it involves a complete ban on trading with another country. An embargo is usually imposed due to political reasons and is an effective means of showing displeasure towards the policies of a particular country. The American government has done this on numerous occasions with the objective of isolating countries such as Cuba or North Korea.

**Dumping:**

Sometimes, with the intention of capturing a foreign market, the government of a particular country may pursue a policy of offering its products for sale at an exceptionally low price in another country. This price is sometimes even below the cost price but is an effective tool for destroying the domestic industry of that country. The Chinese are known for this and they have applied these tactics quite successfully in industries such as textile and telecommunication.

**Subsidies:**

These are incentives offered to the business community, specially the domestic industry, in the shape of tax exemption, availability of cheap raw material etc. These subsidies prove to be an indirect restriction on the foreign competitors. The government, through a variety of incentives, provides the domestic industry with an opportunity to attract customers on the basis of lower prices.

**RELEVANT QUESTIONS FROM THE PAST PAPERS (SECTION 1)****Oct/Nov 2012, P1, Q4,**

- 4 (a) Define the term 'public limited company'. [2]  
 (b) Briefly explain **two** advantages a public limited company has compared to a private limited company. [3]

**Oct/Nov 2012, P2 (Biz Bank) a (i),**

- 1 (a) Explain the following terms:  
 (i) social enterprise (lines 5–6) [3]

**May/June 2010, Paper 1, Q3,**

- 3 Briefly explain **two** economies of scale that a hotel chain might achieve if it purchases another hotel company. [5]

**May/June 2010, Paper 1, Q6,**

- 6 Discuss how the objectives of stakeholder groups in a profitable business might be in conflict. [20]

**May/June 2010, Paper 2, Sheep Stew Q2 (a) (i),(ii), (c),**

- 2 (a) Explain the terms:  
 (i) shareholders (line 1) [3]  
 (ii) primary sector (line 2). [3]  
 (c) Analyse the advantages and disadvantages to BFC of changing to a public limited company. [8]

**May/June 2010, Paper 3, Teen Print, Q6.**

- 6 Evaluate the extent to which external economic change will be the major factor determining future profits of the TeenPrint company. Refer to Appendix D and other information in your answer. [20]

**Oct/Nov 2010, Paper 1, Q3,**

- 3 Explain the importance of the profit maximisation objective to a business. [5]

**Oct/Nov 2010, Paper 2, Big Boxes, Q1 (a)(i), (c), Newtown hospital, Q2 (a)(i)**

- 1 (a) Explain the following terms:  
 (i) interest rates (line 6) [3]  
 (c) Analyse the likely impact of external influences on the activities of BB. [8]  
 2 (a) Explain the following terms:  
 (i) public sector (line 1) [3]

**Oct/Nov 2010, Paper 3, Radar cosmetics, Q6, Q7.**

- 6 Discuss the extent to which the data in Appendix A and other external factors could influence the future success of Radar. [20]  
 7 Evaluate the extent to which Radar is fulfilling its responsibilities to stakeholders. [20]

**May/June 2011, Paper 2 Turbo Tractors, Q1(a)(i), McQuarry, Q2(a),(i),(ii),(d).**

- 1 (a) Explain the following terms:  
 (i) Economies of scale (line 2) [3]  
 2 (a) Explain the following terms:  
 (i) Secondary sector (line 9) [3]  
 (ii) Add value (line 28). [3]  
 (d) Evaluate the impact of the Crushblock project on **two** of MQ's stakeholders. [10]

**Oct/Nov 2011, Paper 12, Q4(a),(b), Q6,**

- 4 (a) Define the term 'objective' as used by a business. [2]  
 (b) Explain **two** objectives a small business might have in the first year of trading. [3]



- 6 Discuss how the ethical decisions of a large clothing retailer might help or hinder its business performance. [20]

**Oct/Nov 2011, Paper 22, Rex Cinema, Q2(d),**

- 2 (d) Discuss the extent to which Rex's overall objective is being achieved. [10]

**Oct/Nov 2011, Paper 32, Atlantic Steel company, Q2 (b), Q6.**

- 2 (b) Discuss the impact of ASC's privatisation on the company's stakeholders, using data in Table 1 and other relevant information. [16]
- 6 Evaluate the usefulness of long-term planning and corporate objectives to ASC, which operates in a constantly changing business environment. [20]

**May/June 2012, Paper 12, Q1, Q5,**

- 1 (a) Define the term 'economies of scale'. [2]
- (b) Briefly explain **two** economies of scale a retail business could achieve as it expands. [3]
- 5 (a) Explain the advantages of a 'co-operative' as a form of business. [8]
- (b) Discuss the factors that could influence the success of a small business. [12]

**May/June 2012, Paper 32 Global Conglomerate Company, Q1, Q2(b), Q7.**

- 1 Analyse the benefits to GCC of being a widely diversified conglomerate. (Lines 4–5.) [10]
- 2 (b) Assess whether the directors of GCC should substantially increase dividends to shareholders. [14]
- 7 Discuss the importance of corporate objectives and corporate planning to GCC's future success. [20]

**OCT/NOV 2009: PAPER 12, Q1 (b),**

- 1 (b) Briefly explain **two** objectives a small business might have, other than profit maximisation. [3]

**OCT/NOV 2009: PAPER 22, PEDRO'S FISH, (d),**

- 2 (d) If PF decide to use the boat for tourists, evaluate the impact the government might have on PF (apart from interest rates). [10]

**OCT/NOV 2009: PAPER 32, CHAN BEAUTY COMPANY (CBC), Q7.**

- 7 To what extent should it be a priority for this business to meet the needs of stakeholders other than shareholders? [20]

**MAY/JUNE 2009: PAPER 1, Q3,**

- 3 Explain **one** advantage and **one** disadvantage a multi-national company might bring to a developing country. [5]

**MAY/JUNE 2009: PAPER 3, CAR MANUFACTURER AT A CROSSROADS, Q1.**

- 1 Assume Eastern Motors has a factory in your country. Analyse the impact of any **two** legal controls on this factory's operations. [8]

**OCT/NOV 2008: PAPER 1, Q4.**

- 4 (a) State **two** ways of measuring the size of a business. [2]
- (b) Briefly explain why growth may not be the most important objective for a business. [3]

**OCT/NOV 2008: PAPER 2, PAPER CLIPS, a(i), CC COSMETICS, (d).**

- 1 (a) Explain the terms:
- (i) Stakeholders (line 7), [3]
- 2 (d) Discuss the implications for CC of its ethical approach to business activities. [10]

**OCT/NOV 2008: PAPER 3, TANROH'S DILEMMA, Q6, Q7.**

- 6 Discuss whether the government should support and protect important industries in your country. [20]

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- 7 To what extent will the future success of Tanroh's business depend on him setting clear objectives? [20]

**MAY/JUNE 2008: PAPER 1, Q1, Q3, Q5.**

- 1 (a) State **two** objectives a business might set in the short run. [2]  
 (b) Briefly explain the importance to a business of setting objectives. [3]

**MAY/JUNE 2008: PAPER 2, GANMOR CARS, (a),(i),(ii),(b).**

- 2 (a) Explain the terms:  
 (i) multinational (line 9) [3]  
 (ii) economies of scale (line 22). [3]  
 (b) Analyse how the Government might influence the activities of GC. [8]

**MAY/JUNE 2008: PAPER 3, PYRAMID TELEVISIONS(PT) Q6.**

- 6 Would you recommend PT to take over the TV4U chain of shops? Evaluate the advantages and disadvantages of this takeover and justify your recommendation. [20]

**OCT/NOV 2007: PAPER 1, Q3, Q5, (a), (b),**

- 3 Briefly explain the importance of economies of scale to a manufacturer of cars. [5]  
 5 (a) Analyse the benefits which a private limited company might gain by becoming a public limited company. [8]  
 (b) Discuss how different stakeholder groups might view the decision to change from private limited company to a public limited company. [12]

**OCT/NOV 2007: PAPER 2, ZETA OIL, (i), (c), (d).**

- 1 (a) Explain the following terms:  
 (i) Stock Exchange (line 11) [3]  
 (c) Analyse the main uses of ZO's accounts for stakeholders other than ZO's workers. [8]  
 (d) Discuss how the Government might affect the activities of ZO. [10]

**MAY/JUNE 2007: PAPER 1, Q1.**

- 1 (a) Explain one objective of a public sector organisation in your country. [2]  
 (b) Briefly outline the main features of a 'public limited company'. [3]

**MAY/JUNE 2007: PAPER 2, TECH NEW, a, BEE'S MEALS, a (ii).**

- 1 (a) Explain the terms:  
 (i) private limited company (line 1) [3]  
 (ii) multinational (line 3). [3]  
 2 (a) Explain the following terms:  
 (ii) payback. (line 13) [3]

**MAY/JUNE 2007: PAPER 3, CRAFT DESIGNS, Q3.**

- 3 Evaluate the likely impact on the business of the forecast economic conditions in Appendix A. [14]

**OCT/NOV 2006: PAPER 2, HILLTOP SERVICES, a (i),**

- 1 (a) Explain the following terms:  
 (i) sole trader (line 2) [3]

**OCT/NOV 2006: PAPER 3, LOCOST AIRWAYS, Q3, Q7.**

- 3 The different stakeholder groups of LoCost Airways will be affected in very different ways if the firm is sold to UWA. Discuss whether it is in the best interests of LoCost Airways' stakeholders for UWA to take over the business. (You might find data in Appendix B helpful). [16]  
 7 Discuss the advantages and disadvantages to companies, such as UWA, of a strategy of continuous growth through integration with other businesses. [20]



**MAY/JUNE 2006: PAPER 1, Q1, Q3, Q7(a),**

- 1 (a) Outline **one** difference between the public sector and private sector of an economy. [2]
- (b) Explain **one** difference between private and public limited companies. [3]
- 3 Explain the importance of profit maximisation for a public limited company. [5]
- 7 (a) Analyse the benefits to your country's economy from a multinational manufacturer of computers locating a new factory there. [8]

**MAY/JUNE 2006: PAPER 2, STAR PHARMACEUTICALS, (c), HOME FARM, a(ii), (b),**

- 1 (c) Discuss the extent to which ethical issues should concern SP. [8]
- 2 (a) Explain the following terms:  
(ii) export market (line 3) [3]
- (b) Explain how an increase in the country's exchange rates could affect the farm's profits. [4]

**MAY/JUNE 2006: PAPER 3, RAVE CONFECTIONERY, Q7.**

- 7 To what extent would you advise businesses such as Rave to consider the interests of all stakeholder groups when taking major decisions? [20]

**OCT/NOV 2005: PAPER 1, Q1 (a), Q2, Q3, Q7.**

- 1 (a) State **two** reasons why the market for a product might reduce in size. [2]
- 2 Explain how a manufacturing business might be affected by ethical issues. [5]
- 3 (a) State **two** ways in which a business may achieve added value. [2]
- (b) Why is added value important for businesses? [3]
- 7 (a) Explain the advantages and disadvantages of being a small business in food retailing. [8]
- (b) Discuss whether the government should support small businesses in your country. [12]

**OCT/NOV 2005: PAPER 2, SUN HOTEL, (d),**

- 2 (d) Outline briefly how a rise in the country's exchange rates might affect the Sun Hotel. [4]

**OCT/NOV 2005: PAPER 3, MERCADO PLC, Q6.**

- 6 Discuss whether Mercado should continue to manufacture products from the factory that pollutes the local environment. [20]

**MAY/JUNE 2005: PAPER 1, Q6,**

- 6 Discuss how businesses in your country might be influenced by government intervention. [20]

**MAY/JUNE 2005: PAPER 3, WOTTON COLLEGE, Q3, Q7.**

- 3 Discuss the possible advantages and disadvantages to Wotton College of taking over Midvale School. [16]
- 7 To what extent should a business such as Wotton College take the interests of stakeholders into account when making decisions? [20]

**OCT/NOV 2004: PAPER1, Q1, Q3 (a),**

- 1 (a) Define the term 'free market economy'. [2]
- 3 (b) State **three** legal controls which affect the way in which businesses operate. [3]
- (a) State **two** different ways in which the size of a business might be measured. [2]

**OCT/NOV 2004: PAPER 2, BALJIR THE BUILDERS, (c), (d).**

- 1 (c) Discuss the likely objectives of the stakeholders in 'Baljir's business. [8]
- (d) Examine the problems that Baljir might experience from expanding the business. [10]

**MAY/JUNE 2004: PAPER 1, Q1, Q6.**

- 1 (a) Define the term 'sole trader'. [2]
- (b) Explain **one** disadvantage of being a sole trader. [3]

- 8 Discuss how a government's macro-economic policies might affect the ability of businesses to achieve their objectives. [20]

**MAY/JUNE 2004: PAPER 2, CANDY SHOWS LTD, a (i), (ii), (d), LASTING MEMORIES, (b), (d).**

- 1 (a) Explain the following terms:  
 (i) economies of scale (line 10) [3]  
 (ii) multinational (line 12). [3]  
 (d) Examine whether Candy Shows Ltd. should become a public limited company if the management decides to arrange much larger events. [8]
- 2 (b) Suggest why the Government supported Lasting Memories. [6]  
 (d) Examine the marketing difficulties that Ahmed and Beatrice might have if they expand into export markets. [10]

**MAY/JUNE 2004: PAPER 3, DECISION TIME AT TOPAZ, c (i), (e).**

- 1 (c) Assume that the directors decide to export "Robot Warrior" and "Gita Doll" to your country.  
 (i) Outline **two** problems that Topaz might experience. [4]  
 (e) Do you think that Topaz should introduce Management by Objectives? Justify your answer. [8]

**OCT/NOV 2003: PAPER 1, Q1, Q4, Q5(a), Q6(b).**

- 1 (a) Distinguish between the public sector and private sector of an economy. [2]  
 (b) Explain why some goods and services are provided by the public sector in your country. [3]
- 3 (a) Distinguish between the mean and the median of a set of data. [2]  
 (b) Explain one business situation where the mode would be a useful measure. [3]
- 5 (a) Analyse the benefits to your country's economy of a multinational manufacturer of consumer goods locating a factory there. [8]
- 6 (b) Discuss why the owners of a private limited company might wish to convert it into a public limited company. [12]

**OCT/NOV 2003: PAPER 2, ROUND PLC, a (i), (ii), (d).**

- 1 (a) Define the following terms:  
 (i) plc (public limited company) (line 1) [3]  
 (ii) market share (line 2) [3]  
 (d) Evaluate the impact of new technology on any **two** stakeholder groups of Round plc. [10]

**MAY/JUNE 2003: PAPER 1, Q1.**

- 1 (a) Distinguish between secondary and tertiary levels of activity. [2]  
 (b) Outline the benefits to a country of successful businesses. [3]

**MAY/JUNE 2003: PAPER 2, THE FURNITURE MAKER, (a), (b), (c).**

- 1 (a) Define the following terms:  
 (i) economies of scale (line 2) [3]  
 (ii) fiscal policy (line 7). [3]  
 (b) Explain **two** possible reasons why the government has encouraged foreign businesses to locate in its country. [4]  
 (c) Analyse the factors that the multi-national business might have considered when deciding to locate near to The Furniture Maker. [8]

**MAY/JUNE 2003: PAPER 3, FAST FOOD FRANCHISE, a(i),(ii).**

- 1 (a) (i) Analyse the advantages and disadvantages to Rashid and Shivani of their decision to take out a franchise. [8]  
 (ii) Discuss the likely impact of economic constraints on the future success of this business. [8]



**OCT/NOV 2002 PAPER 1, Q1, Q3, Q5 (a), Q7 (a).**

- 1 (a) State two different methods of measuring the size of a business. [2]  
1 (b) Briefly explain why it might be difficult to compare the size of different businesses. [3]  
3 Outline how, in your country, legal constraints might limit business activity. [5]  
5 (a) Analyse the advantages and disadvantages for a private limited company of converting to a public limited company (plc). [10]

**OCT/NOV 2002 PAPER 2, TRAVELSTOP HOTEL, a (ii), (d).**

- 1 (a) Define the following terms:  
(ii) Interest rates (line 23) [3]  
(d) Evaluate the impact on the Travelstop Hotel of a rise in interest rates. [10]

**MAY/JUNE 2002: PAPER 1, Q1, Q5,**

- 1 (a) Distinguish between private and public limited companies. [2]  
(b) Explain the significance for companies of limited liability. [3]  
5 Discuss how government policies may affect business decision making in your country. [20]

**MAY/JUNE 2002: PAPER 2, THE EATING SHOP, (d).**

- 1 (d) Discuss the relative advantages and disadvantages of businesses such as The Eating Shop continuing to grow in size. [10]

**MAY/JUNE 2002: PAPER 3, SPORTSWIZE LIMITED, (e).**

- 1 (e) Evaluate the impact on Sportswize Ltd. of the predicted changes in Government economic policy (lines 10–13). [10]

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## UNIT 2

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# People In Organizations

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A Level  
Business  
Teacher's Notes

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## Syllabus 2016 –18

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## UNIT 2 PEOPLE IN ORGANIZATIONS

### 2.1 MANAGEMENT AND LEADERSHIP

#### Management and managers

#### Functions of management

Henri Fayol listed the following functions or elements of management:

##### Planning:

This involves setting objectives and also the strategies, policies, programmes and procedures for achieving them. Planning is primarily the job of line managers who might act upon the advice of specialist staff managers. For instance, the production manager carries out human resource planning in the production department using the skills of the personnel manager.

##### Organizing:

Managers set tasks which need to be performed if the business is to achieve its objectives. Jobs need to be organized within sections or departments and authority to be delegated so that jobs are carried out. For example, the goal of a manufacturing company may be to produce and deliver quality goods. The tasks, such as manufacturing and packaging need to be organised to achieve this goal.

##### Commanding:

Managers have to give instructions to subordinates to carry out tasks. He has the authority to make decisions and the responsibility to see tasks are carried out.

##### Coordinating:

Coordination is the bringing together of the activities of people within the business. Individuals and groups will have their own goals, which may be different to those of the business and each other. Management must make an effort to develop a common approach, so that the company's goals are achieved.

##### Controlling:

Managers measure and correct the activities of individuals and groups, to make sure that their performance fits in with plans.

#### Mintzberg's roles of management:

Henry Mintzberg identified the following three roles that must be played by a manager.

##### Interpersonal roles:

These arise from the manager's formal authority. Managers have a figurehead role. For example, a chief executive represents the company at dinners and conferences. Then, they have to play the role of a leader also. A manager is responsible for hiring, firing, training and motivating employees. They have a liaison role as well. Managers spend a lot of time meeting with other managers in order to know what is happening in other departments. Senior managers spend a great deal of time interacting with people outside the business also. By doing all this, a manager gets in a position to extend his influence both within and outside the business.

##### Information roles:

Managers are well connected within the organisation and act as channels of information to be carried from one department to another.

##### Decision making roles:

The manager's formal authority and access to information means that there is no one else in a better position to take decisions about matters relating to a particular department.

### **Types of managers/authority:**

#### **Line managers:**

Line managers are those who have authority over others in a hierarchical structure. For example, the sales director will have line authority over the sales managers. Line managers have responsibility for achieving specific business objectives that pertain to their own department only.

#### **Staff managers:**

They are specialists who are employed to give advice to senior line managers. They might be economists, specialist market researchers or scientific experts advising on the environmental impact of certain products or processes. It is important to note that staff managers act in an advisory capacity only and have no authority to make decisions in the other department.

#### **Functional managers:**

Functional authority is when a specialist has the authority to make a line manager accept his or her advice. For instance, the finance manager can guide other departmental heads regarding budget related issues and his advice will be binding upon them.

### **Leadership**

Leadership is the art or process of influencing people so that they perform assigned tasks willingly and in an efficient and effective manner. Leadership is, therefore, crucial in motivating and inspiring the workforce. It is useful to distinguish between managers and leaders. Managers have positional or legitimate power as a result of an appointment to a particular position. Leaders may be appointed or may emerge. Managers act as functionaries whereas leaders are innovators. Moreover, managers accept responsibility but leaders are known for seeking it.

### **Leadership roles in business (directors, managers, supervisors, worker representatives)**

#### **Directors:**

These senior managers are elected by shareholders in a limited company. They are usually head of a major functional department, such as marketing. They will be responsible for delegating within their department, assisting in the recruitment of senior staff in the department, meeting the objectives for the department set by the board of Directors and communicating these to their department.

#### **Managers:**

Manager is an individual responsible for people, resources or decision making. They will have some authority over other staff below them in the hierarchy. They will lead, motivate and, if necessary, discipline the staff in their section or department.

#### **Supervisor:**

These are appointed by the management to watch over the work of others. This is usually not a decision-making role, but they will have responsibility for leading a team of people in working towards pre-set goals. The modern role of these members of staff is less of an inspector and much more of a work colleague who is appointed to help staff achieve objectives in a cooperative spirit.

#### **Workers' representative:**

They are elected by the workers, either as trade union officials or as representatives or works councils, in order to discuss areas of common concern with managers.

### **Qualities of a good leader:**

Early studies of leadership attempted to identify traits common to leaders. Some studies concentrated on physical traits (energy, appearance etc.), while others gave importance to intelligence or personality (self confidence, enthusiasm) or social characteristics (inter personal skills). In the words of Gary Yukl, successful leaders are adaptable to situations, alert to social environment, ambitious and achievement oriented, assertive, cooperative, decisive, dependable, dominant, energetic, persistent, self confident, tolerant of stress and willing to assume responsibility. Similarly, there are writers who believe that



intelligence, creativity, tact and diplomacy, communication skills knowledge, persuasiveness, social skills, self discipline and organising ability are the characteristics that make a good leader.

## Choice of leadership style

### Leadership styles: Autocratic, democratic, laissez faire:

Henri Fayol, a renowned social scientist, was of the opinion that a typical manager should be capable of performing the functions of planning, organising, coordinating, commanding and controlling. These characteristics are responsible for maintaining high efficiency level within an organisation. Managers adopt a variety of measures in order to enforce company's policies effectively. In this context, the following leadership styles are commonly used by managers in order to motivate the workforce and make them achieve the optimum results for the organisation.

#### AUTOCRATIC:

It is a leadership style in which the manager takes his own decisions and does not believe in consulting his subordinates and colleagues. An autocratic leader works like a dictator and expects all his orders and instructions to be followed by the workforce. An autocratic leader establishes a centralized structure of management in the company and hardly ever delegates his powers to others. In such a structure the decision making powers are concentrated in the hands of an individual or a very small group of people who are closely related.

The supporters of this style of leadership advocate their view point by saying that this technique ensures timely decision making and a high level of confidentiality. Moreover, the chance of fraud being committed can be reduced since the manager does not rely on others. This leadership style is recommended in a situation where the workforce is small and/or inexperienced.

A significant drawback of autocratic leadership is that it demotivates the workforce leading to a decline in the level of confidence and job satisfaction. Moreover an autocratic leader might make mistakes due to excessive work load. This style of leadership also suffers from a lack of specialization and innovation and may prove to be ineffective in case of growing businesses.

#### DEMOCRATIC:

Democratic style of leadership is decentralized in nature and a democratic manager makes every possible attempt to involve his subordinates in the decision making process. He encourages the employees of the company to come up with new ideas that can be implemented in various departments of the company. Democratic leadership always leads to specialization and an improvement in the motivation level of the employees. In well known companies like 'Toyota', democratic leadership style is followed and the employees are financially as well as non-financially rewarded for generating new ideas. It results in the creation of a committed workforce and the image of the company is enhanced. Delegation of powers allows the senior management to share the workload with others. However, this approach may cause an unnecessary delay in decision making and there is always a possibility of sensitive information being leaked. Moreover, democratic leadership might not produce the desired results if the subordinates are unskilled or undependable.

#### Free rein or laissez faire:

It is an extension of democratic leadership, allowing the employees to exercise maximum possible control over their method of working with hardly any interference from the management. It may result in the possible misuse of authority delegated to the workforce, eventually leading to deterioration in the overall performance of the company. However, if the employees have the required skills, integrity and experience, a free-rein style of leadership can make them more responsible and committed and the high level of motivation can help them produce the desired results.

#### Bureaucratic leadership:

It is a type of leadership in which the manager believes in following and enforcing the rules and regulations of the company strictly. He goes by the book and is highly inflexible. He suffers from the drawback of not being able to adjust his policies according to the changing market conditions, thereby

demoralising the subordinates. The positive side, however, is that a bureaucratic leader seldom makes a technical mistake since he never violates the specified procedures.

## Emotional intelligence (EQ)

Daniel Goleman defines emotional intelligence as the capacity for recognising one's own emotions and those of others. Recent studies of successful managers have found that effective leaders consistently have a high level of emotional intelligence.

There are five components or competencies of EI or EQ namely self awareness, self regulation, motivation, empathy and social skills.

### Self-awareness:

Self-awareness involves having a deep understanding of one's emotions, strengths, weaknesses and drives. People with strong self awareness are neither overly critical nor unrealistically optimistic. They assess themselves as well as the organisation honestly.

### Self-regulation:

Self-regulation frees us from getting too much influenced by our feelings. Self-regulated people find ways to control their emotions and even channel them in useful ways. People who are in control of their feelings and impulses are able to create an environment of trust and fairness. Once they have mastered their emotions, they are in a better position to bring about and implement change in an organisation.

### Motivation:

People with leadership potential are often driven by a strong sense of achievement. Instead of being focused on external factors such as money only, they seek out creative challenges, have a love for learning, and take pride in a job well done. Also, motivated people have a high level of energy to do things better as well as a restlessness with the status quo. They are eager to explore new approaches to their work.

### Empathy:

Empathy means thoughtfully considering an employee's feelings, along with other factors, in the process of making intelligent decisions. It enables managers to sense and understand the viewpoints of everyone around the table. Empathy plays a key role in retaining talent. Human capital is particularly important in today's competitive world because it can give a decisive edge to a firm over its rivals in the industry.

### Social skill:

This component is concerned with a person's ability to manage relationships with others. Social skill may be viewed as friendliness with a purpose, i.e., moving people in the direction you desire, whether that's agreement on a new marketing strategy or enthusiasm about a new product. Socially skilled people tend to have a wide circle of acquaintances and know how to build a rapport with associates.

## 2.2 MOTIVATION

### Motivation as a tool of management and leadership

#### The need to motivate employees to achieve the objectives of a business:

Motivation is the driving force that enables a worker to perform at his best level. A business should have a well motivated workforce if it wishes to achieve its objectives such as raising productivity, minimising wastage, enhancing efficiency, maximising profit, enhancing the company's image etc...

### Human needs/motivation theories

A number of social scientists have expressed their views regarding the importance of having a motivated workforce. The following theories highlight this aspect of business effectively.



### Abraham maslow's "hierarchy of needs":

Maslow came up with a motivational theory which requires that the following needs of the workers must be fulfilled by the management to ensure that the employees produce optimum results.

#### **Physiological needs:**

These are the basic human needs that must be taken care of in order to provide the workers with an environment in which they can maintain a high performance level. Physiological needs include food, shelter and clothing. It is the responsibility of the management to arrange these facilities for all the members of the workforce.

#### **Security or safety needs:**

It is the right of every employee to enjoy a sense of job security; his job has to be governed by a set of rules and regulations specified in a preferably long-term written contract that are binding on both the parties. This contract safeguards the rights of the workforce, as well as the management. For example, the employee cannot quit without serving the employer with a notice beforehand and the employer is also required to abide by this law in case he decides to lay off the worker. The management should also ensure that the workforce is not operating in an unsafe environment and all the necessary safety equipment including masks, gloves and goggles must be provided.

#### **Belonging needs:**

It is advisable for the firm to develop a sense of belonging amongst the members of the workforce. They should make the employees feel that they are an integral part of the organisation and their contribution towards its growth and success is deeply valued by the owners.

#### **Esteem needs:**

The workforce can be easily motivated if the management recognises their good performance and keeps encouraging them. This appreciation could be in the form of financial (e.g., bonuses) or non financial (e.g. more authority) rewards. This approach can certainly go a long way in persuading the employees to improve their performance even further.

#### **Self-actualisation:**

The significance of self-actualisation is highlighted by the fact that numerous social scientists have expressed their views in this context. It is based on the philosophy that an employee can be motivated if he is allowed to control his way of working. By letting the workers perform their jobs independently, and reducing the level of interference, the superiors can pose their confidence in the abilities of the subordinates. Self-actualisation inculcates a sense of responsibility and achievement in the workers and proves to be useful in motivating them and enhancing their overall performance.

### **Fredrick Taylor's "SCIENTIFIC MANAGEMENT THEORY"**

Taylor focused his attention on the concept of "the economic man". He was of the opinion that the ultimate motivating factor for an employee is the monetary return that he receives for his effort. Taylor's scientific principles were designed also to reduce inefficiency of workers and managers and keep a check on wasteful work practices. The following commonly offered financial rewards can serve the purpose of useful motivational tools.

#### **a) Piece rates:**

This is a payment scheme in which an employee is paid strictly in accordance with the level of output or sales. This is normally applicable in case of industries representing the secondary sector of production, e.g., manufacturing of footballs. This approach encourages the worker to take his job and performance seriously for better monetary rewards. However this system may lead to deterioration in quality because the worker may overlook the qualitative factors and decide to focus his attention on the quantity only.

#### **b) Time rates:**

The employees under this system are paid on the basis of the working hours they spend at the work place. It may prove to be a motivating factor, particularly in case of companies that need to meet deadlines. However, supervision is required in order to avoid wastage of time.

**c) Fee:**

This is an amount offered to specialists in return for rendering services in a particular field. Fee is typical of the tertiary sector, often observed in professions that offer non-standardized services such as architecture, law and medicine.

**d) Commission:**

Commission is the percentage of the monetary value of goods being produced or sold by an individual. It is applicable to large as well as small scale business and is enforced with the help of employees who perform their function signing a temporary employment contract with the management. It is useful in encouraging the workers to strive for a specific goal. However the commission agents may be responsible for damaging the image of the company if they over-commit to the customers in an effort to sell the product.

**e) Salary:**

This is the annual sum which is usually paid on a monthly basis. It is a fixed rate which is not based on the number of hours or unit produced. The fixing of the salary level for each job is very important because it helps to determine the status of the post.

**f) Performance related pay:**

This is a scheme to reward staff for above-average work performance. It is used for workers whose output is not measureable in quantitative terms such as management, supervisory and clerical posts.

**g) Bonus:**

Bonus is the amount paid to the worker if the company has earned an additional amount of profit in the year or month. It may also be offered if the employee manages to accomplish a particular task.

**McGregor's theory "X and Y":**

McGregor coined the terms of Theory X and Theory Y in order to describe and differentiate between the factors that motivate workers for performing their respective tasks efficiently. Theory X assumes that people are lazy by nature and that is why strict control or a threat of punishment is required for ensuring that targets are achieved and rules not broken. For example, if a worker knows that he will not be getting his yearly increment if he is unsuccessful in achieving the targets set by the superiors, he will most probably start making an effort to improve upon his performance.

On the other hand "Theory Y" is based on the assumption that people are generally responsible and committed, and enjoy having control over work. Therefore, if rewards such as job enrichment or more authority are offered to them, it may prove to be an effective motivating tool.

**Fredrick Herzberg's two-factor or hygiene theory:**

On the basis of his interaction with a group of professional engineers and accountants, Herzberg was able to identify the factors that cause satisfaction or dissatisfaction amongst the members of the workforce. He divided these elements into the following two categories.

**Motivators:**

These are the factors which give workers job satisfaction, such as recognition for their effort. Increasing these motivators is needed to give job satisfaction. This, it can be argued, will make workers more productive. A business that rewards its workers for, say, achieving a target is likely to motivate them to be more productive. However, this is not guaranteed, as other factors can also affect productivity.

**Hygiene factors:**

These are the factors that can lead to workers being dissatisfied, such as low pay or unfavourable working conditions. Improving hygiene factors should remove dissatisfaction. For example, better canteen facilities may make workers less dissatisfied about their environment. An improvement in hygiene factors alone is not likely to motivate an individual. But, if they are not met, there could be a fall in productivity.



**Elton Mayo's "HAWTHORNE EFFECT":**

Mayo carried out a series of experiments at the Hawthorne factory in Chicago to monitor the behaviour of the workforce in different working conditions. He observed numerous groups of workers as they performed their respective duties under varying working conditions, involving lighting, heating, rest periods, etc. This experimentation continued for five years, at the end of which, Mayo concluded that the performance of the workers improved every time the physical conditions of the workplace changed, improved or worsened. He explained that the employees behaved in this particular manner because their superiors were successful in convincing them of their good intentions and the significance of these changes. They made them believe that the management of the company is greatly concerned about their betterment and this factor played a key role in motivating the employees.

Mayo also attaches a lot of importance to team-work and team spirit and firmly believes in providing the workforce with an opportunity to perform in a unified manner. The Swedish car manufacturer, Volvo, has applied Hawthorne effect very successfully to their production process in which a group of 10 individuals is made responsible for manufacturing a Volvo truck or car in a given period of time. The management of Volvo claims that the productivity level has risen considerably as a result of this.

**Vroom's Expectancy Theory:**

This theory holds that people will be motivated to do things to reach a goal if they believe in the worth of that goal and if they can see what they do, will help them achieve it. In other words, Victor Vroom believed that an individual's motivation towards doing anything will be determined by the value he places on the outcome of his effort, multiplied by the confidence he has that his effort will materially aid in achieving a goal. This may be described as:

$$\text{Force} = \text{Valence} \times \text{Expectancy}$$

where, Force is the strength of a person's motivation, Valence is the strength of an individual's preference for an outcome, and Expectancy is the probability that a particular action will lead to a desired outcome. Obviously, the force exerted to do something will depend on both valence and expectancy. A decrease in either of these variables should result in a reduction in the motivation level of the individual.

**McClelland's Needs Theory:**

David McClelland has contributed to the understanding of motivation by identifying three types of basic motivating needs. These are:

**Need for power:**

McClelland suggests that people with a high need for power have a great concern with exercising influence and control. Such individuals generally are seeking positions of leadership. They are frequently good conversationalists, though often argumentative; they are usually forceful, outspoken and demanding and enjoy teaching and public speaking.

**Need for affiliation:**

People with a high need for affiliation derive pleasure from being loved and tend to avoid the pain of being rejected by a social group. As individuals, they are likely to be concerned with maintaining pleasant social relationships, to enjoy a sense of intimacy and understanding, to be ready to console and help others in trouble, and to enjoy friendly interaction with others.

**Need for achievement:**

People with a high need for achievement have an intense desire for success and an equally intense fear of failure. They want to be challenged, and they set moderately difficult goals for themselves. They take a realistic approach to risk and prefer to analyse and assess problems, assume personal responsibility for getting a job done, and like specific and prompt feedback on how they are doing. They tend to be restless, like to work long hours and would rather run their own show. The above mentioned three drives must be recognised by the management, in the opinion of McClelland, in order to raise the motivation level of the workers.

## Motivation methods in practice, financial motivators, non-financial motivators

### Non-financial motivators:

The term represents all non-monetary forms of rewards that may be offered to workers for motivating them. It is now widely recognized that money alone will not create the eagerness to complete jobs efficiently that all businesses are looking for in employees. The range of non-financial motivators is very extensive and the most widely adopted ones are:

#### Fringe benefits (Perks):

These non-monetary incentives are used by businesses in addition to normal payment systems in order to give status to higher-level employees and to recruit and retain the best staff. Perks or fringe benefits generally include company cars, free insurance, pension schemes, discounted company products and interest-free loans.

#### Job rotation:

It is a commonly followed practice these days, in which an employee is moved or rotated from one department to another after regular intervals. For example, the finance Manager is temporarily shifted to the marketing or production department. Job rotation is extremely useful in raising the level of job satisfaction for a worker and plays a key role in career growth as well. He is provided with an opportunity to learn new skills and have an idea about the overall working of an organisation.

#### Job enlargement:

This term refers to any attempt to increase the scope of a job by broadening or deepening the tasks undertaken. The employee is supposed to carry out more work of similar nature and enjoys a sense of achievement and job satisfaction. For instance, an employee responsible for manufacturing a single component previously is moved to a section where the whole machinery is being assembled.

#### Job enrichment:

This non-financial reward allows an employee to work with greater independence and hold a more authoritative position in the company. He is encouraged to use his full abilities with less interference from the superiors. Such an arrangement is very helpful in making an employee more responsible and confident, and also enhances his overall motivation level. It must be noted that the strategies of job rotation, enlargement and enrichment combined form a concept known as **job redesigning**.

#### Team work:

It is an established fact that workers perform their duties more effectively if they were given a chance to operate in form of groups or teams. They can work as a cohesive unit and pursue mutual goals successfully. Moreover, this practice makes work enjoyable and less monotonous.

#### Empowerment:

This method involves passing down the authority to perform tasks to workers. Empowerment goes further, by allowing workers some degree of control over how the task should be undertaken. This is also termed as delegation of powers (discussed in detail under organisational structure).

Participation:-This method is influenced by the Japanese technique termed as "quality circles", (discussed in detail in Section 4.)

#### Training:

Training involves employees being taught new skills or improving skills they already have. It is essential to have a well trained workforce due to the following factors:

- It enhances the image of the company because the employees are considered to be the true representatives of a business organisation.
- A trained workforce helps in reducing the chances of accidents which may occur due to the negligence of untrained workers.



- A trained worker performs the given task in a cost-effective manner, minimising wastage.
- A trained workforce results in a low labour turnover, since there is a higher degree of job satisfaction. Chances of problems arising due to an induction crisis are also reduced.

### **Induction training:**

Induction involves training newly appointed employees at the work place. This is carried out in order to avoid an "induction crisis". This term refers to a situation in which a recently appointed employee finds it difficult to get adjusted in the new working environment. As a result, he may decide to quit his job after a short period of time. The concerned business organisation would like to avoid this situation by conducting an induction training program so that the employees are able to settle down quickly.

Training methods can be classified into "on-the-job" training and "off-the-job" training. On-the-job refers to a system in which an employee is guided and trained while performing his duties at the workplace. Off-the-job training requires the employee to be sent away from the workplace to a training institute or a workshop. On-the job training can be further categorized into:

- a) Job rotation:
- b) Job enlargement:
- c) Job enrichment:

The above mentioned three methods have already been discussed.

#### **d) Pairing:**

In this method a newly appointed employee is paired with an experienced worker who is responsible for guiding him through various procedures, rules and regulations to be followed in a department or business organisation.

#### **e) Internship/apprenticeship:**

It is a temporary arrangement in which an individual is allowed to work with a business for a specific period of time and acquires useful skills relating to a particular department or overall functioning of the firm. In case of a satisfactory performance, the apprentice may be offered a permanent job upon completion of the internship period, if there is a vacancy in the firm.

## **2.3 HUMAN RESOURCE MANAGEMENT (HRM)**

### **Purpose and roles of HRM**

**The role of HRM in meeting business objectives: recruitment, selection, training, induction, advice, guidance, workforce planning**

Human resource management is a management function that deals with various aspects of staff performance. Many businesses today have a personnel department. It manages the firm's human resources and ensures their optimum use to the mutual benefit of the enterprise, each member of the organisation and the community at large. It is responsible for improving relations between the employees and the employers. This department deals with various issues related to the workforce of a business in order to enhance efficiency and minimise wastage. These issues include training, motivation, recruitment and selection, workforce planning, guidance, advice etc...

#### **Recruitment:**

Recruitment is the process in which a large number of candidates apply for a job and the most suitable one is selected.

#### **Workforce planning:**

It is the establishment of the workforce requirements of the business for the foreseeable future in quantitative and qualitative terms, or in other words, the decisions regarding number and skills of employees required.

**Training:**  
(discussed under non-financial motivators)

**Induction:**  
(discussed under non-financial motivators)

## Recruitment and selection

**Labour turnover, methods of recruitment and selection**

**Labour turnover** is the number of employees who leave a business over a period of time, usually one year.

**Labour turnover rate =**

$$\frac{\text{Number of Workers leaving in 1 year}}{\text{Average Number of Workers}} \times 100$$

**Methods of recruitment and selection:**

Broadly speaking, recruitment can be classified into:

### a) Internal recruitment

This is a practice which allows the management of a company to choose an employee from within the organisation. Such an individual is already employed in the firm but is moved or promoted to a new position.

**Advantages:**

- It is not a time-consuming process and proves to be a cost-effective technique for the company.
- Chances of an induction crisis arising can be minimised since the newly appointed employee is already familiar with the corporate culture of the organisation.
- The management is aware of the strengths and weaknesses of the employee and can treat him accordingly.
- Internal recruitment can be used as an incentive to motivate the existing workforce so that can avail the opportunity of getting promoted as a reward for high performance

**External recruitment:**

It is a procedure followed by the management in which external candidates are allowed to apply for particular vacancies. They are judged on the basis of their performance in specially designed tests/interview and the most appropriate one is offered the job.

**Advantages:**

- There is a possibility that the external candidates are better qualified and more experienced as compared to the limited number of employees available internally.
- External recruitment can be used as an effective promotional tool for the company also. That is why the management makes an attempt to highlight salient features of the organisation in the advertisement with reference to a job vacancy.
- It can be applied as a useful way of pushing the employees who are already working for the company to work harder so that they are not replaced by a better qualified external candidate.

**Types of external recruitment:**

**Commercial employment agencies:**

These are the organisations that maintain a database comprising of all relevant information on individuals who are looking for jobs and businesses where vacancies exist. These agencies make an effort to arrange meetings or a communication channel between the two parties and charge commission of their services.



**Local career services:**

It is a commercial employment agency that makes arrangement for a job at the local level and proves to be highly useful for individuals who intend to work in their hometown.

**Head hunting:**

It is a commonly followed strategy in which an organisation promises an attractive package to an employee of another competing firm and offers him a job. This technique is responsible for a major reshuffling in the employment structure within the business community and is considered to be an aggressive way of overcoming competition as well.

**Advertising agencies:**

These act as a platform where jobs can be offered to the general public. The qualifications required are clearly explained to the interested candidates so that they can make up their mind regarding a particular job opportunity.

**Educational institutions:**

Nowadays educational institutions such as reputable universities and colleges act as a reliable source for preparing candidates for business organisations on a regular basis. The company representatives may visit renowned institutions in search of appropriate candidates for a specific job.

**Vocational centers:**

These are training centers where specific skills are passed on to candidates who can join companies afterwards.

**Job fairs:**

It is an exhibition where various companies can advertise or publicize job vacancies, providing useful and relevant information to the applicants. It may be held on a six monthly or yearly basis.

## **Job descriptions, person specifications, job advertisements**

### **Purposes of job descriptions, person specifications and job advertisement.**

**Job analysis:**

This is the initial step in the process of recruitment and enables a company to advertise a job vacancy through media. All the relevant details regarding the qualifications of suitable candidates are highlighted so that the applicants can make up their mind whether or not to apply for the job. Job analysis is usually based on education, qualification, past experience and specific personality traits.

**Person specification:**

Every business organisation forms a profile or image of an ideal candidate with reference to the requirements of a particular job. This profile is used as a gauge to measure the efficiency and competence of different applicants and the person with the closest match is offered the job.

**Job description:**

Once a newly appointed employee takes charge, his superiors are responsible for guiding him through all the procedures pertaining to his job. Issues such as code of conduct, working hours and other job requirements are clearly addressed so that the new employee does not face any problem in performing his specified task. For example, every newly appointed employee at McDonald's is handed over a manual that describes various job related issues in detail and assists the employee in understanding his job quickly and easily. It has 385 pages approximately, highlighting the importance of being courteous with customers, maintaining eye contact, etc.

**Job evaluation:**

A business organisation seeks profit and therefore it adopts every possible measure to minimise costs. In this context the package offered to an employee is carefully determined in order to avoid any chances of

over-payment or under-payment. This is done in accordance with the contribution the employee makes to the overall profitability and success of a business.

**Testing:**

Nowadays, a combination of tests is used by firms in order to analyse the potential of the applicants and select an individual who is suitable for a particular job. These include:

**Aptitude tests:**

This category helps the management in judging the ability of the candidate to cope with a given situation under pressure. In this method, case studies are often involved and the company observes the temperament of the applicant closely.

**Attainment tests:**

In this technique the actual skills of the candidate are tested and the management is able to evaluate the true potential of the applicant. For example, the typing speed of a typist is checked or tested.

**Intelligence test**

The company uses a series of questions, based on mathematical calculations and general knowledge so that the IQ (Intelligence Quotient) level of the applicant can be determined.

**Personality tests**

It is required that a candidate has certain personality traits for performing the job efficiently. In this context, communication skills and the confidence level are given due importance by the management, since it is a key feature required for carrying out various business activities. Personality tests are often conducted in the shape of an **interview**. An interview is an extremely effective tool brought to use by the management of the company for comparing the skills and potential of various applicants. It is a dialogue that may be personal or telephonic in nature. An interview is often the decisive factor in finalising the job offer and the company considers it to be the ultimate way of gauging the worth of a candidate.

**Employment contracts****The main features of contract of employment:**

A contract of employment is an agreement between the employer and the employee under which each has certain obligations. It is binding to both parties in the agreement which means that it is unlawful to break the terms and conditions in the contract without the other party agreeing. Every newly appointed employee is entitled to a contract of employment. It is important to note that a contract could be in a written or a verbal form. The Employment Rights Act, 1996 requires that the following common features must be highlighted in the contract of employment:

- The names of the employer and the employee
- The date on which the employment is to begin
- The job title
- The terms and conditions of employment

**Disciplinary procedures:****The importance of disciplinary procedures:**

Disciplinary action is likely to be initiated by the management in one of the following situations:

**Poor performance:**

The term refers to a situation in which an employee fails to work to an accepted standard or shows negligence. It involves a variety of issues such as absenteeism, time wasting, missing deadlines, resisting change, bad timekeeping, upsetting customers, lack of commitment, output low in qualitative or quantitative terms, withholding information, etc.

**Misconduct:**

This represents failure to obey reasonable orders and showing unacceptable behaviour. Poor attendance or non-observance of rules also falls in the category of poor performance.



**Gross misconduct:**

This includes violations of a serious nature such as falsifying claim sheets or causing malicious damage to the employer's property.

Gross misconduct can result in instant dismissal (although the employer will have to prove gross misconduct if the dismissed employee seeks legal redress through an industrial tribunal). Poor performance and misconduct can also lead to dismissal but both employment law and good personnel practice demand that the matter be dealt with fairly, constructively and in accordance with agreed procedures. That is why the management often issues a verbal or written warning in such a situation just to give the defaulter a second chance.

**Redundancy and dismissal****Difference between redundancy and dismissal.****Redundancy:**

This is a situation in which the employee is asked to leave the job not because of his work being unsatisfactory but because he is no longer needed in the organisation. Redundancy is caused owing to a major change or development in the micro or macro environment of a business, e.g., a technological change such as growing robotisation, merger decisions, etc.

**Dismissal:**

This is the act of cancelling the contract of employment of the worker due to his incompetence or negligence. It is a formal procedure and might be termed as "unfair dismissal" if not carried out according to certain rules and regulations.

**Staff morale and welfare****Relationship between HRM, staff morale and welfare in a business.**

Human resource management greatly affects the workforce and welfare of the business. If the human resource management is successful in increasing the motivation level of the workforce by providing them with the necessary rewards and incentives, it would boost their confidence level and increase the efficiency of the workers who will perform and produce optimum results for the management. This would lead to cordial relations between the management and the workforce and both the parties that are actively involved in the working of the business will be satisfied creating an atmosphere of harmony in the entire company.

**Staff training**

- The purpose of staff development/training as a means of securing required skills and motivating the workforce.

(The advantages of training have already been discussed under "non-financial rewards")

The management of the company benefits to a great extent whenever incentives or rewards are offered to the workers. The employer's objectives behind motivating the workforce are:-

**Low labour turnover:**

Motivation techniques ensure a low labour turnover since the workforce is satisfied with the working conditions and the policies followed by the company.

**Prestige:**

The image of the company can be enhanced if it is considered to be a good paymaster and a fair employer. Since the workforce is supposed to be a true representative of the company, motivated and satisfied employees can contribute significantly towards a positive image of the organisation.

**Control:**

The management of the company can exercise better control over the workforce if they are motivated and satisfied with the working conditions. Moreover, they will work with greater commitment, honesty and dedication, leading to the desirable results.

- **Measures of employee performance**
- **The measurement, causes and consequences of poor employee performance**

Poor employee performance can be disastrous for business. It is the result of low motivation levels and unsatisfied workforce. This is due to the reasons we have discussed earlier. There are a number of ways in which staff performance can be measured. The following measures can be used to assess the level of achievement and morale of the workers.

**Labour productivity:**

This is a key test of worker performance. It is a comparison of the number of workers with the total output.

**Labour productivity:**

$$\frac{\text{Output Per Time Period}}{\text{Average Number Of Workers}}$$

Output per time period average number of workers:

If this result increases over time then labour productivity or efficiency is increasing. It also means that, given constant wage rates, labour costs per unit will be falling. This is therefore a major factor influencing the competitiveness of a business. Labour productivity data does have some very important uses but, with any single measure of performance, the causes of changes in it need careful analysis.

**Absenteeism rates:**

This measures the proportion of the total workforce who are absent over a particular time period.

$$\text{Absenteeism (\%)} = \frac{\text{Number Of Staff Absent}}{\text{Total Number Of Staff}} \times 100$$

Staff absenteeism is disruptive to any business, especially those providing consumer services. Once a consumer has experienced poor service due to staff absence the consumer might never return. This is a commonly used method of staff performance measure of workforce motivation as, it is argued, that motivated staff will always avoid missing days from work at all costs.

**Labour turnover:**

This is a measure of the rate at which staff leaves a business over a certain time period.

$$\text{Labour turnover Rate} = \frac{\text{Number Of Leaving}}{\text{Total Number Of Staff Employed}} \times 100$$

Therefore, if in a firm employing 200 workers, 30 decide to leave then the labour turnover rate would be 15%. If this result is high and increasing over time then this is a good indicator of staff discontent, low morale and, possibly, a recruitment that leads to the wrong people being employed. The costs of high labour turnover can be substantial. There will be additional recruitment and training costs. Disruption of production and poor customer service could result from staff shortages. High labour turnover could be the result of external factors such as low rate of unemployment, which tends to create more job opportunities or improved geographical mobility of labour. It is the tendency of workers to move from one working place to another. High labour turnover might be beneficial for a business that is looking to reduce staff numbers or for a firm that needs to employ new workers as they believe that new workers will bring in new ideas.

**Strategies for improving staff performance:**

Staff performance can be improved by the methods of appraisal discussed above. Training (discussed under "staff training") could be used. Financial and non-financial motivators could be used (discussed under "Motivation methods in practice, financial motivators, non-financial motivators").



- Management by objectives
- *The implementation and usefulness of management by objectives*
- (Already discussed in Section 1)
- Labour legislation
- The need for labour legislation and the broad principles that often underlie
- (Already discussed in Section 1)
- Workforce planning
- Reasons for and role of a workforce plan

It is the comparison of the organisation's existing human resources with its forecast needs, with a statement of planned strategies to eliminate any discrepancy.

### **Role and objectives:**

Judging future labour requirements

The main purpose of workforce or manpower planning is to forecast the organisation's labour requirements for the future and to devise strategies to ensure that sufficient labour of the appropriate types is available to enable the organisation to achieve its overall objectives. For example, a growing business, such as a call centre, might find that it needs an extra 20 telephone operators over the next year. It may therefore plan to recruit the required number of individuals over the period.

### **Recruitment and selection (already discussed in detail)**

This is concerned with obtaining the number and type of people required by the organisation. Organisation design and development Workforce planning is helpful in designing and developing a structure in which all activities are covered and are grouped in the best ways to achieve the organisation's objectives. The human resource or workforce plan is usually one of the responsibilities of the personnel or human resources department. The planning could be short-term or long-term in nature. Short-term workforce plans are aimed at the immediate needs of the business, such as filling vacancies left as a result of maternity leave. Long-term planning, on the other hand, concerns the future. For example, if a company aims at changing its production techniques in the next few years, it would need to plan the number of employees, training needed and perhaps the incentives and motivation that workers would require.

### **Role of trade unions in HRM:**

#### **Purpose and value of trade unions:**

Trade union is an association of workers employed by a business organisation or representing the whole industry, responsible for adopting all possible measures for the betterment of the employees and safeguarding their interests. It takes all steps that can lead to improvement in the living standard of workers. It pertains to issues such as salary and working conditions. A strong trade union can influence the government whenever the new trading policy is about to be launched. The government does not want to displease or demotivate the workforce and that is why will make an effort to pass favourable laws for them. For example, the determination of minimum wage level is often based on the status of the trade unions in the country. In some countries the operations and activities of the trade unions are restricted or banned by law. However trade unions are allowed to function in most of the countries these days since they are an integral part of a mixed economic system. Trade unions prevent workers from being unfairly dismissed or subjected to inappropriate treatment. They are also responsible for improving relations and acting as a bridge between the management and the workforce through the process of **collective bargaining**.

#### **Collective bargaining:**

Trade unions are involved in a process called collective bargaining. It refers to a situation in which the management of the company and the representatives of the trade union are engaged in a negotiation process with reference to a variety of relevant issues before any decision is finalised. Both the parties express their view over matters such as salary package, hiring and termination policy, promotion, annual

increments etc. A series of discussions may lead to a mutually acceptable decision and the employers can work in harmony with the employees.

### **Single Union Deals:**

#### **The meaning of single union deals and why they might be used:**

Single union agreements enable a business to recognise and negotiate with one union over pay and other working conditions. A union may agree not to strike in return for wage increases, improved conditions or limited redundancies. The following are the salient features /advantages of single union deals:

#### **Single union recognition:**

This reduces time, complexity, conflict and administrative costs.

#### **Single job status:**

This removes differentials in salaries, conditions, uniforms, car parking etc, between white-collared (non-manual) and blue-collared (manual) workers.

#### **Job flexibility:**

This means workers agreeing to annualised hours rather than a fixed number of hours a week.

#### **Union acceptance:**

Union acceptance of training or retraining of employees improves the flexibility and quality of the workforce.

#### **Negotiation and arbitration:**

Arbitration is the settlement of a dispute by the intervention of a third neutral party. Single union deals encourage the use of negotiation and arbitration rather than "industrial action", a term used for sanctions imposed by unions in support of a pay claim or some other dispute.

## **2.4 ORGANISATIONAL STRUCTURE**

### **Relationship between objectives, people and organisational structure**

#### **Purpose and attributes of an organisational structure such as flexibility, meeting the needs of the business, permit growth and development:**

An organisational structure is the internal, formal framework of the business that shows the way management is linked together and how authority is transmitted. It shows the levels of hierarchy. Each level of hierarchy represents a grade or rank of staff. The greater the number of levels the greater the number of different grades and ranks in the organisation.

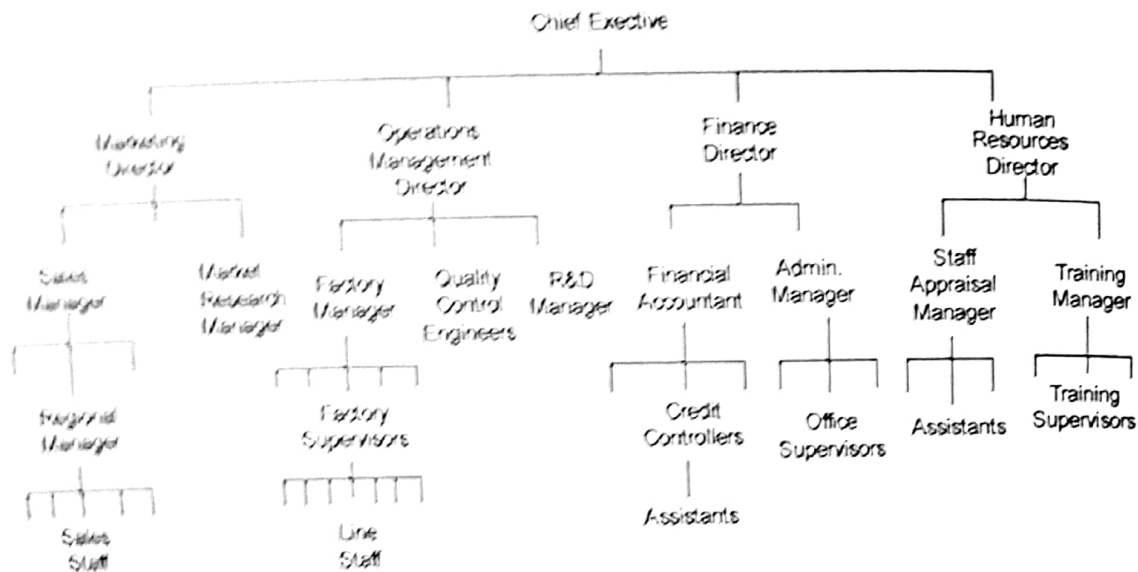
It shows:

- Who has overall responsibility for decision making?
- The formal relationship between different people and departments
- The way in which accountability and authority will be passed down in an organisation
- The identification of supervisors and managers to whom each worker is answerable
- Types of structure: functional, hierarchical (flat and narrow), matrix

Diagrammatic illustration of a typical organisational structure can be viewed on the next page.



An example of a typical organisational structure:



### Advantages and disadvantages of different types of structure:

#### Hierarchical (or bureaucratic) structure:

These are the layers of management with fewer and fewer people on each high level.

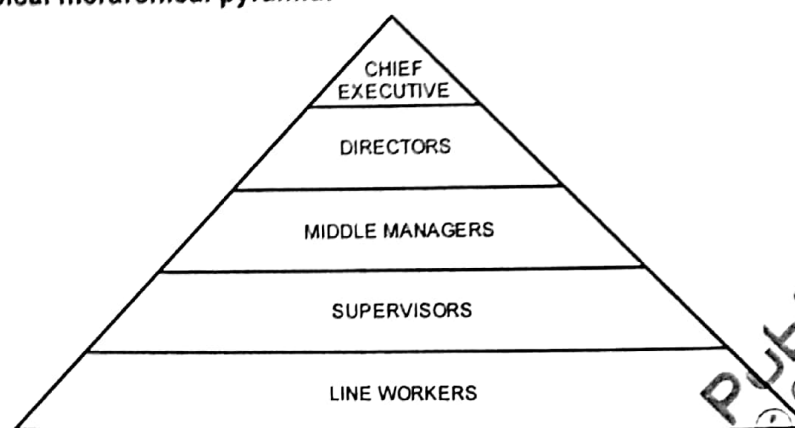
##### Advantages:

It enables the decision making power to be from the top and passed down to lower levels. The role of each individual is clear and defined. Duplication of jobs can be avoided. This is typical of organisations based on "role culture", where the importance of the role determines the position in the hierarchy.

##### Disadvantages:

Managers are criticised for only dealing with issues pertaining to their department and not going beyond that. It is an inflexible system and leads to change resistance. This is because managers tend to defend their own position in the hierarchy and own department.

#### An example of a typical hierarchical pyramid:



#### Matrix structure:

This type of structure consists of project teams made up of all departments and divisions. Emphasis is placed on an individual's ability to contribute to the team rather than their position in the hierarchy.

##### Advantages:

It shows the communication between various members of the team including different departments. There is less chance of people focusing on what is good for their department. As new project teams could be created, this system is well designed to respond to changing market or technological decisions.

**Disadvantages:**

There is less direct control by the senior level of management as teams are empowered to undertake and complete a project. This trend may be resisted by senior managers. Teams might have more than one leader. This could cause a conflict of interests.

	Finance Dept	Production Dept	Marketing Dept	Human Resources	Research & Development
Project Team 1					
Project Team 2					
Project Team 3					

**A typical Matrix organizational structure**

**Why some organisations are structured by product and others by function or geographical area:**

**Organisation by function:**

The most common way of organising a business is by function. This is where the business is divided into different sections or departments according to the operation undertaken.

**Organisation by area:**

Some businesses prefer to organise their activities on a geographical or regional basis. This is specially applicable in case of businesses having similar operations which are widely dispersed nationally or globally.

**Organisation by product:**

Businesses with a wide range of products find organisation by function ineffective as different products need different approaches to production and marketing. Large diversified businesses organise their businesses by grouping different functional staff who are involved in the production of the same product lines or activities.

**Formal and informal organisations:**

Features of formal structure: Levels of hierarchy, chain of command, span of control, responsibility, authority, delegation/accountability, centralised/decentralised

**Levels of hierarchy:**—This shows and represents a grade or rank of staff. Lower ranks are subordinate to superiors of a higher rank. The greater the number of levels, the greater the number of different grades or ranks in an organisation.

**Chain of command:**

This is a route through which authority is passed down an organisation. Orders are passed down a hierarchy, information regarding sales or output levels is sent upwards.

**Span of control:**

These are the number of subordinates directly answerable to a manager. Span of control can be narrow, having less people answerable to a manager; and it can be wide, having more people under a manager.

### **Authority, responsibility and accountability:**

The term **'authority'** represents the legitimate exercise of power, which, in turn, is the ability to exercise influence over objects, persons and situations. It is important to note that authority is vested in positions, not people. It is accepted by subordinates and flows down the vertical hierarchy. If authority means the right to make a decision, **'responsibility'** is the duty to perform the task or activity that has been assigned. The subordinate is **'accountable'** or answerable for carrying out the task.

### **Delegation:**

This is a very important principle having far reaching effects on the organisation. Delegation involves passing down of authority to perform tasks and take decisions from higher to lower levels in the organisation. It should be remembered that it is only the task that is assigned to the subordinate but the final responsibility rests in the hands of the manager.

### **Centralisation/decentralisation:**

Centralisation means where the decision-making powers are reserved for the head office or the centre of an organisation, whereas decentralisation is the opposite and it requires passing down the decision-making authority to managers in other areas or departments in the business, allowing decisions to be taken away from the head office.

## **Delegation and accountability**

### **Advantages and disadvantages of delegating:**

#### **Advantages:**

- Releases managers to undertake a more strategic role.
- It shows trust in the subordinates and motivates the staff to do well.
- As Herzberg and other social scientists pointed out, this process can be a very effective way of enhancing worker performance. The worker feels they are trusted and are capable of performing the task. There is a sense of belonging that leads to higher level of self-actualisation.
- Develops and trains staff for more senior positions and is one way of assisting people to achieve their potential.

#### **Disadvantages:**

- Delegation would be unsuccessful if task is not made clear or training is not provided.
- Managers may delegate boring jobs that they do not want to do. This will not prove to be demotivating for the subordinates.
- The worker might not be able to perform the task in the desired manner.

### **The impact of delegation on motivation:**

(Already discussed under **"advantages of motivation"**)

The greater the number of levels of hierarchy, the longer will be the chain of command and the span of control will be narrower. This decreases the chances of delegation as more managers are able to control the work of a few people. Whereas in a wide span of control the managers delegate more as there are more people to manage. There is uniformity and less discrimination as more people are at the same seniority level. It also improves communication between the managers and his subordinates as there is direct interaction between them.

### **Examples of and distinction between line and staff management; conflict between them:**

(Already discussed).



## 2.5 BUSINESS COMMUNICATION

### Purpose of communication

#### Situations in which communication is essential:

Communication is the transfer of messages from the sender to the receiver through a medium. Effective communication is the one in which message is understood by the receiver and acted upon through a feedback if required. Communication is essential if a business wishes to operate successfully, as the members of an organisation need to communicate internally as well as externally. They need to interact with multiple stakeholders including government, suppliers, consumers, shareholders etc... Customers have to be given the required knowledge about the product so that they are familiar with its features. A business needs to be in contact with its suppliers in order to make sure that it is able to purchase the raw material whenever required, in order to cope up with the changing consumer demand. A business needs to have an access to government sources as well so that it is updated on any future opportunity or threat. Communication can also have an impact on the internal working of a business. If staff is encouraged to participate in group discussions then they are going to be motivated as well. They can also give ideas and problems can be solved if they are allowed to take an active part in meetings. If the consumers are able to convey their opinion regarding a particular product offered by the business, then the management will be able to react accordingly. Incorrect understanding of a message will lead to incorrect responses. There should be effective communication and coordination between departments so that they are able to operate smoothly. Slow communication between various departments of the business will lead to a slow decision making process and thus will affect the performance of the entire business in a negative manner. It will also create a de-motivated workforce and there would be a lack of a sense of direction in the business. For these reasons, managers should think of the best possible ways to communicate within the business as well as externally.

#### Within groups; spoken, written, electronic:

#### Strengths and weaknesses of the different methods of communication:

The choice of method used to communicate a message can have a significant impact on the effectiveness. These methods include:

##### Spoken:

Spoken communication, also called verbal communication, involves dialogue between two or more individuals, based on an oral transfer of data. The major advantage of verbal communication is that it enables the people involved to clarify their doubts without wasting time. For example, a manager talks to his subordinate regarding a mistake committed by him. However, it does not have any permanent record and is hard to be presented in a court of law.

##### Non-verbal:

This form of communication comprises of body language based on gestures, facial expressions, eye contact etc. It provides useful support to verbal communication and helps in conveying a point forcefully.

##### Written:

Written communication involves the use of written material to convey a message. Notices, letters, applications etc. are all examples of written communication. It is a time consuming process but is on record and, therefore, more appropriate for handling matters of an official or formal nature. Another point that favours written communication is that it facilitates the sender of the message to transfer data including figures, calculations and graphical representation.

##### Electronic:

This has the benefit of speed and combines written with oral communication, e.g., email, fax messages, video conferencing and mobile telephone. This has revolutionised business communication in recent years. The growing use of "E-commerce" or Electronic commerce is an elaboration of this. It helps businesses interact with other businesses on a global level. But it has its disadvantages as well. It requires staff to be trained which is a costly affair. There is evidence that use of excessive information

technology can lead to an overload and prevent really important messages from being noticed and acted upon.

## Channels of communication

**How communication works within an organization:**

**Difference between one and two-way communication, vertical and horizontal communication:**

**One-way** communication is the method of communication that does not allow or encourage feedback from the receiver of the message, e.g., messages pinned on notice boards or written instructions that need to be acted upon immediately. **Two-way** communication allows the receiver to respond as well, e.g., one-to-one conversations, meetings etc. This can prove to be motivating because it encourages participation. Two-way communication is typical of a democratic style of management. **Horizontal** communication exists between people at the same seniority level. In other words, it occurs along an organisational chart, between people at the same status but different responsibilities, e.g., a Production Manager communicating with a Marketing Manager. **Vertical** communication is carried out between individuals who are positioned at different seniority levels; in other words, people at different levels of hierarchy, e.g., a manager and an assistant manager.

## Barriers to communication

**Barriers to communication; attitudes, perceptions, noise, language, inappropriate medium, etc:**

The following factors are responsible for failure of communication. Due importance must be given to these aspects of communication so that a message can be conveyed properly from the sender to the receiver.

### Skill of the sender and the receiver:

In order to have an uninterrupted flow of ideas from one point to another, it is essential for the sender and the receiver to share the same skills. For example, communication will be distorted if the parties involved do not understand the same language.

### Jargon:

It is a set of terms used by the members of a specific community. Communication will definitely fail if an individual makes an effort to use jargon while having a conversation with someone who is not a part of that community.

### Long chain of command:

The length of the chain of command affects the quality of communication significantly. Communication often fails if a message is transmitted through different levels of hierarchy.

### Systems breakdown:

If there is some technical problem with the device or instrument being used as a mode of communication, message cannot be conveyed properly to the receiver.

### Stereo typed thinking:

Communication can easily fail if the sender of the message is not given a fair chance by the receiver to express himself properly. It has been often observed that communication cannot be properly carried out if one has pre-conceived notions about the personality of the other. It means that our attitude towards another person may also be a key factor in determining the quality of communication.

**Geographical limitations:**

It is often observed that physical distances between the sender and the receiver affect the communication process greatly. There is always some deterioration in the quality of communication if the concerned people are stationed in different cities or countries, despite the availability of technology.

**Role of management in facilitating communication****The role of informal communication within a business:**

Informal communication is casual in nature and takes place between colleagues who have been able to develop a friendly relationship over a period of time, for example, meetings in the staff dining rooms; often referred to as "grapevine" method of communication. This can lead to rumours and exaggeration. A business needs to provide clear formal messages so that the informal communication does not become the only method. However, informal communication can help people form an opinion about a common problem at the work place. Informal channels could be used to discuss ideas but then the ideas could be further forwarded to the management using formal channels of communication. Formal communication exists between colleagues whose relationship is purely job-based, for instance, a subordinate discussing a business related problem with his manager. It is more suitable for issues of an official nature.

**Ways in which communication can influence the efficiency of a business.**  
(Discussed under "*purpose of communication*")

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## RELEVANT QUESTIONS FROM THE PAST PAPERS (SECTION 2)

**May/June 2013: P1, 5(a),**

- 5 (a) Explain the potential benefit to a business if employees are involved in the decision-making process. [8]

**May/June 2013, P2(Regal Restaurants)(d)**

- 1 (d) Evaluate methods that Rose could use to reduce the high labour turnover. [10]

**May/June 2010: Paper 1, Q1, Q7,**

- 1 (a) Define the term 'span of control'. [2]  
 (b) Briefly explain **two** problems that might arise with a wide span of control. [3]  
 7 (a) Explain how a business might use financial rewards to motivate workers. [8]  
 (b) Discuss why a business might use non-financial rewards to motivate its workers. [12]

**May/June 2010: Paper 3, Teen Print, Q2.**

- 2 Discuss which of the two approaches to managing the workforce in the printing factory should be adopted by the company in response to the problems explained on lines 64–71. [16]

**Oct/Nov 2010: Paper 1, Q7,**

- 7 (a) Explain the benefits to a workforce that might result from job enrichment. [8]  
 (b) Discuss arguments for and against the introduction of more delegation in a business. [12]

**Oct/Nov 2010: Paper 2, Newtown Hospital, (d),**

- 2 (d) Discuss the factors that NH needs to consider in managing its human resources when starting the 'renting out' project. [10]

**Oct/Nov 2010: Paper 3, Radar Cosmetics, Q5.**

- 5 Discuss the advantages and disadvantages to Radar of forcing factory staff to accept temporary and flexible working contracts. [14]

**May/June 2011: Paper 1, Q3, Q6,**

- 3 Briefly explain the main functions of management. [5]  
 6 Discuss how the management of an airline might motivate its cabin crew\*. You should make reference to relevant motivation theories you have studied. [20]

**May/June 2011: Paper 2 Turbo Tractors, (c), McQuarry, (d),**

- 1 (c) Discuss whether Balzac's proposed new payment system is likely to solve the problems of lost sales and increased customer complaints. [10]  
 2 (d) Evaluate the impact of the Crushblock project on **two** of MQ's stakeholders. [10]

**May/June 2011: Paper 3 FitsU, Q5, Q7.**

- 5 Evaluate the most appropriate Human Resource strategies that FitsU could adopt to increase staff motivation without increasing the unit costs of sales. [16]  
 7 Discuss the importance of effective management of change to the future success of FitsU. [20]

**Oct/Nov 2011: Paper 1, Q3, Q5,**

- 3 Explain **two** employee needs identified by motivational theorists. [5]  
 5 (a) Explain the possible advantages to a business of autocratic leadership. [8]  
 (b) Discuss the qualities of an effective business leader. [12]

**Oct/Nov 2011: Paper 3, Atlantic Steel Company, Q5.**

- 5 ASC has taken measures to reduce the impact of the global fall in steel demand (lines 38–43). Evaluate the likely effects of these measures on human resource management and operations management at ASC. [16]

**May/June 2012: Paper 1, Q2, Q3,**

- 2 (a) State **two** methods of staff recruitment. [2]  
 (b) Distinguish between 'job description' and 'person specification'. [3]  
 3 Explain the main qualities of a successful entrepreneur. [5]

**May/June 2012: Paper 2 Bright Air Conditioning, (a), Large Football Club, (d).**

- 1 (a) Explain the following terms:  
 (i) performance related pay (line 26) [3]  
 (ii) empowerment (line 26). [3]  
 (d) Evaluate the importance of leadership to LFC's success. [10]

**OCT/NOV 2009: PAPER 1, Q5 (a),(Q7).**

- 5 (a) Explain why a Human Resources Manager (HRM) should have a good knowledge of motivation theory. [8]  
 7 (a) Explain **two** methods that might be used for the visual presentation of business information. [8]  
 (b) A manufacturer of soft drinks wants information about customer needs and preferences. Discuss how this information might be collected. [12]

**OCT/NOV 2009: PAPER 3, CHAN BEAUTY COMPANY, Q1 (a),(b), Q6.**

- 1 (a) Analyse **two** possible reasons for the communication problems in the factory. [8]  
 (b) Evaluate **two** ways in which communication might be improved in the factory. [10]  
 6 Discuss whether the future success of the company will depend more on June's management skills or on external factors outside of the company's control. [20]

**MAY/JUNE 2009: PAPER 1, Q6,**

- 6 Discuss the usefulness to managers of any **two** motivation theories when trying to improve worker motivation. [20]

**MAY/JUNE 2009: PAPER 2, CHEAPO AIR, (d),**

- (d) Discuss the human resource management (HRM) issues that would arise if CA did switch from low cost flights to business flights. [10]

**MAY/JUNE 2009: PAPER 3, CAR MANUFACTURER AT A CROSSROADS, Q2.**

- 2 (a) Using data from Appendix B, calculate for the Northcape factory in 2008:  
 (i) The proportion of workers who left [2]  
 (ii) Output of cars per worker. [2]  
 (b) 'If we can increase productivity and reduce wastage and absenteeism in the Northcape factory then this will make us more competitive.' (lines 48–50)  
 Recommend an appropriate Human Resources strategy to achieve this objective. Support your recommendation. [16]

**OCT/NOV 2008: PAPER 1, Q1 (a), (b), Q5 (a),(b), Q7 (a),**

- 1 (a) Define the term 'hierarchy' as used in formal organisational structures. [2]  
 (b) Briefly explain **two** advantages of hierarchical organisations. [3]  
 5 (a) Management has been described as getting things done through people. Given this description, explain the importance of management for a large business organisation. [8]  
 (b) Discuss the view that a manager will be more effective by adopting a democratic rather than an autocratic leadership style. [12]  
 7 (a) Information is collected by the Human Resources Department (Personnel). Explain how a business might use this information. [8]

**OCT/NOV 2008: PAPER 2, CC COSMETICS, (c),**

- 2 (c) Analyse the Human Resource Management issues for CC if the planned international expansion takes place. [8]

**OCT/NOV 2008: PAPER 3, TANROH'S DILEMMA, Q2 (a), (b).**

- 2 (a) Analyse the importance to Tanroh of human resources planning if Option A is chosen. [8]  
 (b) Do you agree with Abi that Tanroh will need to delegate if more staff are employed? Give reasons for your answer, explaining the possible advantages and disadvantages to Tanroh. [12]

**MAY/JUNE 2008: PAPER 1, Q6.**

- 6 Discuss the qualities required by effective business leaders. [20]

**MAY/JUNE 2008: PAPER 3, PYRAMID TELEVISIONS (PT), Q1.**

- 1 (a) Discuss how PT's management might resolve the pay dispute with the workers. [10]  
 (b) Assess the advantages and disadvantages to the Research and Development department of changing the organisational structure of the business. [10]

**OCT/NOV 2007: PAPER 1, Q1, Q6,**

- 1 (a) Define the term 'span of control'. [2]  
 (b) Explain one reason why an organisation chart would be useful to the employees in a business. [3]  
 6 Discuss the extent to which financial rewards are a good way of motivating employees. [20]

**OCT/NOV 2007: PAPER 2, ZETA OIL, (b), EXCELLENT TRAINING, (d),**

- 1 (b) Explain the arguments that the workforce of ZO might use to justify their demand for a 10% increase in wages. [6]  
 2 (d) Identify and briefly analyse how ET might recruit suitable trainers. [6]

**OCT/NOV 2007: PAPER 3, CURRY CUISINE, Q2 (a), (b).**

- 2 (a) Analyse **two** possible problems that might result from the approach to managing staff used within the Asian Experience kitchen. [6]  
 (b) Evaluate the appropriateness of Ling's approach to managing staff within the Curry Cuisine restaurant. [14]

**MAY/JUNE 2007: PAPER 1, Q5.**

- 5 (a) Outline the main factors which a manager of a large hotel might consider when carrying out manpower planning. [8]  
 (b) Discuss the extent to which the hotel manager might improve workers' motivation by re-designing their jobs. [12]

**MAY/JUNE 2007: PAPER 3, CRAFT DESIGNS, Q7.**

- 7 The Operations Director has proposed outsourcing all supplies of stone sculptures so that the company could start jewellery production. Discuss how Ade might try to solve what you consider to be the most important **human resource** and **operational management** problems that might result from this decision. [20]

**OCT/NOV 2006: PAPER 1, Q4, Q6,**

- 4 (a) Define the term "levels of hierarchy". [2]  
 (b) Briefly explain the advantages of a matrix organisational structure. [3]  
 6 Discuss the advantages and disadvantages of delegation for an expanding business. [20]

**OCT/NOV 2006: PAPER 2, HILLTOP SERVICES, a (ii), (c), ELDORADO RESTAURANTS, a (ii),**

- 1 (a) Explain the following terms:  
 (ii) democratic leadership style (line 7). [3]  
 (c) Analyse the human resource management issues that Farad should consider if he decides to convert the car repair building into a shop. [8]  
 2 (a) Explain the following terms:  
 (ii) manager (line 13). [3]



**OCT/NOV 2006: PAPER 3, LOCOST AIRWAYS, Q6.**

- 6 The rapid expansion of businesses such as LoCost Airways often leads to problems with the management of people within the organisation. Evaluate how businesses could attempt to reduce these problems. [20]

**MAY/JUNE 2006: PAPER 1, Q2, Q6.**

- 2 (a) Define the term 'redundancy'. [2]  
 (b) Briefly explain the role of human resource management. [3]  
 6 Discuss the importance of good leadership for a successful business. [20]

**MAY/JUNE 2006: PAPER 2, STAR PHARMACEUTICALS, (b), HOME FARM, (d),**

- 1 (b) Explain the factors that SP might consider in deciding on an organisational structure if they relocate some of their production to Country B. [6]  
 2 (d) Analyse reasons why the employees might join The Farmworkers Union (TFU). [6]

**MAY/JUNE 2006: PAPER 3, RAVE CONFECTIONERY, Q5.**

- 5 Discuss how the directors might encourage staff involvement and cooperation in helping to solve the problems faced by Rave. [16]

**OCT/NOV 2005: PAPER 1, Q6,**

- 6 To what extent is it important for a business to have a Human Resources Manager? [20]

**OCT/NOV 2005: PAPER 2, THE SUN HOTEL LTD, a (ii), (c), MERCADO PLC, Q1, Q7.**

- 2 (a) Explain the following terms:  
 (ii) working capital (line 15). [3]  
 (c) Would you advise Padman to change to a salary only based pay system at the Sun Hotel? Justify your answer. [10]

**OCT/NOV 2005: PAPER 3, MERCADO PLC, Q1, Q7.**

- 1 Discuss the advantages and disadvantages for Mercado plc of introducing a decentralized management structure. [12]  
 7 Advise the management of Mercado on the most appropriate ways to motivate production line workers. [20]

**MAY/JUNE 2005: PAPER 1, Q1, Q5 (b),**

- 1 (a) Define span of control. [2]  
 (b) Briefly explain why some people might prefer to work for a business with wide spans of control. [3]  
 5 (b) Discuss the importance to a growing business of human resource planning. [12]

**MAY/JUNE 2005: PAPER 2, MATPACK PACKAGING, a (i), (d), OUR NEWS LTD, a (ii), (c),**

- 1 (a) Explain the following terms:  
 (i) non-financial motivators (line 9) [3]  
 (d) Discuss whether MPP should introduce the same working conditions and benefits in all of its factories. [10]  
 2 (a) Explain the following terms:  
 (ii) human resource management (line 14) [3]  
 (c) Analyse how Lucky might manage the human resource problems that could result from changing from a daily newspaper to a monthly magazine. [8]

**MAY/JUNE 2005: PAPER 3, WOTTON COLLEGE, Q1, Q6.**

- 1 Evaluate how communications between management and staff might be made more effective within Wotton College. [14]  
 6 Assume Paula decides to buy Midvale School. Evaluate how Paula might deal with the Human Resource Management problems that are likely to occur. [20]

**OCT/NOV 2004: PAPER 1, Q5.**

- 5 (a) Discuss the importance for a business of effective communication. [12]

- (b) How might a business overcome barriers to effective communication? [2]

**OCT/NOV 2004: PAPER 2, BALJIR THE BUILDERS, a (ii), FOOD2U LTD, (a).**

- 1 (a) Explain the following terms:  
(ii) organisational structure (line 7). [3]

**OCT/NOV 2004: PAPER 3, FOOD2U LTD, (a).**

- (a) Assume the expansion goes ahead. Discuss how Neerna and Min Chul could try to make sure that the larger workforce is committed and well motivated. [10]

**MAY/JUNE 2004: PAPER 1, Q5.**

- 5 (a) Explain the main differences between autocratic and laissez-faire leadership styles. [6]  
(b) Discuss the likely effectiveness of a democratic style of leadership. [14]

**MAY/JUNE 2004: PAPER 3, DECISION TIME AT TOPAZ, (a).**

- (a) Discuss the advantages and disadvantages for Topaz of its staff joining a Trade Union. [10]

**OCT/NOV 2003: PAPER 1, Q7,**

- 7 Discuss the importance of delegation for effective management. [20]

**OCT/NOV 2003: PAPER 2, THE AKSHAY COMPANY, (d),**

- 2 (d) Discuss the importance of Human Resource Management for the success of the new factory. [10]

**OCT/NOV 2003: PAPER 3, ORIENTAL ENGINEERING, c (ii), (e).**

- (c) (ii) Evaluate the usefulness of this technique to the business' management when taking the decision whether to build the Autotrac or not. [6]  
(e) If the Autotrac project is successful, the business will grow quickly. Suggest and justify an appropriate organisational structure for Oriental Engineering Ltd. if this happens. [10]

**MAY/JUNE 2003: PAPER 1, Q3, Q5.**

- 3 Outline the functions of a trades union. [5]  
5 (a) Outline the qualities of a good leader in a business context. [8]  
(b) Discuss the appropriateness of any **two** styles of leadership that managers might use. [12]

**MAY/JUNE 2003: PAPER 2, THE FURNITURE MAKER, (d), (ii), THE TEE BUSINESS, (d),**

- 1 (d) (ii) Discuss the possible reaction of TFM's management team to an increase in the level of competition. [10]  
2 (d) Discuss the possible reaction of the sales team to the new incentive scheme. [10]

**MAY/JUNE 2003: PAPER 3, FAST FOOD FRANCHISE, (b).**

- (b) Examine how Rashid and Shivani might try to establish good relations between management and workforce in their business. [10]

**OCT/NOV 2002: PAPER 1, Q5.**

- 5 (a) Analyse the advantages and disadvantages for a private limited company of converting to a public limited company (plc). [10]  
(b) Discuss why public limited companies find it difficult to satisfy the interests of both shareholders and other stakeholders in the business. [10]

**OCT/NOV 2002: PAPER 3, THE CASTLE LODGE, a.**

- (a) (i) Suggest possible advantages to the business of employing a part-time and flexible workforce. [4]  
(ii) Discuss how the directors might encourage these new employees to work effectively as part of a team. [8]

**MAY/JUNE 2002: PAPER 1, Q2, Q7 (b).**

- 2 (a) Define the term "span of control". [2]  
(b) Explain the advantages of a broad "span of control". [3]  
7 (b) Discuss the human relations problems which the manufacturer might face if it changed from batch to flow production. [12]

**MAY/JUNE 2002: PAPER 2, EATING SHOP, (b).**

- 1 (b) Explain the possible disadvantages of the leadership style adopted by Kevin. [6]

**MAY/JUNE 2002: PAPER 3, SPORTWIZE LTD, (a).**

- (a) (i) Suggest possible reasons for the low levels of motivation of the sports tutors at Sportwize Ltd. [4]  
(ii) Discuss how the owners might improve the motivation of the sports tutors. [8]



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**UNIT 3**

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**Marketing**

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**A Level  
Business  
Teacher's Notes**

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**Syllabus 2016 –18****3.1 What is marketing?**

- Role of Marketing and its relationship with other business activities
- Supply and demand
- Features of markets: location, size, share, competitors, growth
- Niche versus mass marketing
- methods
- Segmentation
- Industrial and consumer markets

**3.2 market research**

- Primary and secondary research
- Methods of information gathering
- Sampling methods
- Market research results

**3.3 The marketing mix**

- The elements of the marketing mix (the 4ps)
- The role of the customer (the 4cs)
- Product
- Types of pricing strategies
- Product life cycle
- Price elasticity of demand
- Promotion methods
- Channels of distribution
- Using the internet for the 4ps/4cs
- Marketing planning
- Elasticity
- Product development
- Forecasting

## UNIT 3 MARKETING

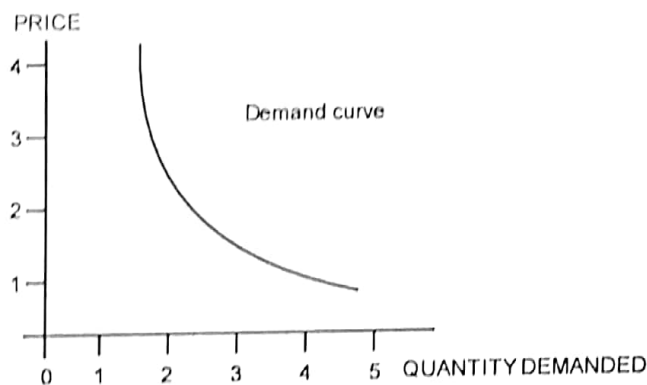
### 3.1 WHAT IS MARKETING?

#### Role of Marketing and its relationship with other business activities

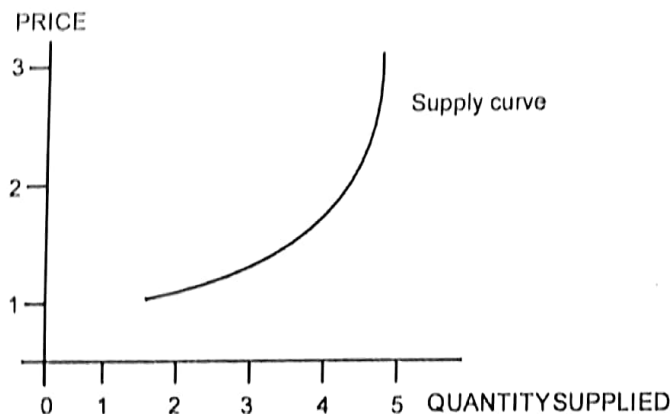
#### Supply and demand

**Factors influencing the supply and demand for the product/services of a business:**

**Demand** is the willingness and ability of the customer to purchase a commodity. The law of demand states that the quantity demanded for a product declines as the price of the product increases, *ceteris paribus* (other non-price factors remaining constant).



**The law of supply** states that with an increase in price, there is an increase in the quantity supplied because the manufacturers intend to enjoy higher profits by selling the product at a higher price.



#### Factors influencing the demand of a product/service:

##### Price:

As the law of demand states, an increase in price leads to a fall in the quantity demanded of that product, all other factors remaining the same or constant.

##### Substitutes:

A product that may replace the other product when required is called a substitute, for example, Coke and Pepsi. The fact that as the price of Pepsi increases, customers will start switching to Coke resulting in a rise in the demand for Coke, indicates that both are close substitutes.

**Complements:**

Complementary items are jointly demanded and are usually simultaneously consumed as one is useless without the other. So if the price of one item increases, it will lead to a fall in the demand of the other complementary good also. For example, string and kite.

**Income:**

As the income of an individual increases, it will lead to an increase in the demand of expensive or luxury items such as branded watches and a reduction in the demand for inferior goods such as cheap clothing.

**Advertising:**

In today's competitive world of business, advertising and sales promotion techniques play a key role in creating demand for the product. Companies adopt a variety of methods for attracting customers and overcoming competition.

**Weather conditions:**

Certain products are greatly influenced by seasonal conditions. For example, demand for winter or summer clothing, heaters, air-conditioners etc. largely depends on weather conditions.

**The role of government:**

The government facilitates the production and availability of certain goods such as merit goods by providing subsidies to manufacturers. In this way the easy availability of goods has a positive impact on the demand of these particular commodities.

**Trends and fashion:**

The ongoing trends and fashion play a key role in determining the current level of demand of a certain product. It is often observed that the customers are even willing to pay a higher price for products that are in fashion and considered to be trendy. It is applicable to almost all industries, particularly clothing and other consumer durables and non-durables.

**EXCEPTIONAL DEMAND:**

Certain products violate the law of demand and do not experience a decrease in the demand even when the prices are rising. Such products are said to have an exceptional demand. These products can be further classified into three categories.

**Basic necessities of life:**

These include items such as staple foodstuff like wheat, rice, corn etc. A rise in the price of any of these commodities has no significant effect on the level of demand.

**Luxury items:**

These are purchased by individuals who represent the highest income group. These products are often purchased as a status symbol and that is why an increase in price does not have a negative impact on the demand. In fact it has been observed in many cases that an increase in price of such products may even lead to a rise in demand.

**Investments:**

Investors buy shares, property, foreign exchange etc. whenever there is an upward trend in prices. The reason for this increase in demand is that they expect the trend to continue in the future and wish to make a profit by selling these things at a higher price afterwards.

**Factors influencing the supply of a product/service:****Weather conditions:**

A large number of products are directly influenced by seasonal variation. The agriculture-based items such as wheat fall in this category as their production depends on the climatic conditions of that particular region. Air-conditioners, heaters and summer/winter clothing are also relevant examples.

**Taxation and subsidies:**

The government is responsible for encouraging economic growth through subsidies or retarding it through taxes. Thus the supply increases if the government offers subsidies or decreases if they impose taxes.



**Technology:**

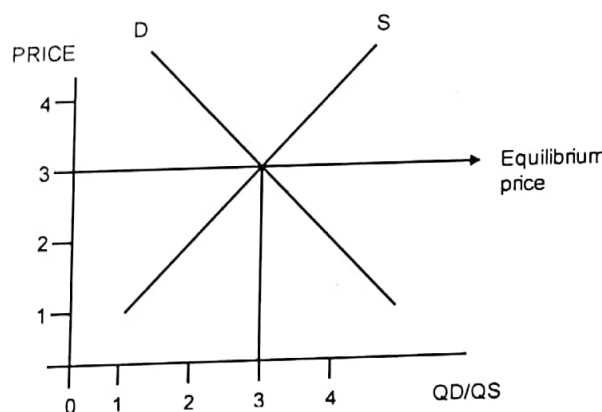
The use of advanced technology accelerates the production process resulting in a rise in the quantity supplied. Moreover, the time factor is given due importance and the firm is in a position to accomplish the task quickly.

**Demand/consumption:**

Demand is the driving force behind the level of supply of a particular commodity. The manufacturers supply the product in demand and make sure that the flow of goods is not interrupted. Thus the number of units consumed is a major factor that determines the quantity supplied.

**Interaction between price, supply and demand:**

The price at which the demand of the product exactly matches its supply is termed as the market or equilibrium price.

**Features of markets: location, size, share, competitors, growth**

**How markets may differ: such as consumer/producer markets; national regional and international markets:**

(covered under section 1)

**Difference between product and customer orientation:****Product orientation:**

Occurs when a business's main focus of activity is on the product itself. Such businesses would include production of agricultural tools or fresh foods. These are basically general products that consumers need to buy.

**Customer orientation:**

Businesses focusing on national and international markets first carry out market research in order to find out about the customer requirements, presently and in the future so that they can produce the right goods that will sell well and earn them a profit.

It has been observed that businesses that are market-orientated are better able to survive as compared to product-orientated businesses as they are more prepared for changes in customer tastes. They are able to reap the advantages of new market opportunities and can launch the product with more confidence once customer requirements have been identified.

## Industrial and consumer markets

How marketing might differ for different types of goods and services

Product differentiation and USP (Unique Selling Point):

Classification of products:

Marketing and corporate objectives:

The term "**corporate objectives**" or business objectives represents the goals of the business that it wishes to achieve. For example, if a manufacturer wants an increase of 10% in sales, that will be categorised as a business objective.

Marketing objectives are the goals that a business wants to achieve as a result of its marketing campaign. These are derived from the overall corporate objectives of the organisation. Targeting a particular segment, such as the higher income groups, is a marketing objective.

It is important to note that a company's marketing objectives are influenced to a great extent by its corporate or business objectives. For example, **Adidas** pursued the corporate objective of overcoming threat posed by **Nike** with the help of an aggressive promotional campaign focusing on durability as a **unique selling point**.

**Unique selling proposition (USP):**

The unique selling proposition (USP) of a product is the key aspect or aspects of that particular product which sets it apart from those of its competitors. It could be quality, price, availability or any other factor. The USP of Polo Mints, for example, is that it is a mint with a hole in the middle.

## Industrial and consumer markets:

Classification of products:

All business activity results in the production of goods (tangible) or services (intangible). **Consumer goods** are those sold to the general public and fall into two categories:

**Durable goods** are the ones that can be used repeatedly for a long period of time, such as furniture and electronics.

**Non-durable goods** are consumed within a very short period of their purchase, such as food and newspapers.

**Capital goods** are the ones purchased by businesses and used to produce other goods, for example, tools, equipment and machinery.

The supply of **services** has grown in recent years. Banking, hairdressing and advertising represent the tertiary or the service sector.

Business activity also results in the production of **waste material**. Most waste is useless and some, like radioactive nuclear waste, is highly dangerous and should be disposed off carefully. Some production techniques result in by-products also that can be sold.

**Segmentation methods:**

Tactics such as mass versus niche marketing, market segmentation, product differentiation and portfolio analysis as ways of achieving marketing objectives

## Niche versus mass marketing

The term mass marketing is used to describe a procedure in which a standardised product is manufactured and distributed in bulk. A specific market segment is not targeted and the nature of product is such that it is equally popular with different sections of the market. Mass marketing is typically and effectively used in case of "**fast moving consumer goods**" (FMCG) such as food items with a high turnover. However, it is important to note that economies of scale and profit will not be enjoyed if the company is unable to sell a sufficiently large number of units.

**Niche marketing**, on the other hand, is a set of activities aimed at fulfilling the requirements of a relatively small, untapped market segment comprising of individuals who share a unique characteristic. High income groups and diet conscious people are all examples of a niche market. This strategy is useful in enhancing the image of the company as an organisation that deals in exclusive products. However, there will be no significant economies of scale and high quality standards must be maintained in order to justify high prices and satisfy the target audience.

## Methods Segmentation

Market segmentation is the breaking down of a market into sub-groups with similar characteristics. The results of market research help producers identify people with similar needs. Then a suitable strategy can be developed for addressing and meeting these needs so that the objective of market-orientation is achieved.

Broadly, a market can be segmented in the following ways:

### Demographic segmentation:

All the population related factors fall in this category. These primarily include:

#### Age:

Manufacturers design, price and promote products in accordance with the requirements of specific age groups. The clothing industry gives due attention to the age factor while producing different varieties. Similarly, firms representing the electronics industry, e.g., Sony, segment the market by age while manufacturing products such as the Playstation. Even banks are offering special services like the "**young savers account**" with the objective of catering to the needs of teenagers.

#### Gender:

Segmentation by gender also proves to be effective since there is a fairly high degree of variation in the approach of each gender towards the products to be purchased. Brand names like Gucci and Armani keep this distinction in mind while offering their wide range of products to the target market. This is observed in case of electronics also. Pink Motorola cell phone and pink Playstation are relevant examples. Some financial institutions such as Merrill Lynch highlighted this aspect when journals like "**A handbook for women investors**" were launched successfully.

#### Income:

Income is another key demographic factor that gives direction to a business. Important decisions pertaining to quality, pricing and distribution are finalised on the basis of the requirements of the income group being targeted. Luxury items such as **Rolex** watches are designed and promoted in such a manner that the status-conscious customers are satisfied. Airlines and banks offer special concessional packages for those representing the middle or lower income groups.

### Geographic segmentation:

A market may be segmented geographically or on a regional basis. Residents of different areas vary in terms of their lifestyle and demand. That is why it is recommended and practiced that manufacturers conduct an extensive market research in order to learn about specific regional requirements. This is specially true in case of clothing and foodstuff. Needless to say, the weather conditions have a major influence on the type of clothing to be worn in different regions. Similarly, Campbell's best-selling Nacho soup is spicier in Texas as this is how the customers like it there. The success of spicy Chinese food or Pizza Hut's "**Tikka pizza**" in the Asian market is another illustration of geographic segmentation.

### Psychographic segmentation:

Psychographic segmentation divides buyers into different groups based on social class, lifestyle or personality characteristics. It is also worth mentioning that the lifestyle of customers is determined to a great extent by their social and religious beliefs. It makes perfect sense for a company to closely look into this particular aspect and take marketing decisions accordingly. The introduction of interest-free banking in Muslim countries by some banks, Duckhead apparel targeting a casual student lifestyle and promotion of "**Spree**", a trendy scooter by Honda are all examples of psychographic segmentation.



## 3.2 Market Research

### Primary and secondary research

#### Purpose of market research in determining customer characteristics, wants and needs

Market research is the collection, analysis, storage and presentation of relevant information by a business organisation pertaining to a specific business project.

Market research helps the business make judgment as to how many are interested in buying their products, what type of people are interested in buying the product, the price that should be charged for it and the most appropriate place at which the product should be sold. Unless they are clear about these aspects, a great deal of money might be wasted producing something that people might not want. Before it starts working on a market research plan, the business organisation must define an objective or mission. The goal should be defined in quantitative terms, i.e., including figures and calculations, if possible. Qualitative research includes information where some personal judgment or opinion is involved.

### Methods of information gathering

#### Distinction between primary and secondary research, desk and field research, and the main features of each:

##### Primary research:

It is the collection of first hand data or information which the market research specialists collect with their own efforts; also called field research. The following primary research approaches are commonly used.

##### Observational research:

This is a technique in which the market research specialist observes the ongoing trends in the market and prepares a plan on the basis of whatever he has witnessed.

##### Focus group research:

The MR specialist interacts with a small group or a sample of carefully selected people who represent a specific target market. Their opinion is given due weightage while a plan is being finalised.

##### Survey research:

This requires the marketing department to approach as many people as possible so that sufficient information can be gathered about the lifestyle of the potential customers.

##### Experimental research:

Customers or employees are asked to consume and comment on the quality of a particular product. This is very commonly observed in case of the telecommunication industry.

Market Research involves the use of the following instruments.

##### Questionnaire:

It is a document consisting of a set of questions that enable the company to judge the lifestyle of the target audience accurately. A typical questionnaire comprises of **open-ended as well as closed-ended questions**.

An **open-ended question** allows the customer to express his opinion freely without any restriction or limitation, e.g., **"What is your favourite colour?"**

A **closed ended question**, on the other hand requires a customer to choose from the given options, while answering the question. In other words it is multiple-choice question, for example: **"Is the quality of food in a restaurant good, bad or excellent?"**

There are some **mechanical instruments** also that are proving to be quite useful during market research. For instance, the galvanometer is an instrument designed in such a way that it is able to

measure the fluctuation in human emotions. Thus a selected customer may be asked to use a particular product and the galvanometer indicates the degree to which he likes or dislikes it. Similarly an **audiometer** is advice that is installed in a television set and keeps a record of the time spent on the viewership of various channels. This enables the company to form an idea about the target audience habits and proves to be helpful in selecting an appropriate T.V. channel for advertising purposes.

### Interviewing:

Personal or telephonic interviewing is a useful means of collecting relevant data. Interviews can be carried out individually or in groups.

**Secondary research** involves the already existing data that was collected by another source. It is also called desk research and is usually available in the shape of government statistics or published company reports. **Secondary research** can be **internal** as well as **external**.

**Internal research** is the information that is available to the company from its own records. For example the sales department can help analyse the trend of sales or the finance department can help on the costs regarding the product.

**External research** is when the information is obtained from outside the company. The information obtained from an external source is of a general nature often involving the internet, special journals newspapers etc.

Secondary market research is cheaper and less time consuming but primary data is customised and more accurate. Therefore a blend of both is recommended during the process.

### Sources of information

#### Printed, paid for and web based sources of information

Printed information can be gathered through newspapers. This could help a company gather information regarding the general state of economy, whether the customers are expected to increase or decrease. Government statistics containing information about the population and age structure of the company are also available in most countries.

Market research agencies collect and maintain relevant information on behalf of the companies. They provide the companies with detailed knowledge regarding various projects and charge heavily for their services.

Web based information can be collected through the internet. It provides an easily accessible source of a very wide variety of information pertaining to websites, other companies etc. However, one should run a proper check since the information is not always authentic.

### Sampling methods

#### Random, stratified and quota sampling; the appropriateness of each to a given situation:

As discussed earlier, a sample is a selected group of people with specific characteristics, representing all potential buyers of the product. There are several techniques of sampling such as:

##### Random sampling:

In this method each member of the survey population has an equal chance of being selected in the sample as they are selected randomly. Nowadays, this is often done electronically by means of computer-generated random numbers. This is useful in case of products such as Coke that are equally popular with everyone.

##### Stratified sampling:

This includes dividing the population into sub-groups and only questioning from those sub-groups who are interested in the product of question, e.g., men and women.

##### Quota sampling:

This method requires people to be selected according to specific characteristics like particular income groups. The group is representative of the entire population.

**Cluster sampling:**

This includes people selected on the basis of the area they represent. For example, if a magazine is being launched in a specific region then people from that area will be selected. This can be done randomly.

**Limitations of sampling:**

The benefits of sampling can be limited at times due to the following factors. Firstly, the cost factor is significant and the research becomes very expensive with the sample size. Secondly, the results might be required by the managers quickly whereas the whole process of sampling is very time-consuming.

**Market research results****The reliability of data collection****Analysis of results obtained from market research**

The information collected by the Market Research specialist needs to be sorted out and analysed carefully. Relevant as well as irrelevant data should be stored in such a way that it is easily accessible. This can be done with the help of a computer and the company can bring it to use whenever required.

**Presentation of information:**

The marketing manager prepares the MR plan including all the necessary details and presents it in front of the senior management of the company. It is advisable for him to support his presentation by using facts and figures with accurate calculations and pictorial presentation. After the presentation, it is up to the directors or chief executive to make a decision regarding the implementation of the market research plan.

Market research results can be presented in a number of ways:

**Charts:**

Charts show the total figures for each piece of data or the proportion of each piece of data in terms of the total number. Charts can be classified into **Pie Charts** and **Bar Charts**.

**Pie Charts:**

A pie chart can be used to show what proportion of the total figure is made up by each component. Each slice of the pie chart represents a particular component's contribution to the total amount. The size of each slice is determined by the angle at the centre of the circle. This is calculated in the following way:

$$\frac{\text{Value of Section}}{\text{Total Values}} \times 360 \text{ degrees}$$

**For example:**

A company sells its products to a number of different countries. The table shows the data collected by the Sales department regarding the value of sales to each country.

Country	Sales figures (\$000)
UK	2
Belgium	3
USA	5
Tanzania	3
Egypt	2
Saudi Arabia	4
Argentina	1

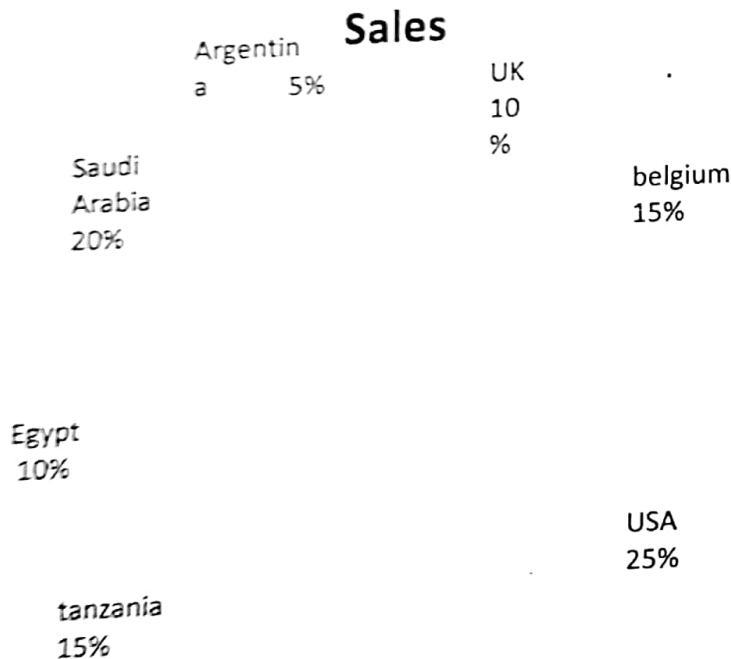
In order to draw a pie chart:  
Total sales = 20

$$\text{UK} = \frac{2}{20} = 0.1$$



The answer also provides the percentage of total sales if multiplies by 100; so  $0.1 \times 100 = 10\%$   
 Degrees can be calculated by multiplying 0.1 with 360 as stated in the formula;  $0.1 \times 360 = 36$  degrees.  
 Likewise.

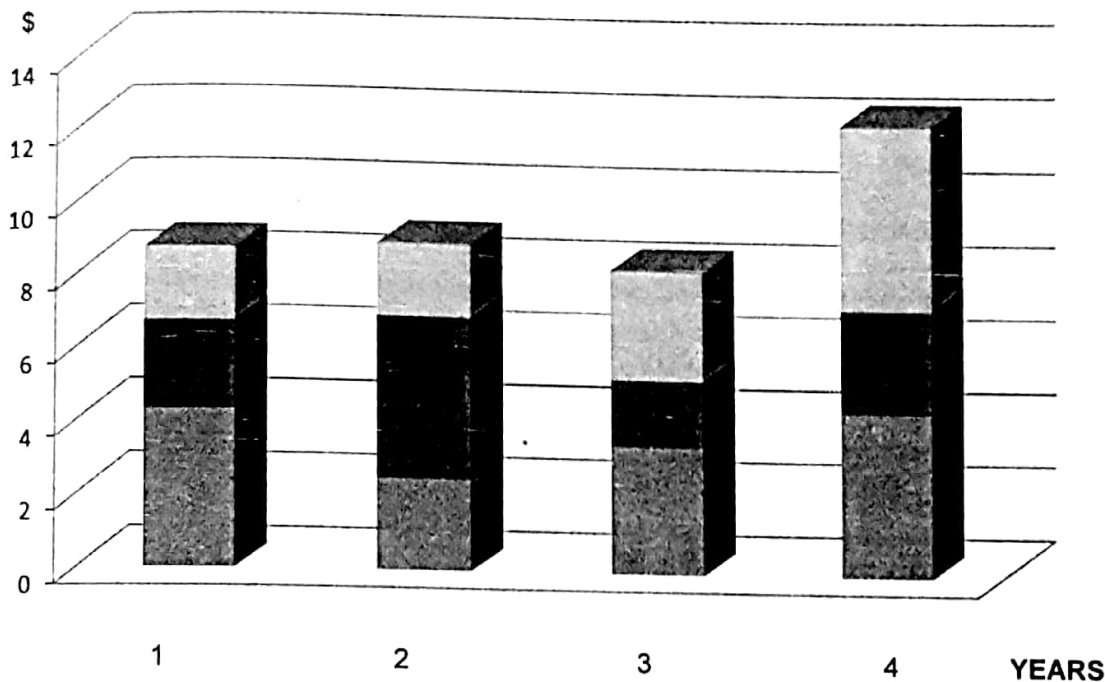
Belgium = 54 degrees = 15%  
 USA = 90 degrees = 25%  
 Tanzania = 54 degrees = 15%  
 Egypt = 36 degrees = 10%  
 Saudi Arabia = 72 degrees = 20%  
 Argentina = 18 degrees = 5%



Pie Charts allow easy comparison between two sets of results to see if proportions have changed. But it does not allow for changes in the total size of the pie, this involves trying to compare the areas of two different circles. Secondly, pie charts are less useful than bar charts but showing precise values, which is why these are usually included on the pie chart itself.

#### Bar Charts:

A bar chart or bar graph is a chart with rectangular bars with lengths proportional to the values that they represent. The bars can also be plotted horizontally. It is the most simplest and common means of representing data. The bars can be drawn vertically or horizontally. The main advantage of using bar charts is that it represents results very clearly and is easy to interpret. At a glance the reader can get a general feel of the information and identify and trends or changes over the time period. Bar charts are also attractive that tables and can be used to interpret data more quickly. It is possible to produce a bar chart from collected data, such as from market research. This data may be collected in a tally chart.



The figure represents a typical bar chart which shows the profit levels for a company over a four year period. From this graph we can easily deduce that the profit level remained almost constant over the first three years but rose to the highest level in year four.

#### Pictograms:

A pictogram is another form of a chart. It presents data in a similar way to bar charts. The difference is that data are presented by pictorial symbols and not bars.

#### Histogram:

Histograms look similar to a bar chart but there are few differences. In a histogram it is the area which represents the frequency whereas in a bar chart it is the length or height of the bars. Histogram is used for grouped data, for example the number of people between the ages of 0 and 9.

Other forms of visual presentation includes, tables, line graphs, frequency curves, maps, etc...

### 3.3 The marketing mix

#### The elements of the marketing mix (the 4ps)

##### The 4Ps: product, price, promotion, place (distribution channels):

Marketing mix includes all the variables that go into marketing a product or service. These variables are summarised as the 4Ps.

##### Product:

This applies to the product itself, i.e., the design of the product, the quality, what stage of the plc it is at, the type of packaging to be used etc.

##### Price:

This includes determining an appropriate price of the product at which the product should be sold. This is done by considering different factors specially the price elasticity of demand.

##### Promotion:

This is how the product is being advertised and promoted. Deals with the type of advertising media that has to be used and the sales promotion techniques to be applied.

#### **Place:**

This refers to the channels of distribution that are adopted by the company. Relates to the decisions to be taken whether the product will be sold directly to the consumers or through retailers, selection of the most appropriate location, etc

### **The role of the customer (the 4cs)**

**The relationship between the customer and the business (the 4Cs): customer solution, cost to customer, communication with customer, convenience to customer**

**Ways in which customer relations can be improved**

**How the 4Cs relate to the 4Ps**

**The role of the customer (the 4Cs)**

The concept of Marketing Mix was developed by McCarthy about half a century ago. More progressive marketing experts have observed that 80% of the newly launched products every year fail to produce the desired results. That is why the 4Ps are being replaced by the 4 Cs model, representing "customer solution", "cost to customer", "communication with customer" and "convenience to customer".

#### **Consumer wants and needs (vs. Products):**

One cannot simply develop products and then try to sell them to a mass market. You have to study consumer wants and needs and then attract consumers one by one with something each one wants. In most cases, manufacturers have to find out what people want and then "build" it for them, their way.

#### **Cost to satisfy (vs. Price):**

Producers have to realise that price - measured in monetary terms - is one part of the cost to satisfy. The seller of burgers, for example, has to consider the cost of driving to the restaurant, the cost of conscience of eating meat, etc. One of the most difficult places to be in the business world is the retailer selling at the lowest price. If you rely strictly on price to compete, you are vulnerable to competition - in the long term.

#### **Convenience to buy (vs. Place):**

You must think of convenience to buy instead of place. You have to know how each subset of the market prefers to buy - on the Internet, from a catalogue, on the phone, using credit cards, etc. Lands End clothing, Amazon Books and Dell Computers are just a few businesses that do very well over the Internet.

#### **Communication (vs. Promotion):**

One must consider communication instead of promotion. Promotion is somewhat manipulative since it is from the seller. Communication, on the other hand, involves a "give and take" between the buyer and seller. The seller needs to be creative and make advertising "interactive" through the use of phone numbers, web site address, etc. He must understand why customers are "with" him. Developing a brand takes into account these considerations. Developing a brand is developing a promise. When a producer or seller takes into consideration the "4 C's" noted above, he begins the process of developing a brand.

It is evident that the 4Cs model is more consumer-oriented and fits better in the movement from mass marketing to niche marketing.

### **Product**

**Goods, services and products that are a blend of both**

**Recognising the product as a bundle of tangible and intangible attributes**

**(Discussed under Section 1)**

**Importance of product development**

**(Discussed under 3a1.4 "MARKETING PLANNING")**



## Types of pricing strategies

### Use and value of alternative pricing strategies including competitive, penetration, skimming, price discrimination, cost-based pricing:

There are various factors that the business should keep in mind when deciding an appropriate pricing strategy for the product. Sometimes they may charge what they think the consumer will pay, or charge what their competitor is charging etc...

The following pricing strategies might be used by the business for its products:

#### Cost-plus pricing strategy:

Involves estimating the cost of manufacturing a product and then adding a percentage mark-up for profit. This method is useful and easy to apply but not if the price is a lot higher than the competitors.

#### For example:

the cost of manufacturing a bar of chocolate is \$10. If a company wishes to earn a profit of 50% then they will have to first calculate what 50% of \$10 is, by

$$10 \times \frac{50}{100} = 5$$

So the price charged should be  $10 + 5 = \$15$ .

#### Penetration pricing:

Is when the price is set lower than its competitors in order to be able to enter a new market. This method ensures a high level of sales but the revenue might not be that much due to low price.

#### Skimming pricing:

In this technique a higher price is set when the product is being launched in the market. This might be for a new invention or for a product on which a lot of money has been spent for research and development. This normally targets the higher income group or people belonging to the egoistic side.

#### Price discrimination:

Price discrimination takes place in markets where it is possible to charge different groups of customers, different prices for the same product.

#### Competitive pricing:

This includes charging a price of the product in line with its competitors. This enables the sales to be high as your price is at a realistic level and the product is not over-priced or under-priced. This might be a costly affair as research has to be done as to what your competitors are charging.

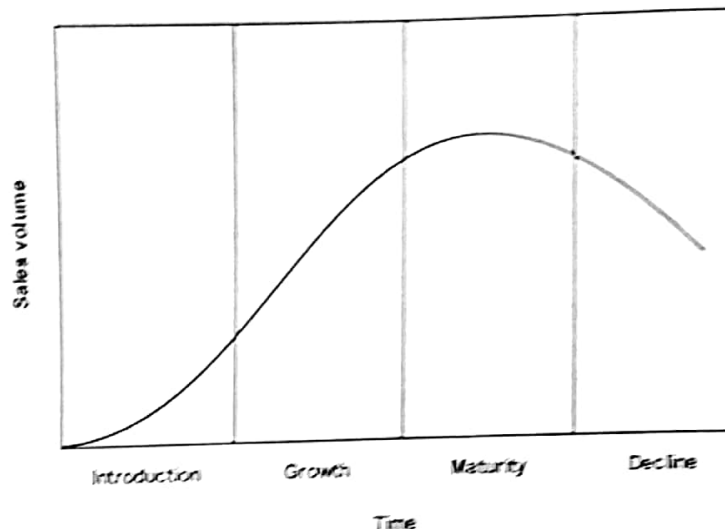
## Product life cycle

### How Product Life Cycle stage influences marketing activities

#### Decisions about extension strategies

Various stages through which a product passes during its lifetime are technically termed as the product life-cycle.

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Typically, it includes **introduction, growth, maturity and decline**. The time period involved varies from product to product, ranging from months to centuries (Coke was launched back in 1886). The following characteristics and strategies are associated with different stages.

#### Introduction:

This is often considered to be the riskiest and the most critical stage in the product life-cycle. There are numerous teething problems to be tackled which may lead to the collapse of a new product at an early stage. Tough competition, lack of relevant knowledge and experience, unfavourable government laws and unpredictable consumer behaviour are a few issues that must be taken seriously by a company, specially at the introductory stage. Sales are low in relation to costs. Profit is usually non-existent and, typically, businesses pursue the objective of **survival** at this stage. It is important for a business to use aggressive advertising as the product is launched, in order to ensure that primary demand is created. **Informative advertising**, an advertising technique in which all the salient features of a product are highlighted so that it can be introduced to the customers effectively, is recommended at the introductory stage. This should be coupled with an appropriate pricing strategy so that a positive consumer response can be triggered. As discussed above, a **skimming** strategy for luxury items and a **penetration** strategy for fast moving consumer goods (FMCG) can lead to desired results at this stage of the product life-cycle.

#### Growth:

This stage is characterised by an increase in the market share due to a favourable response of the customers towards the product. Now the company is in a position to enjoy economies of scale since the rise in the level of production and sales would lead to a reduction in average costs. Profits indicate an upward trend and product has managed to find a foot-hold in the new market. It is very important for a manufacturer at this stage not to compromise the quality factor. There have been numerous cases in the past when the initial success of a particular product led the manufacturers to believe that they could possibly take advantage of the favourable situation and bring down the quality level to some extent in order to control costs. Such a move must be avoided, since it could easily prove to be disastrous for a business and the long-term success of the product. In case of a growing product, **persuasive** advertising proves to be highly effective. This advertising technique allows the customers to compare the features of various competing products and decide in favour of one. A suitable pricing strategy at growth could be cost-plus pricing (already discussed) for greater flexibility or competitive pricing (already discussed) in case of high competition. The manufacturer can also consider the option of widening the range of brands at the growth stage since the company is currently enjoying a good reputation in the eyes of the stakeholders.

#### Maturity:

Maturity indicates that the sales have levelled off and even though the company is generating a substantial amount of funds and profit through the sale of this product, there is no significant growth, as indicated in the diagram. There is an established brand-loyal clientele and the business is enjoying

economies of scale. However, the retardation in growth rate requires the company to adopt some concrete measures for extending the maturity stage over a long period of time. Numerous steps may be taken by a business at this stage, commonly known as the **extension strategies**. Firstly, the customers can be persuaded to increase the consumption of the product, for example, using a tooth paste thrice a day. Another extension strategy could be to suggest varied uses of the same product, for example, a cell phone can be used as a computer as well as a camera. Changing the outlook of the product, adding or removing ingredients or offering sales promotion schemes such as discounts can all be categorised as extension strategies that will enable the company to attract more customers. Moreover, **reminder** or **reinforcement** advertising proves to be useful at the maturity stage. In this technique, the target audience is reminded over and over again of the presence of an established brand in the market.

#### **Decline:**

Decline describes the alarming situation characterised by a reduction in sales, market share and profit. Customers start switching to better substitutes available in the market. Slipping sales lead to a decrease in the production level and hence a rise in the average costs. There could be two possible courses of action taken by the management at this stage. One, they may realise that further production and distribution can prove to be costly and that it is in the best interest of the business to discontinue the sale of this product in order to avoid further losses. This strategy involves clearing the existing stocks at a low price and using the recovered amount for some other productive business activity. Technically, this approach is termed as **Divesting**. The second possible way of responding to decline is to take the bull by the horns and if, the financial resources permit, make an all-out effort to recover from this decline and bring about an improvement in the position of the product in the market. In this case, companies usually modify their marketing strategy and make an effort to change the outlook of the product and focus on quality. New markets could also be explored and the launch of a new and aggressive advertising and sales promotion campaign may help achieve the desired results.

### **Price elasticity of demand**

#### **Determining price elasticity of demand and suitable prices:**

### **Promotion methods**

#### **Above the line and below the line promotion:**

Promotion includes making people aware of the existence of a particular product; to encourage people to buy that product; to demonstrate the various features of it; to create a brand image of the product so that one can differentiate it from the others. Promotional techniques can be divided into Above the Line Promotion and Below the Line Promotion.

#### **Above the line promotion includes:**

##### **ADVERTISING:**

This is the presentation and promotion of ideas, goods and services carried out with the objective of enhancing the image of the company in the eyes of the stakeholders, ultimately leading to an increase in revenue and profit. Advertising is a direct form of promotion and involves the use of media such as T.V, radio and newspapers. **Philip Kotler**, known to be the father of marketing, came up with a comprehensive theory on advertising known as the "**5 M**" approach. In his opinion, the structure of advertising is built on the following five pillars:-

(M1)

##### **Mission:**

Every business needs to define a mission or an objective before launching an advertising campaign, for example, increasing profit, overcoming competition etc. If possible, this goal should be identified in quantitative terms. It can be achieved with the help of the following three advertising techniques:-



**Informative advertising:**

This type of advertising is used for launching a new product in the market. The company makes an effort to highlight various features of the product in order to create awareness or primary demand in the market, e.g., Telenor advertising its new call rates.

**Persuasive advertising:**

It is appropriate in case of products facing intense competition. The product is advertised in a way that the customers can compare its features to the features of substitutes available in the market, e.g., Colgate versus Close up.

**Reminder/reinforcement advertising:**

Is a suitable technique for promoting products that are already well established in the market. The firm wants to ensure that the sales do not slip and therefore keeps on reminding the customers about its presence in the market, e.g., Pepsi.

**(M2)****Money:**

An **advertising budget** should be carefully prepared so that the product can be promoted effectively. The size of advertising budget depends on numerous factors such as competition, market share, stage of the product in the product life cycle and the financial position of the company.

**(M3)****Media:**

The medium used by a business for conveying a message to the target audience may be classified into electronic media such as radio and T.V, and print media like newspapers.

The medium that is selected should have a wide reach so that the message can be transmitted to the target market effectively. In other words, the number of customers exposed to an advertisement should be large. Moreover, the ability of the medium to maintain a high frequency (number of repetitions) while a product is being advertised is another desirable feature. Lastly, one must give preference to a television channel or newspaper that is capable of leaving a lasting impact on the minds of the customers. It is important to note that a company should give due consideration to factors such as target audience habits, nature of the product and cost effectiveness while choosing among major media types.

**(M4)****Message:**

This is the statement of an advertisement that reflects the viewpoint of a firm. It should be kept in mind that an advertising message should be exclusive and believable or provable at the same time.

**The following techniques are commonly used to generate a message:****Inductive technique:**

According to the method, the company should carry out a survey of the potential customers before launching an advertising campaign and prepare a message in the light of their suggestions.

**Deductive technique:**

The experts who are in favour of using this technique are of the opinion that a typical market can be divided into the following four categories of customers:-

**Rational customers:**

These are the customers who have a logical approach and always take decisions on the basis of facts and figures. Such customers can be convinced to buy a product with the help of a message that contains factual and relevant information, for example; presence of Vitamin C in an energy drink.

**Sensory customers:**

A large number of customers have a sensory or sentimental approach to decision making. They will be persuaded to purchase a product with the help of a message that has a touch of emotion in it. For example, Mc Donald's focuses on the pleasures of family togetherness in its advertising campaign.

**Social customers:**

There is a certain category of customers who intend to do something good for the society in general. Such customers can be convinced to buy a product if the company conveys a message that a certain proportion of sales will be donated to some charitable institution. Unilever has adopted this strategy successfully and has experienced an increase in the sales volume of their cooking oil.

**Egoistic customer:**

These are the status conscious people who want to be a part of an exclusive class belonging to the higher income group. They will be inclined towards an expensive luxury item if their ego is boosted with the help of an appropriate ad, for instance, advertisements for personal aircraft, customised cars, priority banking, etc. attract egoistic customers.

(M5)

**Measurement:**

As a final step, the success or the effectiveness of an advertising campaign has to be measured. This is important in determining whether to continue with a particular ad or not. The following two techniques are used in this context:-

**Communication effect research:**

This is a technique which is based on the feedback received from the customers regarding the quality of an ad or a product. However, this technique may not reflect the true picture and it is not advisable to rely on the results of communication effect research entirely.

**Sales effect research:**

This method proves to be very helpful in measuring the impact of an advertisement. It is based on the fluctuation in the level of sales before and after an advertisement is launched. A positive change in the number of units sold signifies that the ad has been effective enough.

**Below the line promotion:**

This includes all promotional techniques, other than advertising, applied by a company with the objective of improving sales. These sales promotion methods give a customer some incentive to buy the product. Business organisations use a variety of sales promotion techniques/schemes for enhancing their performance. Most of these schemes are quite useful in adding significantly to the sales volume. These include money back guarantee, scratch cards, lucky draws, clearance sales, buy two get one free, etc.

**Types of packaging:**

Packaging is the container or wrapper used for carrying or containing the product in order to make it more convenient and presentable for the customers. It can be classified into:-

**Primary packaging:**

This type of packaging is used to carry a product right after it is manufactured, for example, the plastic tube carrying the tooth paste.

**Secondary packaging:**

The container that carries the primary package, cardboard box in this case, is known as the secondary package.

**Shipment packaging:**

Refers to the huge cartons used for carrying the secondary package in bulk from the production plant to the wholesalers and retailers.

Packaging plays a key role in determining the success or failure of the product. The following factors add to the importance of packaging.

**1) Promotion:**

Packaging can be used as an effective tool to promote the sale of a product. It attracts the customers since they generally link the quality of the packaging with the quality of the product itself. That is why the

Industry involved in the manufacturing of perfumes is known to spend almost 50% of their budget on bottling (packaging).

## 2) Convenience:

Packaging adds a touch of convenience to the lifestyle of the customers. It assists them in purchasing the product from an outlet and carrying it conveniently to the place where it has to be consumed.

## 3) Protection:

Specially designed packaging material is widely used by manufacturers, enabling them to present the product to the end user in a safe and secured manner. This factor is specially applicable in case of sensitive or fragile items including electronics, food stuffs, glass wear etc. This not only protects the product against any possible damage but also enhances the period of useful life.

## 4) Information:

Relevant and useful information is passed onto the customers with the help of the data printed on the primary or secondary package. The customers can benefit from the information involving the list of ingredients, expiry date etc., and take a rational purchasing decision.

In case of some products the company is legally bound to provide specific information to the customers so that they can make logical decision regarding the purchase of a certain product. In Muslim countries the word "HALAL" has to be mentioned on every food item.

## 5) Environmental factor:

There are a number of organisations working for the conservation of the environment, for example, the Green Peace movement. Such associations act as a pressure group and enforce the business sector to adopt precautionary measures for the preservation of the environment. In certain countries there has been a proper legislation against the use of products causing pollution. Therefore, a business needs to take this factor into account when selecting a material for packaging. An effort is made to use environment friendly packaging material such as paper bags instead of polythene bags so that the image of the company is enhanced.

## Branding as part of product/promotion

**Brand name** is the unique name of the product that distinguishes it from other brands. Businesses use branding as a way of promoting their products as it leads to **brand loyalty**. This is when consumers keep buying the same brand again and again instead of choosing a competitor's brand. Branded products are generally considered to be of superior quality as compared to unbranded products. This way a **brand image** is created which gives the product an identity of its own and distinguishes it from its competitor's brands.

## Channels of distribution

### Choosing between alternative types of channel of distribution

Channel of distribution is the route by which a product is passed from the point of production to the point of consumption. This includes:

#### Zero level channel:

In this case, a product is directly passed from the manufacturer to the consumer. This type of distribution is applicable in case of agricultural items or food stuff, products that are non-durable in nature. They have to be sold to the consumers directly and swiftly since they have limited shelf life.

#### Single level channel:

This includes passing down of the product from the manufacturer to the retailer who then displays them in the retail outlets and sells them to the final consumers. This is applicable in case of products that are expensive such as jewellery.



### Dual level channel:

This requires the manufacturer to sell the product in bulk to the wholesaler who then performs the function of **breaking bulk**. The wholesaler divides the product in small quantities and supplies them to the retailer who then makes them accessible to the consumer.

### Multi level channel:

This channel requires the use of an **agent**. An agent is an independent person or business that is appointed to deal with the sales and distribution of the product. The agent will charge a commission for his services or keep a high final price of the product. This is typically used in case of products being sold through the export market. The agent sells the product on behalf of the company as he will be aware of the local conditions of that country.

### Types of distribution:

#### Intensive distribution:

It is a distribution strategy in which an organisation relies on a large number of intermediaries for the distribution of its products. It is especially applicable in case of commonly used consumer non-durables or FMCG (fast moving consumer goods) that need to be supplied to different parts of a city, for example, soft drinks, tooth paste etc...

#### Selective distribution:

It requires the services of a few distributors who are responsible for making a product available on a regional basis. It proves to be useful in distributing expensive products such as electronics.

#### Exclusive distribution:

Branded products are made available to a limited clientele with the help of exclusive agents who have the license of selling the product. Normally a single dealer looks after the sale and distribution of a particular luxury item in one city or country, e.g., Rolex or Mercedes.

## Using the internet for the 4ps/4cs

### Online advertising catalogues, sales, dynamic pricing, distribution (download of digital products) Using the internet for the 4Ps/4Cs

The Internet has given us a new way of looking at business. Experts recently came up with a new set of 4 Ps to describe the unique challenges of Internet Marketing - Positioning, Permission, Partnership, and Performance. The old saying in real estate is location, location, location. For websites, it's **positioning**, positioning, positioning. Whatever marketing method one decides to use, one needs to make sure one's getting good positioning from it. For example, if a business uses "**banner ads**" or "**text links**" for promoting its products, it is essential they are on relevant sites and visible and enticing to the target audience. If you don't have good positioning, you are not going to get any real benefit from the time you put into promoting your site. According to almost every big name in Internet Marketing, people who have given you **permission** to market to them are many times more valuable than people who you try to force your product on to. If you can run a newsletter for your visitors, that's a very good idea. Otherwise, the key idea here is to establish people's trust before you try and sell them stuff. Just throwing up links on your front page and expecting your visitors to follow them is a long shot (that said, it works if you're getting a large enough volume of cheap / free visitors). Show your visitors that you know what you are talking about, give them what they want, then they will be happy to sign up for the sites you suggest. Working together is a great way to get things done. It's been true since the first primitive animals started hunting in packs, and it will be true long into the future. However, **partnership** can also be a recipe for disaster. Almost everything you do on the Internet, from things as small as exchanging links to as large as a complete merger of two businesses is a partnership. Selecting who to partner with is an art rather than a science. The most important question I ask is "**do I feel I can trust them?**" if the trust is there, then it's a matter of working out how best to benefit each other. Partnership opportunities are everywhere on the Internet, from promoting someone's product in return for an affiliate commission, to using other people's newsletter lists, or running a free-roll poker tournament in conjunction with other portals, you're limited only by your imagination. The important thing to remember though is that no matter how tempting the offer, the trust factor must not be overlooked. Measuring your **performance** is important for just about

any business. It's about knowing what works and what doesn't, about knowing where your visitors come from, what they do on your site, and where they go from it (hopefully to sign up for a partner's website). It's about knowing which of your partners and which banners are converting best for your traffic. Internet businesspeople are perhaps the only people more obsessed with statistics than baseball fans. Sure, you can run your business without statistics, but that's like saying you can drive a car with a blindfold on.

## MARKETING PLANNING ELASTICITY

**Income elasticity, promotional elasticity, cross elasticity; usefulness of the concept of elasticity in its various forms**

Price elasticity of demand is the responsiveness of demand to a change in price. If the increase in quantity demanded is more than proportionate in response to a change in price, it is said to be elastic and if there is no substantial change in demand, it is said to be inelastic.

$$PED = \frac{\text{percentage change in quantity demanded}}{\text{percentage change in price}}$$

**Specimen numerical:**

The demand for a product changes from 75,000 units to 90,000 units due to a change in price from \$8 to \$7. Calculate the elasticity of demand and comment on the nature of elasticity.

$$\frac{15000}{75000} \times 100$$

$$\frac{1}{8} \times 100$$

$$\frac{20}{12.5} \times 1.6$$

If the E.O.D. is greater than 1, it is said to be elastic.

If it is less than 1, it is said to be inelastic.

If it is equal to 1, it is said to be unitary elastic.

So, in this case the elasticity of demand is elastic, meaning that a change in price will lead to a more than proportionate change in demand for the product.

**Cross elasticity of demand** is the responsiveness of demand of one product to a change in price of another.

$$\frac{\% \text{ change in quantity demanded of product A}}{\% \text{ change in price of product B}}$$

If the answer is positive then the products are considered to be substitutes but if the answer is negative then the products are said to be complementary.

**Promotional elasticity** of demand is the responsiveness of demand to a change in promotional spending.

$$\frac{\% \text{ change in quantity demanded}}{\% \text{ Change in promotional spending}}$$

**Income elasticity of demand** is the responsiveness of demand to a change in income.

## Product development

- Product development as a process from original conception to launch and beyond
- Sources of new ideas for product development
- The importance of product development

A new product is defined as a new invention or an improved version of an existing product. Companies spend a large amount of money on research and development so that the process of new product

development can be carried out swiftly. It is an essential step for every firm that wants to overcome competition and widen its customer base. The following steps should be taken by the company in order to develop a new product and introduce it in the market:-

**Idea generation:**

A variety of sources are used by the business organisation for the generation of new ideas. It may include employees, media, customer feedback, competitor's reports etc. An effective idea is responsible for the success of the project in the long run. That is why companies take the issue of idea generation seriously and even reward the employees if they come up with a new idea that can be implemented by the firm.

**Idea screening:**

An idea committee is formed with the purpose of conducting an analysis of all the ideas that have been generated through different sources. This committee comprises of a few experienced employees with relevant skills. It is responsible for avoiding any "go" or "drop" errors. A "go-error" is the term used for a mistake due to which an idea is implemented that proves to be disastrous in the long run. Similarly a "drop error" may also have a negative impact on the ability of a business to achieve its goals. It shows a situation in which a potentially good idea is turned down or rejected. The same idea may be implemented by another company successfully.

**Concept development and testing:**

At this stage the company makes an effort to prepare a detailed program for manufacturing and launching the product. A concept is a factual detailed version of the idea that was generated previously. The firm finalises various aspects of the product development including the identification of target market, quantity, quality etc... All the departments participate in the process of concept development and a series of tests is also conducted for evaluating the feasibility of this concept.

**Business analysis:**

The finance department handles all the affairs relating to the availability and usage of funds. The finance manager estimates costs, expected return etc. It advises other departments on monetary issues and allocates funds according to the requirements of each section. The role of finance department is of immense importance since it is the foundation for all business activities and determines the profitability of a proposed project.

**Marketing strategy development:**

It is not possible for a firm to achieve success without a proper promotional strategy. An effective marketing campaign is the key to success for a firm that is operating in a competitive environment. Decisions regarding the use of media and sales promotion techniques are finalised at this stage. The firm should be able to analyse the pros and cons of different marketing strategies and adopt a policy which is in the best interest of the organisation. Availability of funds as well as the nature of the product are the key factors determining the advertising strategy.

**Prototype development:**

Once the firm has completed all the paper work, an actual sample has to be developed and tested for all practical purposes. This sample is technically termed as a prototype and is similar to the product which will be offered to the customers eventually. The prototype is tested with the help of the customer feedback or actual lab tests may also be carried out to judge whether the product meets the quality standards or not.

**Market testing:**

The final product should be launched in a limited area to a selected market segment initially. It is advisable for any firm since it provides the firm with an opportunity to judge market response. The management can decide to modify a particular product in case some defects are detected and the customers do not respond positively towards the product.

**Commercialisation:**

At this stage the company is prepared to go all out and launch the product with the help of an aggressive distribution strategy. It will make every possible effort to target as many customers as possible and create



a substantial primary demand for the product. It will enable the firm to overcome competition and widen its profit margin.

- Promotional campaigns
- Applying the ideas of AIDA and DAGMAR in choosing a promotional campaign

### AIDA/DAGMAR MODELS:

Businesses sometimes use certain models to develop an effective promotional strategy. "AIDA" suggests that advertising should raise awareness and encourage interest, desire and awareness in order to persuade the customers to buy a particular product. The "DAGMAR" (defining advertising goals for measured advertising results) model is also used to measure the effect of advertising. A business can measure how far the group that is targeted has progressed along a scale of unawareness, awareness, comprehension, conviction and action, as a result of advertising.

- Forecasting
- The need to forecast marketing data
- Calculation and use of moving average method to forecast sales

## FORECASTING

The term represents a blend of techniques adopted by a business for predicting the micro and macro environmental changes that may have an impact on its performance in the future. Forecasting is applicable in case of a host of variables such as sales, profit, costs, government policies, target audience habits etc. The basic objective is to minimise the risk factor associated with future investments and make appropriate and timely arrangements accordingly. This would ultimately improve probability of success for the proposed ventures. Forecasting can broadly be classified into qualitative and quantitative techniques. Qualitative methods are used in situations where data is inadequate or not available at all. Quantitative techniques are recommended when the company has an access to sufficient amount of data that can be utilised in making calculations.

### Qualitative forecasting:

#### Personal insight:

This is a simple but risky forecasting technique based on the personal judgment or opinion of an individual. One simply highlights the anticipated trend without presenting any supporting evidence or justification.

#### Panel consensus:

This is when a group of experts comments on the expected trends. The panelists exchange views on a particular issue and try to reach an agreement regarding a suitable business strategy for proposed projects.

#### Delphi method:

This forecasting technique is quite similar to the panel consensus with the only difference that the experts in this case express their opinion and record their findings independently, and share their observation afterwards with the other panellists. This is a more realistic approach and ensures that more ideas are generated and one does not get influenced or dominated by others easily, which might be the case in panel consensus.

#### Historical analogy:

The term refers to a comparative analysis involving the current situation and similar events that have taken place in the past. The concerned department can forecast the future trend by giving due importance to past experience. This often proves to be effective in case of seasonal products.

#### Market survey:

Observational market research may also be carried out for developing a strategy in accordance with the ongoing trends. A market survey could be highly effective in determining the expected fluctuation in prices, design, distribution and the overall purchasing pattern of customers.

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www.

## Quantitative forecasting

### Causal method:

An experienced and observant market research specialist knows how to establish a link between the cause and effect of an activity in order to highlight the anticipated trends more accurately. For instance, the rise in income is an indicator of an increase in the demand for luxury items.

### b) Time Series Analysis (Moving Averages):

Time Series Analysis or the Moving Averages technique always gives the business an access to updated or latest information. As soon as there is a new development, it is recorded immediately, facilitating the management in taking rational and timely decisions. Practically, the Moving Averages technique is very commonly applied in case of the stock exchange where the figures fluctuate after very short intervals. The phenomenon is elaborated in the following schedule.

TIME	PRODUCTION	MOVING TOTAL	MOVING AVERAGE	CENTERED MOVING AVERAGE	VARIANCE
Q1	35				
Q2	42	166	41.5	45.125	-6.125
Q3	39	195	48.75		
Q4	50	214	53.5	51.125	-1.125
Q5	64				
Q6	61				

### Extrapolation:

Extrapolation, an easy-to-apply forecasting technique, is simply based on the assumption that the on-going trend will continue in the future also.

### Importance of research and development:

**Research** is the discovery and inquiry of new ideas in order to solve a problem or create an opportunity, whereas **Development** involves changing ideas into commercial products. All businesses cannot afford research and development, but those who can, are able to reap a number of advantages. These include the production of new products, new materials, new machines can also be developed. It is often argued that expenditure on R&D is used to enhance company's image. Investment in R&D creates opportunities for creativity and invention. A successful R&D department generates a mood of optimism and anticipation in the organization. This has a positive effect on the motivation of the staff. The amount of money allocated to R&D by different businesses varies greatly. The size of the R&D budget depends on the number of factors.

### Nature of the industry:

Certain industries such as pharmaceuticals, computers and defense tend to have a high R&DD budget due to the nature of the industry.

### Availability of funds:

It is common for the firms to vary their investment according to the funds available in any year. If profit falls for a period of time, R&D spending might fall.

### Larger establishments:

Larger public limited companies tend to be more committed to R&D. They are better able to meet the cost and bear the risk involved than smaller businesses.

### Competition:

Some businesses are forced to invest in R&D to compete. Failure to keep pace with the investment of rivals may mean that a business struggles to survive in the market.

### Globalization and international marketing:

Globalization is the trend towards free international trade and free movement of capital between nations. This results in the growth of multinational corporations that seek the widest markets for their uniform products and the cheapest locations for the production.

## RELEVANT QUESTIONS FROM PAST PAPERS (SECTION 3)

**May/June 2013, P1, Q2,**

- 2 (a) Define the term 'random sampling'. [2]
- (b) Briefly explain **two** advantages of using quota sampling. [3]

**M/J 13, P2, (a) (Regal Restaurants)**

- 1 (a) Explain the following terms:
  - (i) corporate responsibility (line 15) [3]
  - (ii) above the line promotion (line 20). [3]

**OCT/NOV 2009 P1: Q2, Q7.**

- 2 (a) Define the term 'market segmentation'. [2]
- (b) Briefly explain **two** methods of market segmentation. [3]
- 7 (a) Explain **two** methods that might be used for the visual presentation of business information. [8]
- (b) A manufacturer of soft drinks wants information about customer needs and preferences. Discuss how this information might be collected. [12]

**OCT/NOV 2009: PAPER 2, PHONEQUIP, a (i), PEDRO'S FISH, a (i),**

- 1 (a) Explain the following terms:
  - (i) market segmentation (line 2) [3]
- 2 (a) Explain the following terms:
  - (i) market price (line 4) [3]

**OCT/NOV 2009: PAPER 3, CHAN BEAUTY COMPANY, Q5.**

- 5 Assume Option 1, the market development option, is chosen. Discuss the important features of a marketing plan for a successful launch in your country of the ethical beauty products. [16]

**MAY/JUNE 2009: PAPER, 1 Q1.**

- 1 (a) State the main difference between a skimming pricing strategy and a penetration pricing strategy. [2]
- (b) Briefly explain why a business might choose to use a skimming pricing strategy. [3]

**MAY/JUNE 2009: PAPER 2, BOB'S BAND, Q1(d), CHEAPO AIR, Q2a (ii) and Q2(c),**

- 1 (d) Discuss the factors that FB need to consider in promoting the concert. [10]
- 2 (a) Explain the following terms:
  - (ii) price inelastic (line 12). [3]
- (c) Analyse the factors that CA would need to consider in setting a price for their business customers. [8]

**MAY/JUNE 2009: PAPER 3, CAR MANUFACTURER AT A CROSSROADS, Q3, Q6.**

- 3 To what extent do you agree with the Chief Executive when he states that 'Research and Development spending always creates innovative products and increases profits'? (lines 58-59) [16]
- 6 In your opinion, should EM go ahead with the plan to start producing luxury and sports cars for sale in new market segments? Justify your decision. [20]

**OCT/NOV 2008: PAPER 2, PAPERCLIPS, Q1a(ii) and (c). CC COSMETICS, Q2a(i), b.**

- 1 (a) Explain the terms:
  - (ii) Market research (line 20). [3]
- (c) Advise Ling on the factors that she will need to consider in recommending a marketing mix for PC. [10]
- 2 (a) Explain the terms:
  - (i) Mass marketing (lines 26-27) [3]
- (b) (i) Using Table 4, calculate the price elasticity of demand for CC's main product. [2]



- (ii) The price elasticity of demand for their main competitor is 1.2. How might CC use this information on elasticity and your answer in (b)(i) when deciding on their marketing mix? [4]

**OCT/NOV 2008: PAPER 3, TANROH'S DILEMMA, Q4.**

- 4 Recommend to Tanroh a possible marketing strategy for the safari lodge project. Fully justify your recommendation. [16]

**MAY/JUNE 2008: PAPER, 1 Q7,**

- 7 (a) Explain how the product life cycle might be used by the finance manager of a business. [8]  
(b) Discuss how and why promotional activity might change at different stages of a product's life cycle. [12]

**MAY/JUNE 2008: PAPER 2, EAST FARM WILDLIFE PARK, Q1(c), d(ii). GANMOR CARS, Q2(d).**

- 1 (c) Identify information that EFWP needs to collect before it can make a decision about the expansion. [4]  
(d) (ii) Assume that the information collected shows a market for the new development. Using Table 1 and other information, advise EFWP on whether to go ahead with Sue's expansion plans. [8]  
2 (d) Discuss the factors that would influence GC's choice of a marketing mix. [10]

**MAY/JUNE 2008: PAPER 3, PYRAMID TELEVISIONS, Q1(b), Q4.**

- 1 (b) Assess the advantages and disadvantages to the Research and Development department of changing the organisational structure of the business. [10]  
4 (a) Using the data in Appendix A calculate, for both PT and its major competitor, the:  
(i) Income elasticity of demand  
(ii) Promotion elasticity of demand. [8]  
(b) Discuss possible changes to PT's future marketing strategy based on these results and other information in the case. [14]

**OCT/NOV 2007: PAPER 1, Q2.**

- 2 (a) Other than price, outline one factor which could cause an increase in the demand for mobile phones. [2]  
(b) A business sells a product whose demand is relatively price inelastic. Explain the effect on sales and revenue of a price increase. [3]

**OCT/NOV 2007: PAPER 2, EXCELLENT TRAINING Q2(c),**

- 2 (c) Discuss the factors that ET will need to consider when marketing their courses to schools and colleges. [10]

**OCT/NOV 2007: PAPER 3, CURRY CUISINE, Q7.**

- 7 Assume that Chas and Ling decide to go ahead with the "ready made meals" proposal. Evaluate the arguments for and against developing a marketing plan for this project. [20]

**MAY/JUNE 2007: PAPER 1, Q7.**

- 7 (a) Outline the main determinants of demand for consumer goods in your country. [8]  
(b) Discuss how a clothes retailer might segment the market for its goods. [12]

**MAY/JUNE 2007: PAPER 2, TECH NEW, Q1(c).**

- 1 (c) Discuss the marketing and other factors that Tariq should consider before deciding whether to sell components on the Internet. [10]

**MAY/JUNE 2007: PAPER 3, CRAFT DESIGNS, Q(5).**

- 5 Evaluate the importance to Craft Designs of effective market segmentation in the tourist gift market. [14]

**OCT/NOV 2006: PAPER 1, Q5,**

- 5 (a) Explain the importance of a market-orientated approach for a business in the consumer goods market. [8]  
 (b) Evaluate the pricing strategies a business might use when launching a new product. [12]

**OCT/NOV 2006: PAPER 2, HILLTOP SERVICES, Q1 b, d. ELDORADO RESTAURANTS, Q2(d),**

- 1 (b) (i) Using data from the case calculate the price elasticity of demand for Farad's sales of petrol. [3]  
 (ii) Comment on your answer to (b)(i). [3]  
 (d) Recommend changes to the current marketing mix that might be needed for the restaurant at the international airport. Justify your answer. [10]

**OCT/NOV 2006: PAPER 3, LOCOST AIRWAYS, Q5.**

- 5 Gavin suggested taking the airline "up market" to a different market segment. To what extent do you agree with him that "the most important change we need to make to our marketing strategy to guarantee success is more promotion"? (lines 51-52) [14]

**MAY/JUNE 2006: PAPER 1, Q4, Q7(b),**

- 4 (a) Briefly distinguish between primary and secondary market research. [2]  
 (b) Explain why a business might use quota sampling in market research. [3]  
 7 (b) Discuss how a computer manufacturer might choose between different channels of distribution in a new export market. [12]

**MAY/JUNE 2006: PAPER 3, RAVE CONFECTIONERY, Q1 (a), Q6.**

- 1 (a) Assess the usefulness of market research methods, other than those referred to in the case, that Rave could use before deciding whether to launch "Fruit Choc Delight". [10]  
 (b) Using Appendix B and other information, evaluate the usefulness of product portfolio analysis techniques, such as the Boston Matrix, to Rave. [12]

**MAY/JUNE 2005: PAPER 1, Q7,**

- 7 (a) Analyse how a soft drinks manufacturer might segment the market for its products. [8]  
 (b) Discuss the most suitable methods of market research for a new product being developed by a soft drinks manufacturer. [12]

**MAY/JUNE 2005: PAPER 2, MATPACK PACKAGING PLC, Q1(c), OUR NEW LTD, Q2a(i), b(ii).**

- 1 (c) Analyse the marketing factors that MPP should consider when launching the new product. [8]  
 2 (a) Explain the following terms:  
 (i) secondary market research (line 5) [3]  
 (b) (ii) Outline additional market information Our News Ltd would find useful before taking the decision to produce the monthly magazine. [4]

**MAY/JUNE 2005: PAPER 3, WOTTON COLLEGE, Q5.**

- 5 Assume that the new building is constructed. Evaluate a marketing plan that Paula could introduce to attract new students to Wotton College. [16]

**OCT/NOV 2005: PAPER 1, Q1,**

- 1 (a) State two reasons why the market for a product might reduce in size. [2]

- (b) Distinguish between market size and market share. [3]

OCT/NOV 2005: PAPER 2, THE READ AND LEARN BOOKSHOP, Q1b, (d),

- 1 (b) (i) Calculate the price elasticity of demand for travel books between 2002 and 2004. [4]  
(ii) Briefly explain the significance of your result for (i). [2]  
(d) Using Table 1, evaluate the usefulness of the Product Life Cycle to Sophia when deciding on the future product mix of her business. [10]

OCT/NOV 2005: PAPER 3, MERCADO PLC, Q4(b).

- 4 (b) Evaluate the marketing factors that could influence the sales success of the new phone. [12]

OCT/NOV 2004: PAPER 1, Q3 AND Q7.

- 3 (a) State two different ways in which the size of a business might be measured. [2]  
(b) Briefly distinguish between niche and mass marketing. [3]  
7 (a) Examine the factors which determine how businesses price their products. [8]  
(b) Discuss how other elements of the marketing mix might be affected by a business' pricing decisions. [12]

OCT/NOV 2004: PAPER 2, RITEON CLOTHES LTD, Q2 (c) and Q2 (d).

- 2 (c) Discuss sources of information that might help Jennifer to make a decision about whether to enter the fashion market. [8]  
(d) Assuming Riteon decides to enter the fashion market, evaluate a possible marketing strategy the company could use. [10]

MAY/JUNE 2004: PAPER 1, Q2, Q7,

- 2 (a) Define the term 'price elasticity of demand'. [2]  
(b) Explain one determinant of demand for a product other than price. [3]  
7 (a) Discuss how and why promotional activity might change at different stages of a product's life cycle. [12]  
(b) Why might an understanding of the product life cycle be important for business finance managers? [8]

MAY/JUNE 2004: PAPER 2, LASTING MEMORIES, Q2(d).

- 2 (d) Examine the marketing difficulties that Ahmed and Beatrice might have if they expand into export markets. [10]

MAY/JUNE 2004: PAPER 3, DECISION TIME AT TOPAZ, c(ii).

- (c) (ii) Suggest and evaluate a strategy for marketing these toys in your own country. [12]

MAY/JUNE 2003: PAPER 1, Q6,

- 6 (a) Evaluate two different pricing strategies which a consumer goods manufacturer might adopt. [12]  
(b) How might pricing decisions be influenced by knowledge of the Product Life Cycle? [8]

MAY/JUNE 2003: PAPER 2, FURNITURE MAKER, Q1, (d), TEE BUSINESS, Q2, b(ii) and b(iii) and (d).

- 1 (d) (i) Calculate the forecasted market share of The Furniture Maker for 2003. [2]  
(ii) Discuss the possible reaction of TFM's management team to an increase in the level of competition. [10]  
(b) (ii) Calculate the price elasticity of demand, following the price decrease from \$20 to \$18. [3]  
(iii) Comment briefly on your answer to (b)(ii). [2]  
(d) Discuss the possible reaction of the sales team to the new incentive scheme. [10]

MAY/JUNE 2003: PAPER 3, FAST FOOD FRANCHISE, (d).

- d) (i) Suggest two reasons why the bank manager considered the market research



- undertaken by Rashid and Shivani to be inadequate. [2]  
 (ii) Advise Rashid and Shivani how they might conduct further market research. [8]

**OCT/NOV 2003:PAPER 1 Q2, Q5(b).**

- 2 Outline how the market for soft drinks might be segmented in your country. [5]  
 5 (b) Discuss how an exporter of consumer goods might choose between different channels of distribution in a new overseas market. [12]

**OCT/NOV 2003:PAPER 2, ROUND PLC, Q1 a(ii), AKSHAY COMPANY, Q2 (b),**

- (a) Define the following terms:  
 (i) plc (public limited company) (line 1) [3]  
 2 (b) (i) Outline a suitable method of sampling for TAC. [3]  
 (ii) Explain whether secondary data might be useful to TAC in researching the market. [3]

**OCT/NOV 2003:PAPER 3,ORIENTAL ENGINEERING LTD, b (ii).**

- (b) (ii) The marketing manager needs to decide on the price for the Autotrak. Advise the marketing manager on an appropriate pricing strategy for this new product. [10]

**OCT/NOV 2002:PAPER 1 Q2, Q7(b).**

- 2 (a) Explain why successful businesses are usually market-orientated. [2]  
 (b) Why is it important for a marketing manager to understand the concept of the product life cycle? [3]  
 7 (b) This business has decided to sell a new small car in your country. Discuss an appropriate marketing mix for this product. [10]

**OCT/NOV 2002:PAPER 2, TRAVELSHOP HOTEL, Q1 a(i), SOUP MAKERS, Q2 a (i).**

- 1 (a) Define the following terms:  
 (i) Expected demand (line 12) [3]  
 2 (a) Define the following terms:  
 (i) Niche market (line 6) [3]

**OCT/NOV 2002:PAPER 3,CASTLE LODGE, (e).**

- (e) Assume the owners decide to go ahead with the new conference centre. Suggest and evaluate a marketing strategy for the launch of this new centre. [12]

**MAY/JUNE 2002:PAPER 1, Q6.**

- 6 (a) Why might firms choose to undertake both primary and secondary market research before entering a new market? [10]  
 (b) Discuss how knowledge of the product life cycle is important for a business in deciding on its marketing strategy. [10]

**MAY/JUNE 2002:PAPER 2 , THE EATING SHOP,a (i) SMART TILE COMPANY, b(i), (d)**

- (a) Define the following terms:  
 (i) Penetration price strategy (lines 2–3) [3]  
 (b) (i) Using the data in the case study, calculate the price elasticity of demand for tile X. [3]  
 (d) Assume the business decides to lower its prices for all its products. Evaluate other changes to the marketing mix that The Smart Tile Company might need to adopt. [10]

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**UNIT 4**

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# **Operations And Project Management**

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A Level  
Business  
Teacher's Notes

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## **Syllabus 2016 –18**

### 4.1 The nature of operations

- Inputs, Outputs, And the transformation process
- Effectiveness, Efficiency and productivity
- Value added
- Capital versus labour intensity

### 4.2 Operations Planning

- Operations decisions
- Flexibility and innovation
- Operations methods
- Location
- Scale of operation
- Enterprise resource planning
- Capacity utilisation

### 4.3 Inventory management

- Purpose, cost and benefits of inventory
- Managing inventory

### 4.4 Capacity utilisation

### 4.5 Lean production and quality management

- Lean production
- Kaizen
- Quality control and assurance
- Benchmarking
- Total quality management

### 4.6 Project Management

- The need for projects and project management
- Network analysis/Critical path analysis/Network diagrams

## UNIT 4 OPERATIONS AND PROJECT MANAGEMENT

### 4.1 THE NATURE OF OPERATIONS

#### Inputs, outputs, and the transformation process

Production is the process of transforming inputs into outputs. The inputs take the form of capital equipment, material and human resources. Moreover, we should also mention energy, to power the process, and information, to plan and control the process. This transformation process can take one of the following four forms:

- Extraction, e.g., mining
- Analytical techniques, e.g., breaking down substances
- Fabrication, e.g., joining together (welding)
- Synthesis, e.g., creating new substances

As discussed earlier in Section 1, the factors of production of land, labour, capital and enterprise are essential to any production process.

#### Effectiveness, efficiency and productivity

The term *effectiveness* refers to the ability to choose appropriate goals and achieve them. For example, when McDonald's decided on the goal of providing breakfast service to attract more customers, the move proved to be highly effective since breakfast sales now account for almost 30% of McDonald's revenues. *Efficiency* is the ability to make best use of available resources in the process of achieving goals. Organisations are efficient when managers minimise input resources or the amount of time needed to produce a given output or service. For instance, McDonald's raised its efficiency level when it developed a fat fryer which reduces the amount of oil used in cooking by 30% and also speeds up cooking of French fries.

Productivity is the measure of the ratio of output to any of the firm's inputs, usually labour and capital. Productivity is a useful way of judging the efficiency level of a business and is further divided into:

##### Labour productivity

$$\frac{\text{Total Output}}{\text{Number of workers}} = \text{Output per worker}$$

##### Capital productivity

$$\frac{\text{Total Output}}{\text{Capital Employed}} = \text{Output per capital input}$$

Nearly all firms make an effort to increase productivity, even if the total production is not increasing. A business can do this by employing fewer but skilled workers and by using fewer but more technologically advanced machines.

#### Value added

Value added is defined as sales revenue less the value of bought-in materials and components. This process applies to manufacturing and service industries. The aim is to "add value" to the inputs that are purchased by the business so that the resulting output can be sold at a profit. It is a measure of overall company performance and shows the money available for reinvestment in the business and distribution to shareholders.

**Value added = Sales Revenue – External Expenditure**

Where external expenditure represents the value of materials and components purchased.



- The degree of value addition depends on a number of factors such as :
  - An attractive design and high quality can justify high prices charged by the manufacturer.
  - The efficiency with which the input resources are combined and managed, e.g., reduction in wastage can lead to value addition.
  - The impact of promotional strategy and whether this convinces the consumers to pay more for the product than the cost of the inputs, also determines the degree of value addition.

## Capital versus labour intensity

While deciding what combination of factors of production to use, a firm can adopt one of the two following approaches:

- *Labour-intensive techniques*, that involve using a larger proportion of labour than capital.
- *Capital-intensive techniques*, that involve employing more machinery relative to labour.
- For example, chemical production is capital-intensive with only a relatively small workforce to oversee the process. The postal service is labour-intensive with a considerable amount of sorting and delivery done by hand.
- The approach that is chosen depends on a number of factors such as:
  - The nature of product
  - Everyday products with high demand, like newspapers, are mass produced in huge plants using large quantities of machinery.
  - Relative prices of the two factors
  - If labour costs are rising, then it may be advisable for the company to employ more capital instead.
  - Size of the firm
  - As a firm grows and the scale of production increases, it tends to employ more capital relative to labour.

## 4.2 OPERATIONS PLANNING

### Operations decisions

#### The influence of technology:

The search of production methods that could combine highly important factors such as flexibility and worker satisfaction with low unit costs, have led to some important recent developments. These have been greatly aided by tremendous advances in technology. For example, CAD (Computer aided design) and CAM (Computer aided manufacturing) have allowed much quicker development of new products. These interactive computer systems are capable of generating, storing and using geometric and computer graphics. It helps engineers solve design problems. CAD and CAM techniques have led to the creation of designs that are attractive and practical at the same time. Moreover, robotic machinery, that can be switched to making a range of parts, not just one, is another product of the recent innovation in production methods. In addition, developments in the organisation of the production flow-line have reduced the alienating effects of typical mass production. This is significant since the unnecessary emphasis on repetitive boring tasks has been a major factor responsible for poor worker motivation.

### Flexibility and Innovation

The Japanese are great advocates of *flexible specialisms*. They believe that a key factor responsible for the success of a business is its ability to be flexible and innovative. The management should be capable of making necessary adjustments to its policies in order to cope up with the rapidly changing micro and macro-environment. This flexibility can take the form of:

#### Numerical flexibility:

The term describes a situation in which the size of the workforce is modified in accordance with the workload. Instead of offering long term contracts to the employees, irrespective of the increase or decrease in the amount of work being done, the management should hire or fire them purely on the basis of the effort they are required to make at a given point in time. This approach may prove to be cost-

effective in case of seasonal businesses in which there is a marked fluctuation in the workload during different time periods, e.g., cotton ginning. However, some pressure groups regard it as the inability of the management to act in a socially or ethically responsible manner, since a large number of employees are laid off during the off season.

**Time flexibility:**

Following the same principle discussed above, the working hours can be increased or decreased, keeping in mind the amount of work to be carried out. The workers should know that they can be asked to perform their duties for longer hours if deadlines are to be met.

**Functional flexibility:**

It is recommended that a multi-skilled workforce is employed so that there is no interruption in a particular process even if a specialist is not available due to some unavoidable circumstances. Practices such as job rotation are very common these days due to the reason that the management wants the members of the workforce to acquire new skills. Not only will these skills benefit the company but can also go a long way in developing the professional career of the individual.

**Operations methods**

Operations methods or production processes can be classified into the following five types. The choice of process will be determined by the financial resources of the firm and the kind of product the manufacturer wishes to produce.

**Project production:**

It is used in large scale projects made to customer requirements. In other words, this is non-standardised production. Examples are civil engineering projects such as dams and motorways. The product is unique and assembled on site using skilled labour and flexible resources. Considering the size and complexity of the task, considerable planning is necessary. Quantitative techniques such as network analysis are essential to successful management of the project. It is usually necessary to break down the overall project into manageable sub-tasks, many of which are sub-contracted.

**Jobbing production:**

This production process is also concerned with the creation of unique, non-standard goods which are made to order. Unlike project production, the items are small-scale and produced in a workshop. Examples are made-to-measure suits or sailing boats. Multi-purpose machinery is combined with skilled versatile labour in order to carry out job production.

**Advantages of Job Production:**

Firms are in a position to produce unique or one-off orders according to customer needs. For example, a wedding dress may be designed and produced for the individual taste of a client. It is also possible to change the specifications of a job at the last minute even if the work has already begun. Workers are more likely to be motivated. The tasks employees carry out often require a variety of skills, knowledge and expertise. Their work will be more demanding and interesting. They will also see the end result of their efforts and be able to take pride in their work. The level of job satisfaction will be raised. The organisation of job production is fairly simple. Since only one job is handled at a time, coordination, communication, supervision, and inspection can be regularly carried out.

**Disadvantages of Job Production:**

- Labour costs will be higher because production tends to be labour intensive. The workforce is likely to be skilled and versatile and such employees are expensive. The amount of time each employee spends on a particular job will be longer.
- The fact that there is a variety of work, to many specifications, the business would need a wide range of tools, machine and equipment. This can prove to be expensive. Moreover, it may not be possible to achieve economies of scale because only one job is produced at a time.
- Lead times can be lengthy. For instance, a business has to incur costs during the construction of a house which cannot be recovered until the house is sold, which might take a long time.

- Unit 4
- Selling costs may also be high. This is likely if the product is highly complex and technical. The sales team will need to be well qualified, able to cope with questions and deal with problems concerning sales and installation.

### Batch production:

Batch production is the manufacture of different versions of the same basic product in batches, e.g., different colours or types of paints. There is some repetition of production but it is not a continuous process. Short production runs result in higher unit costs than would be the case if production was continuous. Changeover between batches means that resources are idle at times.

### Advantages of batch production:

- Even though larger quantities are produced than in job production, there is still flexibility. Each batch can be changed to meet customers' wishes. It is particularly suitable for a wide range of similar products. The settings on machines can be changed according to specifications, such as different clothes sizes.
  - Employees can concentrate on one operation rather than the whole task. This reduces the need for costly, skilled employees.
  - Less variety of machinery would be needed than in job production because the products are standardised. Also, it is possible to use more standardised machinery.
- It often results in stocks of partly finished goods which have to be stored. This means firms can respond more quickly to an urgent order by processing a batch quickly through the final stages of production.

### Disadvantages of batch production:

- Careful planning and coordination are needed. Otherwise, machines and workers may be idle, waiting for a whole batch to finish its previous operation. There is often a need to clean and adjust machinery before the next batch can be produced.
- More complex machinery may have to be used in order to compensate for the lower skill levels required from the labour force. This would lead to higher costs.
- The workforce may be less motivated, since they have to repeat operations on every single unit in the batch. In addition, they are less likely to be involved with production from start to finish.
- If batches are small, then unit cost will remain relatively higher.
- Money will be tied up in work-in-progress since an order cannot be dispatched until the whole batch has been finished.

### Line production:

It is a standardised production process with high capital investment, e.g., assembly line production of motor vehicles or electrical appliances. Specialist or dedicated machinery is involved in the process and robots are very commonly used. The manpower is required to perform repetitive tasks and the layout of the factory is such that time and cost of movement can be minimised. Line producers must invest heavily in stocks of raw material to prevent stock-out. The advantage of line production is that unit costs can be reduced considerably if long production runs are maintained.

### Continuous flow production:

This process is typically used in the production of fluids. Dedicated plant is used to manufacture a single product on a continuous, 24-hour basis. Relevant examples include chemical manufacturing or oil refining. In flow production, the labour is primarily responsible for monitoring the ongoing process and identifying problems.

### Advantages of flow production:

- Unit costs are reduced as firms gain from economies of scale.
- In many industries, the process is highly automated. Production is controlled by computers and robots. Once the production line is set up and running, products can flow off the end non-stop for lengthy periods of time. This can reduce the need for labour, as only machine supervisors are needed.

- The need to stock-pile finished goods is reduced. The production line can respond to short-term changes in demand. For example, if demand falls, the line can be shut down for a period of time. If it rises, then the line can be opened.

### **Disadvantages of flow production:**

- The set-up costs are very high. An enormous investment in plant and equipment is needed. Firms must therefore be confident that demand for the product is sufficient over a period of time to make the investment pay.
- The product will be standardised. It is not possible to offer a wide product range and meet different customers' needs.
- For a number of reasons, worker motivation can be a serious problem. Most of the manual operations required on the production line will be repetitive and boring. As a result, worker morale may be low and labour turnover and absenteeism high.
- Breakdowns can prove costly. The whole production system is independent. If one part of the supply or production line fails, the whole system may break down.

### **Mass customization:**

This process combines the latest technology with multi-skilled labour forces in order to use production lines for making a range of varied products. Focused or differentiated marketing can be used which leads to higher added value, an essential objective of all operations managers. For instance, Dell computers can make a customised computer to suit the specific needs of a customer in a matter of hours. In mass customisation, by changing just a few of the key components, but keeping the rest the same, low unit costs and greater product choice can be maintained.

### **Location**

One of the most important decisions to be taken by an entrepreneur is regarding the location of business. In fact, it would not be an overstatement to suggest that the location decision, whether it is the production plant, an outlet or a display centre, often proves to be the ultimate factor leading to the success or failure of a business. The following determinants should be taken into consideration while the location is being finalised.

### **Transportation costs/source of raw material**

In order to achieve the objective of profit maximisation, it is essential that costs are controlled. An effective way of ensuring this is that the production plant is situated near the source of raw material. Such a move will not only help in minimising the transportation costs but maintaining high quality standards in terms of freshness of raw material also. That is precisely why sugar mills are often located adjacent to sugar cane fields.

### **Labour:**

Availability of skilled labour at competitive rates, particularly in case of labour-intensive industries, is a factor that must not be overlooked at the time of the selection of a suitable place for a factory. This can have an impact on the performance of a business both in quantitative and qualitative terms.

### **Markets:**

Interaction with the customers is imperative for the growth and success of a business. Therefore, the element of nearness to markets must also be given due consideration by the management in context of the location of business.

### **Physical features and accessibility:**

It is advisable that the physical features of the proposed location must be studied carefully since every production process requires a different and particular set of conditions. Favourable geographical conditions will definitely add to the suitability of the location under consideration. For instance, a steel mill should be located near a source of water since the production process requires an uninterrupted flow of water. Similarly, a cement plant, due to the issue of dust control, has to be situated in a remote



unpopulated area. It is also recommended that there should be a network of roads as well as telecommunication facilities in the areas in order to ensure better accessibility.

#### Role of government:

An important consideration with reference to the selection of an appropriate location is the government policy for that particular region. If the government authorities have a business-friendly approach and incentives such as tax exemption, availability of cheap raw material and other subsidies are being offered, then investors should be inclined towards this location. Governments in different parts of the world have established such tax free zones, particularly in less developed areas, with the objective of attracting industrialists.

### Scale of operation

(Already discussed in detail in Section 1)

### Enterprise resource planning

This is a combination of steps taken by a business for improving its efficiency in relation to inventory control, costing and pricing, capacity utilisation and responses to change.

### Capacity utilisation

It is a measure of productivity, showing the ability of a manufacturer to use the available factors of production in an optimum way.

This is a major factor in determining the operational efficiency of a business. It is measured by the formula,

$$\text{Maximum capacity} = \frac{\text{Current Output}}{\text{Maximum Output}} \times 100$$

Maximum output is the total level of output that a business can achieve in a certain time period. For example, in case of a hotel, the monthly total capacity will be the number of room nights available during this period. For a factory, it will be the total level of output that all of the existing resources; land, capital equipment and labour; can produce. A firm working at full capacity achieves 100% capacity utilisation, meaning there is no spare capacity.

## 4.3 INVENTORY MANAGEMENT

### Purpose, cost and benefits of inventory

The term "inventory" or "stocks" refers to the raw material, semi-finished goods (work-in-progress) or finished goods held by a company with the basic objective of maintaining continuity of operations. The reason why the above mentioned three forms of stocks, particularly the raw material, are held is to allow for variations in supply and to take advantage of bulk-buying discounts and anticipated price rises. The justification for maintaining inventory in the shape of work-in-progress is to strengthen the productive process, allowing greater flexibility and improved machine utilization. Finished goods are held in stock so that the firm can cope with variations in demand, e.g., seasonal goods, or an expected rise in demand. To cope with high demand, it may be necessary to build up stocks beforehand. In addition to these stocks, which are the result of careful decisions, firms might also hold *unplanned stocks* or stocks of unwanted goods. These arise from the inability to sell goods, mistakes in planning, lack of satisfactory stock control procedures and poor communication between the various departments of a firm.

#### Purchasing policies:

For effective inventory management, an appropriate purchasing policy is required for acquiring supplies of raw material and/or components. The following three purchasing policies can be identified in this context: On-contract buying is the one in which all the terms and conditions, pertaining to price and other relevant



**Just-in-time stock management:**

It is a Japanese inventory control system that emphasises low stock levels. It suggests that material should be ordered or purchased only when it is urgently or currently needed, as opposed to buying it in bulk or in excess of the immediate requirement. Suppliers should deliver the material just in time or only at the exact moment required, hence reducing raw material inventory to zero.

The significance of using this technique is that the stockholding /storage/maintenance costs can be reduced considerably since it is financially and technically more viable for the manufacturer to manage a low level of inventory. Moreover, JIT is a flexible and market-oriented method as compared to bulk-buying since the producer is in a position to modify his business strategy strictly in accordance with the rapidly changing pattern of customers. This could be particularly useful in case of perishable items with a limited shelf-life like foodstuff or those prone to the risk of obsolescence such as electronics. Another advantage is that JIT leads to an improvement in the management of funds and the cash flow position since investment in working capital is reduced and the funds are not tied up.

However, JIT often proves to be *risky* since there is too much dependence on suppliers. If a supplier fails to make the delivery in a timely fashion, it will be impossible for the manufacturer to complete the production process and meet deadlines. Furthermore, it is imperative for the entire process to be carefully streamlined and the workforce to be skilled, experienced and motivated for JIT stock management system to work. Without wholehearted employee support, a zero-inventory system could result in costly stock-outs. Another drawback associated with this practice is that the economies of scale, specially purchasing economies, cannot be enjoyed since relatively smaller quantities are purchased. Transportation costs may also rise due to repeated orders.

All the above mentioned pros and cons must be taken into consideration before the Just-in-time inventory control system is implemented in a manufacturing business.

**4.4 CAPACITY UTILISATION**

It is a measure of productivity, showing the ability of a manufacturer to use the available factors of production in an optimum way. This is a major factor in determining the operational efficiency of a business. It is measured by the formula,

$$\frac{\text{Current Output}}{\text{Maximum output}} \times 100$$

Maximum output is the total level of output that a business can achieve in a certain time period. For example, in case of a hotel, the monthly total capacity will be the number of room nights available during this period. For a factory, it will be the total level of output that all of the existing resources; land, capital equipment and labour, can produce. A firm working at full capacity achieves 100% capacity utilisation, meaning there is no spare capacity.

**Outsourcing:**

Outsourcing describes a situation in which a firm contracts out work to other businesses, that might otherwise have been performed within the organisation. It is often observed in case of producers who are operating at close to or at *full capacity*. A contractor is assigned the task of supplying components or carrying out processes that a business might have undertaken. Car manufacturers often outsource production. Brakes, electronics, mirrors, windows, seats, etc., are usually produced by outside suppliers. This is a useful way of improving capacity utilisation. It leads to specialisation of resources as well as better time management and the business is in a position to concentrate on its core areas. Outsourcing can achieve the desired results if there is a quick and effective communication with suppliers and workers. The term *excess capacity* is used when the current levels of demand are less than the full capacity output of a business. This should be a cause for concern for manufacturers since low levels of capacity utilisation lead to higher unit fixed costs.

## 4.5 LEAN PRODUCTION AND QUALITY MANAGEMENT

### Lean production

It is a range of practices inspired by the Japanese firms, applied with the objective of improving quality and minimising wastage. Lean production is a combination of JIT stock management, flexible specialisms, quality circles, cell production, Kaizen, empowerment of workers and team working.

*("JIT", "flexible specialism's" and "empowerment" have already been discussed in Section 4 and Section 2).*

#### Quality circles:

These are discussion groups formed within organisations for encouraging the involvement of operatives in the solution to production problems. The formation of quality circles is typical of a democratic style of leadership since it allows and requires the workers to express their opinion freely in regularly held meetings. Issues are addressed in such a way that new ideas are generated and members of the workforce are able to comment on and identify problem areas, particularly with reference to various production processes. As a result, there is more interaction between individuals holding different positions in the firm and a coordinated effort can be made towards the achievement of short-term and long-term goals. However, due attention must be paid to the fact that these discussion groups prove to be productive and unnecessary delay in decision making is avoided.

#### Cell production:

The term represents a production method in which all the machinery needed to produce the same type of item is placed together, rather than arranging them by function.

### Kaizen

Kaizen, a Japanese concept, literally means "continuous improvement". It is based on the assumption that a continuous improvement in the performance of a business can be brought about by empowering the workers and encouraging team-work, as discussed in Section 2. Workers are often more experienced in practical terms since they are the ones to actually carry out a task at the production plant, as opposed to managers, who are more involved in strategy development and planning. That is why powers should be delegated and a certain degree of authority and freedom of decision making may be allowed by managers to their subordinates. Similarly, team-working enables the members of the workforce to assist each other for achieving group objectives. In this way, workload is shared, new ideas are generated, work becomes more meaningful and enjoyable and the overall motivation level is raised, eventually leading to an improvement in quality.

### Quality control and assurance

Quality is the fitness for purpose. In other words, it is the ability of a product to come up to the expectations of a particular customer. The term quality control represents a blend of techniques aimed at ensuring that these expectations are fulfilled. It can be categorised into:

#### Feed forward control:

It is a pro-active (before or during a production process) quality control technique that focuses on the quality of inputs. It requires that a producer should purchase high quality raw material and hire skilled workers in order to bring about an improvement in the overall performance level.

#### Concurrent control:

This pro-active method is based on the assumption that the ongoing activities during production must be monitored by inspectors regularly. The quality standards will be raised if the management keeps a close check on the performance of workers as well as the machinery.



### Feedback control:

This post-active or reactive quality control technique focuses on the output. It is designed to detect defective goods rather than prevent them from being manufactured in the first place. The company tries to maintain an AQL or "acceptable quality level", which is defined as the maximum number of defects per 100 units. This is also called acceptance sampling which means that if the number of defects does not exceed the AQL, the batch is passed as acceptable. If the number of defects exceeds the AQL, the whole batch is rejected.

### Quality circles:

(Already discussed with Lean Production)

## Benchmarking

Benchmarking is a quality control method in which a company sets quality standards for itself on the basis of the performance level of a leading competitor in the industry. This could be in relation to sales targets for employees, profit, number of branches and a host of other areas. Such an approach may prove to be challenging and motivating for the management and the workforce, leading to an overall improvement. However, this should be done in a carefully calculated way since every business organisation adopts a strategy, keeping in mind its own specific micro and macro environment. By blindly following in the footsteps of other businesses and disregarding its own limitations, a business might end up taking irrational and unprofitable decisions.

## Total quality management

Total quality management or TQM requires that instead of assigning the task of quality control or assurance to a particular department, every member of the workforce and the management is held responsible for maintaining specified quality standards in the organisation. TQM commits all the employees to the continuous, professional and impartial review or improvement of all activities relating to the quality of output and the satisfaction of customer requirements. Quality assurance is the implementation of systems to assure customers that quality standards will be met. It involves a checklist designed to scrutinise procedures in each of the functional areas of the organisation and raise quality consciousness. The role of the QA department is to devise systems and to support, advise and audit the work of other departments to ensure that standards are being met.

## 4.6 PROJECT MANAGEMENT

### The need for projects and project management

Project management involves the use of resources. Labour, buildings, management time and factory or office space will all, to varying degrees, need to be considered when working on different projects, leading to the production of goods or services.

### Network analysis/Critical path analysis/Network diagrams

Critical path or network analysis is a technique mainly associated with the planning of large scale projects. By analyzing all the activities involved in a production process, it becomes possible to make more rational decisions on the allocation of resources.

Network analysis is a term that covers a group of related analytical techniques, one of which is known as critical path analysis. These techniques are used to aid the planning and control of complex projects such as the construction of a building or a bridge the installation of a computer system. The common feature of such projects is that they are made up of a number of smaller tasks which have to be carried out in sequence.

A **network diagram** is constructed to show sequential relationships between the various components. This enables planners to calculate the minimum time needed to complete the project and identify critical activities where delay would prevent completion of the overall project within the minimum time specified.

**Rules of drawing network diagrams:**

There is one entry and one exit point in a network. In other words, there is a starting and a finishing point and the network diagram depicts progress towards the finishing point.

- Networks are drawn from left to right but not necessarily to scale. Thus the duration of an activity is not reflected in the length of the line.
- Activities (parts of a project which consume time and resources) are shown by a straight line.
- Events (transitions between activities) are shown by circles.
- Every activity must have a preceding activity, known as a tail, and a succeeding one, known as a head.
- An event is not complete until all activities leading to it are complete.
- In some network diagrams, a dotted line is shown which represents a **dummy activity**. It is an activity that consumes neither time nor resources.

**Critical and non-critical activities:**

A critical activity is the one which cannot be delayed any further without affecting the overall completion time of the project. A non-critical activity, on the other hand, can be delayed to a certain extent without having an impact on the total duration.

**Float:**

Float is the time by which an activity can be delayed without delaying the completion time for the project as a whole. This can be classified into:

**Total float:**

It is the amount of time by which a path of activities can be delayed without affecting overall project completion.

**Total float** = LST of this activity - EST of this activity  
Or

**Total float** = (LFT of this activity - Duration of this activity) - EST of this activity

Where LST represents the latest starting time, EST, the earliest starting time and LFT, the latest finishing time.

**Free float:**

This is the amount of time by which an activity can be delayed without affecting the commencement of the next activity at its EST.

**Free float** = EST of the next activity - (Duration + EST for this activity)

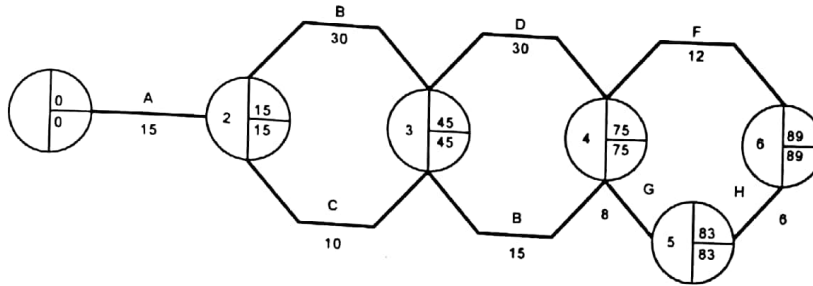
**Advantages of critical path analysis:**

- Allows easier interpretation of problems.
- Reduces the time lost between tasks, ensuring that projects run smoothly.
- Encourages forward planning. The process ensures that all tasks in a particular operation have been identified and timed from start to finish.
- Improves efficiency in production. Resources such as capital and labour can be used more effectively.
- Controls cash flow. This is achieved by not ordering supplies too early and only making purchases when required.

**Disadvantages of critical path analysis:**

- The construction of network alone will not guarantee the smooth completion of a project. Other factors such as the cooperation and commitment of the entire team must also be given due consideration.
- In case of certain large scale projects, network diagrams may become complex and unmanageable.

May/June 2005, Paper 3,  
WOTTON COLLEGE, Q4



**CRITICAL PATH: *ABDGH* (89 days)**

## RELEVANT QUESTIONS FROM PAST PAPERS (SECTION 4)

### MAY/JUNE 2013, PAPER 3, Q4,

- 4 (a) (i) Refer to the data in Appendix 2. Draw a network diagram for the relocation of MT's operations to the new airport. [6]
- (ii) Calculate the earliest start times (EST) and latest finish times (LFT) of each activity. [5]
- (iii) State the duration of the critical path. [1]
- (b) Using your answers from 4(a) and other information, assess whether MT should relocate operations this year or wait until next year. [10]

### O/N 2011, P1, Q1,

- 1 (a) Define the term 'operational efficiency'. [2]
- (b) Explain one way of measuring operational efficiency. [3]

### O/N 10, P2 (a) (Newtown),

- (a) Explain the following terms:
- (i) public sector (line 1) [3]
- (ii) capacity utilisation (line 10). [3]

### OCT/NOV 2009, PAPER 1, Q3,

- 3 Explain the key features of lean production. [5]

### OCT/NOV 2009, PAPER 2, PHONEQUIP, a (ii), (c), (d),

- (a) Explain the following terms:
- (ii) just-in-time (JIT) (line 4). [3]
- (c) Using Table 2, analyse the possible usefulness to PQ of improved quality control. [8]
- (d) Recommend which site (Eastwood or Northfield) would be best for the relocation of PQ's factory. Justify your choice. [10]

### OCT/NOV 2009, PAPER 3.

### MAY/JUNE 2009: PAPER 1, Q5 (a), (b),

- 5 (a) Explain why effective stock control is important for a large retail business. [8]
- (b) Discuss the advantages and disadvantages of using a JIT (just-in-time) approach to stock control for a large retail business. [12]

### MAY/JUNE 2009: PAPER 3, CAR MANUFACTURER AT A CROSS ROADS, Q2 (b), Q5.

- 2 (b) 'If we can increase productivity and reduce wastage and absenteeism in the Northcapa factory then this will make us more competitive.' (lines 48–50)
- Recommend an appropriate Human Resources strategy to achieve this objective. Support your recommendation. [16]
- 5 Recommend whether EM should set up and operate its own car retailing business in Country Z. Justify your recommendation. [16]

### OCT/NOV 2008: PAPER 2, CC COSMETICS, (ii),

- (ii) Quality control (line 15). [3]

### OCT/NOV 2008: PAPER 3, TANROH'S DILEMMA, Q3 (a), (b).

- 3 (a) Using the data in Appendix C, construct a network diagram (CPA) for the safari lodge project, showing all earliest start times and latest finish times. [10]
- (b) If activity B is delayed by two weeks, briefly advise Tanroh on what steps he could take avoid the project taking longer than 16 weeks. [4]

### MAY/JUNE 2008: PAPER 1, Q2 (a), (b),

- 2 (a) Define the term 'quality control'. [2]



- (b) Describe two ways in which a manufacturing company might control the quality of its products. [3]

**MAY/JUNE 2008: PAPER 2, GANMOR CARS, (c),**

(c) Describe how lean production techniques might be used at GC. [6]

**MAY/JUNE 2008: PAPER 3, PYRAMID TELEVISIONS, Q2.**

Analyse possible reasons why average total costs have increased following the increase in capacity utilisation shown in Table 1. [8]

**OCT/NOV 2007: Q7 (a), (b),**

(a) Explain how JIT (Just in Time) could be used to manage stocks in a manufacturing business. [8]

(b) Discuss why businesses need an effective method of stock management. [12]

**OCT/NOV 2007: PAPER 3, CURRY CUISINE, Q5.**

Evaluate the advantages and disadvantages to Curry Cuisine of using batch production methods for the "ready made meals" project. [16]

**MAY/JUNE 2007: PAPER 2, TECH NEW, (d), BEE'S MEALS, (d),**

(d) Using the information in Table 2, explain one method of stock control that TN could use to improve its management of stock. [6]

(d) Discuss the impact on BM and its workers of a change from batch to flow production. [10]

**MAY/JUNE 2007: PAPER 3, CRAFT DESIGNS, Q7.**

The Operations Director has proposed outsourcing all supplies of stone sculptures so that the company could start jewellery production. Discuss how Ade might try to solve what you consider to be the most important **human resource** and **operational management** problems that might result from this decision. [20]

**OCT/NOV 2006: PAPER 1, Q3, Q7 (a),**

Briefly discuss the importance of effective stock control for production managers. [5]

(a) Explain the difference between batch and flow production methods. [8]

**OCT/NOV 2006: PAPER 2, ELDORADO RESTAURANTS, (c),**

(c) Discuss how Zed could improve quality in ER's restaurants. [8]

**OCT/NOV 2006: PAPER 3, LOCOST AIRWAYS, Q4.**

Using the data in Appendix C and any other relevant information, recommend which city LoCost Airways should locate their next base in. Justify your answer. [16]

**MAY/JUNE 2006: PAPER 2, STAR PHARMACEUTICALS, a (i), d(ii),**

(a) Explain the following terms:

(i) flow production (line 9) [3]

(d) (ii) Using your answer to (d)(i), and other information in the case, evaluate the decision to relocate some production to Country B. [8]

**MAY/JUNE 2006: PAPER 3, RAVE CONFECTIONERY, Q2.**

Would you recommend the introduction of lean production methods at Rave? Justify your answer. [14]

**OCT/NOV 2005: PAPER 1, Q3 (a), (b), Q4 (a), (b),**

(a) State two ways in which a business may achieve added value. [2]

(b) Why is added value important for businesses? [3]

(a) Define work study. [2]

(b) Give three ways in which businesses might use the results of work study. [3]

**OCT/NOV 2005: PAPER 3, MERCADO PLC, Q2 (c).**

- 2 (c) Assume that Mercado decides to build a new factory. Evaluate the advantages and disadvantages to Mercado of locating the factory in your country. [12]

**MAY/JUNE 2005: PAPER 1, Q3,**

- 3 Outline the benefits of lean production for a manufacturer of electronic goods. [5]

**MAY/JUNE 2005: PAPER 2, MATPACK PACKAGING, a (ii),**

- (a) Explain the following terms:  
(ii) quality control (line 19). [3]

**MAY/JUNE 2005: PAPER 3, WOTTON COLLEGE, Q4 (a), (b), (c).**

- 4 (a) Refer to Appendix B. Draw a network diagram of this building project, showing all earliest start times and latest finish times. [8]  
(b) Identify the critical path and state the minimum project duration. [2]  
(c) Analyse the usefulness of this technique for managing the building project. [6]

**OCT/NOV 2004: PAPER 2, BALJIR THE BUILDERS, B(i), (ii), RITEON CLOTHES LTD, a(ii).**

- (b) Using the network diagram in Fig. 1:  
(i) identify the critical path and project duration, [2]  
(ii) explain the significance of the critical path for Baljir. [4]  
(a) Explain the following terms:  
(ii) direct costs (line 7). [3]

**MAY/JUNE 2004: PAPER 1, Q3.**

- 3 Outline two ways in which a manufacturer might control the quality of its products. [5]

**OCT/NOV 2003: PAPER 1, Q7,**

- 7 (a) Explain how JIT (Just in Time) could be used to manage stocks in a manufacturing business. [8]  
(b) Discuss why businesses need an effective method of stock management. [12]

**OCT/NOV 2003: PAPER 2, ROUND PLC, (c), THE AKSHAY COMPANY, a (i),**

- (c) Analyse the factors that JPB might have considered when deciding to operate a Just-In-Time production system. [6]  
(a) Define the following terms:  
(i) Capacity utilisation (line 3) [3]  
(ii) Legal constraints (line 5) [3]

**OCT/NOV 2003: PAPER 3, ORIENTAL ENGINEERING, (a).**

- (a) Discuss the factors the company directors should consider before deciding whether to relocate the factory. [10]

**MAY/JUNE 2003: PAPER 1, Q2 (a), (b), Q7,**

- 2 (a) Define the term 'added value'. [2]  
(b) Explain why it might be desirable for a firm to have high added value products. [3]  
7 Discuss the importance of effective stock management for a manufacturer. [20]

**MAY/JUNE 2003: PAPER 2, THE FURNITURE MAKER, (c), THE TEE BUSINESS, a (ii),**

- (c) Analyse the factors that the multi-national business might have considered when deciding to locate near to The Furniture Maker. [8]  
(a) Define the following terms:  
(ii) productivity (line 16). [3]

**MAY/JUNE 2003: PAPER 3, FAST FOOD FRANCHISE, (e).**

- (e) To what extent would Just in Time be appropriate for the management of stocks in this business? [10]

**OCT/NOV 2002: PAPER 2, THE SOUP MAKERS, a (ii), b (i), (ii), (iii), (c).**

- (a) Define the following terms:  
(ii) Work study (line 13) [3]
- (b) Using the information in Fig. 3:  
(i) Calculate the minimum duration. [1]  
(ii) Identify the critical path. [1]  
(iii) Comment on the significance of the critical path for The Soup Makers. [4]

**MAY/JUNE 2002: PAPER 1, Q7 (a),**

- 7 (a) Why might a manufacturer change from batch to flow production? [8]

**MAY/JUNE 2002: PAPER 2, THE SMART TILE COMPANY, a (ii), (c).**

- (a) Define the following terms:  
(ii) Lean production (line 13). [3]
- (c) Analyse the possible impact on the business of lowering stock levels. [8]

## UNIT 5

# Finance and Accounting

A Level

Business

Teacher's Notes

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## Syllabus 2016 –18

### 5.2 Sources of finance

- Short term finance and long term finance
- Start-up capital, capital for expansion
- Working capital
- Distinction between short and long-term sources of finance
- Internal sources
- External sources
- Forecasting cash flows and managing working capital
- Methods of improving cash flow

### 5.3 Costs

- Break even analysis
- Cost information

### 5.4 Accounting fundamentals

- Income statement
- Liquidity ratios
- Profitability ratios
- Main users of account
- Limitations of published accounts
- Variances: adverse, favourable

### 5.7 Contents of published accounts

### 5.8 Analysis of published accounts

- Financial efficiency ratios
- Gearing ratio:
- Investor ratios

### 5.9 Investment appraisal

- The concept of investment appraisal



## UNIT 5 FINANCE AND ACCOUNTING

### Start-up capital, capital for expansion

Why businesses need finance to start up and to grow:

#### 5.1 Working capital

The meaning and significance of working capital as a source of finance:

The term *working capital* refers to the amount of capital which is used to meet the *day-to-day expenses* of running a business. It normally refers to the *surplus funds* that a business has available at any one time to enable it to meet demands requiring immediate settlement.

**Working capital** = Current assets – Current liabilities

Examples include cash, raw material, semi-finished and finished goods. The amount of money needed for the payment of wages or to pay creditors who have supplied goods on credit or to have sufficient funds to supply goods on credit also falls in the same category.

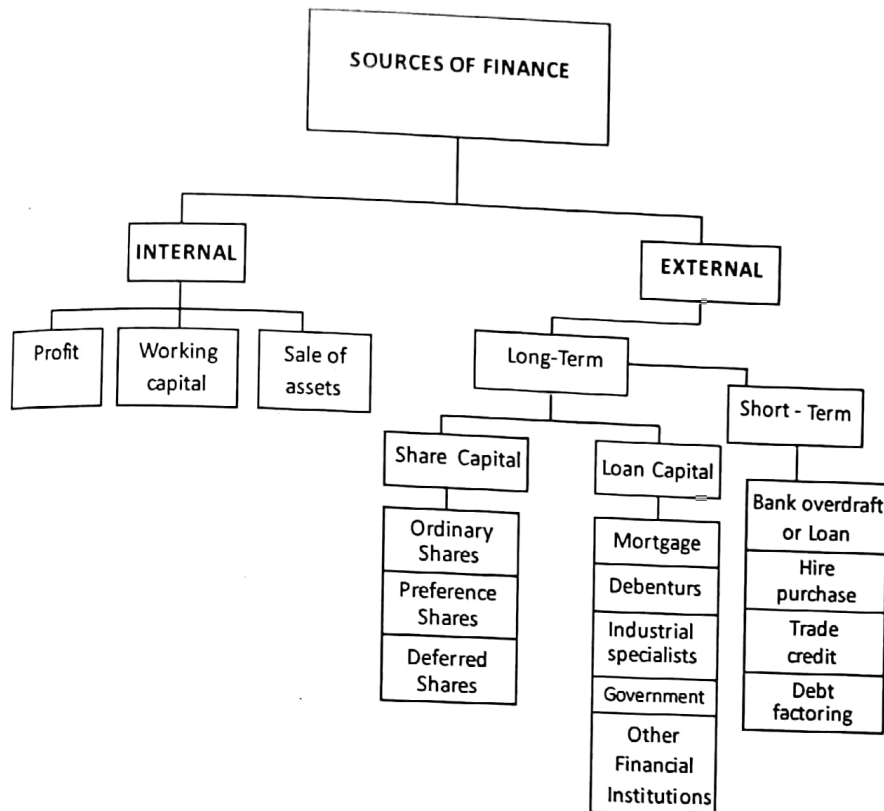
It is very important for business to have sufficient amount of working capital so that it can trade without difficulties. The working capital of a business can be increased by the introduction of more cash capital by the owners, by somebody outside the business lending money to it, by a business making profit on trading, by the business selling some of its fixed assets, thereby increasing its cash resources.

Working capital can be reduced by the owner of a business withdrawing cash for his own use, by a company making a loss on trading, by the purchase of a fixed asset, etc.

**Significance of the distinction between revenue and capital expenditure:**

Any item bought by a business and retained for more than a year, that is, the purchase of fixed assets, is capital expenditure. Any expenditure on assets that are used up within one year such as stocks for resale or print cartridges is revenue expenditure. Other examples include raw materials, wages and fuel. As all the revenue expenditure is on assets and expenses that give short term benefits to the business, they are all recorded in full in each year's profit and loss account and will therefore reduce that year's profit, with the exception of 'unsold stocks' also called 'closing stock'. Capital expenditure, on the other hand, is more complicated. If the cost of a truck is recorded as an expense in the company's profit and loss account it would cause two serious problems; firstly, this would lower the value of the business below its true worth as the asset will have value many years from now and it will be recorded as a single time entry. Secondly, that year's profit will be low as the result of the entire cost of the asset being recorded straight away and profits in the later years will be higher because they do not bear any of the charge of this purchase. This results in a misleading judgment regarding the overall worth of the business and thus it is essential to differentiate between capital and revenue expenditure. Capital expenditure is recorded in the accounts of the business by the process of depreciation (discussed under 5AL.7, "CONTENTS OF PUBLISHED ACCOUNTS").

## 5.2 SOURCES OF FINANCE



### Short term finance and long term finance

### Distinction between short and long-term sources of finance

Sources of finance are either internal or external. Internal sources of finance include the money that is obtained from within the business depending on its own resources. It is a cheap source of finance and the business does not have to pay interest on it. External sources of finance include the money that is obtained by the business from institutions or individuals outside the business. External sources of finance can be further classified into short-term and long-term sources of finance. Short-term sources of finance include the finance that is needed for up to three years, whereas long-term sources of finance include the finance that is needed for more than ten years. Usually this money is used to purchase long-term fixed assets, to update or expand the business or to finance the takeover of another firm.

### Internal sources

**Internal sources of finance: retained profits, sale of assets, working capital:**

#### Retained profits:

It is the profit after tax that has not been returned to the owners. It is also called *ploughed back profit* as it is reinvested into the business. Around 65% of all business funding comes from retained profit. It is the cheapest source of finance with no financial charges such as interest. It does not have to be repaid unlike, for example, a loan. However, there is an opportunity cost. Keeping more profits in the business reduces payments to the owners and conflicts might arise amongst the shareholders of a public limited company if they claim that dividend payments have been frozen by the directors in case they have used the profit in the business.

#### Sale of assets:

An established business may wish to sell those assets which are no longer required by the business, for example, redundant buildings or surplus equipment. This makes better use of capital tied up in the business. This source of finance may not be available to a new business as they have no surplus assets to sell.

### **Working capital:**

(Discussed under 5AS.1/5.AL.1 "working capital").

## **External sources**

**External sources of finance: Share capital (including stock exchanges), venture capital, overdrafts, loans, mortgages, debentures, government grants and loans, new partners**

The long term external sources of finance include *debt finance (loan capital)* and *equity finance (share capital)*. Equity finance includes sale of shares whereas debt finance includes loan capital and debentures. It is important to note that debt finance increases the liabilities of the company.

### **Share capital:**

Shares are also called equities including:

#### **Ordinary shares:**

These are considered to be the riskiest type of shares since the ordinary shareholder is entitled to the residue of profits whenever dividend is declared. Dividend is the amount calculated as a percentage of the profit made by a company over a period of time and distributed amongst the shareholders. Ordinary shareholders are allowed to participate in the annual general meeting (AGM) and cast votes for the appointment holders. The ordinary shares are easily available in the **stock exchange** and are affected by the changes in the market conditions. Stock exchange provides a market to the owners of the shares where they can sell them. If this market did not exist, selling shares would be difficult because buyers and sellers could not communicate with each other. It also provides a means of protection for the shareholders. Companies which have a stock exchange listing have to obey a number of stock exchange rules, which are designed to safeguard shareholders from fraud.

#### **Preference share:**

These shares are normally owned and held by the management of the company. Preference shareholders are given preference over other shareholders at the time of the declaration of dividend. Preference shares are divided into cumulative and participating shares. Cumulative shares are entitled to arrears whenever the dividend is announced after a gap of a few years. Participating shares qualify the shareholders for a fixed rate of return in addition to the dividend.

#### **Deferred shares:**

It is a special category of shares which is not in circulation under normal circumstances. However, the owners of the company who hold these shares may decide to receive dividend against these shares in case it is an exceptionally profitable year.

### **Loan Capital:**

#### **Long-term loans:**

A typical commercial bank makes money by lending money at a certain rate of interest. A loan is sanctioned after a taking the financial status of the applicant is taken into account. Person or organization that is financially sound can get a loan easily whereas a small company or a financially weak individual may find it difficult to borrow money from a bank.

#### **Debentures:**

It is a certificate issued against a certain amount of money received by the company. The debenture holder, who acts as a creditor, is entitled to a fixed rate of interest for as long as the amount is in the custody of the debenture issuing company.

#### **Mortgages:**

A mortgage is a long-term loan from a bank or other financial institution and the lender must use land or property as a security against which the loan is approved.

**Venture capitalists/Business Angels/Industrial loan specialists:**

These are organisations or individuals that are prepared to invest in growing businesses, hoping for some return in future. They often provide funds for businesses that are considered too risky by other investors. Needless to say, they often take a share in the business as reward for their investment.

**Grants:**

Both central and local government provides finance to the businesses, for example, business start-up schemes can provide a small amount of income for those starting new businesses for a limited period of time, providing they meet certain criteria. Mostly, government provides assistance to businesses setting up in areas of heavy unemployment.

**Short-term sources:**

**Leasing/Hire purchase:**

Most of the commercial banks facilitate their customers by assisting them in the purchase of machinery. It can be done with the help of two techniques.

Firstly, the hire purchase facility requires the business to pay a certain amount of money to the bank in the beginning called the "down payment" and the remaining money has to be paid back in installments over a specified period of time. A certain rate of interest is charged. In case of hire purchase, the customer becomes the owner of the property at the end of the specified time period. Leasing is similar to hire purchase with the only difference that the asset has to be returned to the bank at the end of the time period. In other words, leasing is similar to a rental facility and proves to be helpful for companies working on mega-projects involving the use of heavy and expensive machinery.

**Overdraft:**

Banks offer a special credit facility if an account holder needs a certain amount of money urgently without providing the bank with any kind of security or *collateral*. In such a situation, the customer can be given a special permission to draw an amount in excess of the funds actually available in the account. It is known as an overdraft and the overdrawn amount is sanctioned against a certain rate of interest charged on a daily basis.

**Debt factoring:**

Debt factors are specialist agencies that buy the debts of a firm for immediate cash. They may offer 90% of an existing debt. The debtor will then pay the debtor and the 10% is the factor's profit. Through this the risk of collecting the debt will be retained by the factor. But the firm will not receive 100% of the value of its debt.

**Trade credit:**

Many businesses raise their finance by buying raw material on credit. In other words, paying for the goods bought later. However, many companies encourage prompt payments by offering cash discounts. Delaying the goods' payment might deteriorate the relations between the supplier and the company.

**FORECASTING CASH FLOWS AND MANAGING WORKING CAPITAL**

**Purpose of Cash flow forecast:**

It is a prediction of all expected receipts (cash inflow) and expenses (cash outflow) of a business over a future time period which shows the expected cash balance at the end of each month.

**Difference between cash and profit:**

It is important to note that profit is not the same as cash. Profit is calculated using accruals (when things are bought and sold rather than when they are paid for). Cash, on the other hand, is calculated on the basis of money flowing in and out of the business. Therefore, since stock is usually purchased on credit, the two are different. This explains why a profitable business may run out of cash (called insolvency) and a business recording a loss may have a cash surplus.



SK

## The need to hold a suitable level of cash within a business, and the consequences of not doing so

Cash is the most liquid of all business assets. Cash is a part of working capital. A business cannot exist without cash. Initially, cash is used to hire or buy resources. These resources are then converted into goods or services which are then sold to customers in exchange of cash. Some of the money from sales will be used to finance further production. If the flow of cash ceases at some stage then the business will be unlikely to continue.

### Uses/significance/evaluation of cash flow forecasts:

A cash flow forecast is an attempt by the management to plan ahead and prevent future liquidity (ability to pay off short-term debts) problems. Cash flow forecasts and statements have a great utility for the internal (managers, owners, etc.) as well as external (bankers, government, investors, etc.) stakeholders of a business.

Owners and managers can analyse the cash flow situation and address issues such as cash shortages or surplus in a more rational manner. This statement will allow them to identify weak areas that cause an unnecessary increase in costs, subsequently adopting measures to rectify the problem. Similarly, the cash flow forecast provides the bankers with a guideline while approving or disapproving loan applications. The government authorities can also rely on it, to a certain extent, for the calculation of taxes. It also proves to be a useful tool for potential and existing investors who can judge the financial position of a PLC before finalising decisions regarding the sale or purchase of shares. During and at the end of the financial year a business should make comparisons regarding the predicted figures in the cash flow forecast and those that actually occur. By doing this it can find out where problems have occurred. As noted above, cash flow forecasts or statements have several significant advantages, but, as with any judgment about the future, these have to be treated with caution. Too much reliance must not be placed upon their accuracy. Any cash flow forecast could be made inaccurate by unexpected changes in the external economic environment, such as movements in interest rates or inflation at a faster rate than anticipated. Moreover, stakeholders should also give due consideration to the fact that the figures in these statements are often "window-dressed", that is, over or under-stated on purpose, not reflecting the actual financial position of a business.

### Construction of cash flow forecasts:

Refer to May/June, 2003, P3, c (i) (Fast Food Franchise). The following method is recommended for the construction of a typical cash flow forecast.

		APRIL	MAY	JUNE	JULY
<b>CASH INFLOWS:</b>					
	CAPITAL INJECTION	60000			
	CASH SALES	18000	27000	36000	36000
	CASH RECEIVED FROM DEBTORS	0	2000	3000	4000
	TOTAL	78000	29000	39000	40000
<b>CASH OUTFLOWS:</b>					
	FRANCHISE LICENCE	5000			
	FRANCHISE FEE	2000	3000	4000	4000
	PURCHASE OF FOOD&DRINK	10000	15000	20000	20000
	LABOUR COSTS	7000	7000	7000	7000
	RENT	10000	10000	10000	10000
	EQUIPMENT PURCHASES		20000		20000
	TOTAL	34000	55000	41000	61000
	OPENING CASH		44000	18000	16000
	NET CASH FLOW	44000	(26000)	(2000)	(21000)
	CLOSING BALANCE	44000	18000	16000	(5000)

## Methods of improving cash flow

How debtors, reducing costs and/or extending credit periods can improve cash flow:  
Cash flow problems can be tackled in the following ways:

### Reducing or delaying expenditure:

A business can cut costs, such as reducing the expenditure on advertising or delaying the purchase of capital equipment. It can even purchase cheaper supplies of raw materials and components. These decisions might have a positive impact on the short-term cash flows but might affect the business negatively in the long-run.

### Extending credit periods/reducing time given to debtors:

a business can delay payment made to the suppliers for goods purchased on credit.

- Further methods of improving cash flows: debt factoring, leasing
- (Already discussed under 5AS.2/5AL.2)

## 5.3 COSTS

### Cost information

#### The need for accurate cost data/types of costs: fixed, marginal, direct and indirect:

A cost can be defined as a payment for the sacrifice of resources. Costs are incurred by business organisations when they hire resources such as labour, material, machinery and buildings. Costs may be classified in a number of ways. **Direct Costs** are wholly and exclusively identified with a particular unit of output. Hence, the material and labour exclusively used to produce bread in a bakery will be categorised as direct costs of bread production. However, there are certain costs that cannot be identified with a particular unit of output and are incurred by the whole organisation or department, termed as **Indirect Costs or Overheads**. Examples include the cost of employing administrative staff or the heating and lighting bill for the bakery. Costs can be further classified between **Fixed Costs**, that remain the same in the short-run, irrespective of the level of production, e.g., rent, interest payment, etc. and **Variable Costs** that vary with the level of output, e.g., the quantity of material used during a production process. In addition to fixed and variable costs, some **Semi-Variable Costs** can also be identified. These costs contain both fixed and variable elements, e.g., an electricity bill includes a fixed line rent plus an additional variable payment, linked to use. Finally, the cost of increasing output by one more unit is called **Marginal Cost**.

### Break even analysis

#### Determining the minimum level of production needed to break even or the profit made

Break-even is the point of production where total costs are exactly same as the total revenue. It is the point where the business makes neither profit nor a loss. It is possible to calculate the breakeven point if the firm knows the value of fixed costs, variable costs and the price it will charge. For example, in a sports shoe business:

- Fixed costs are \$5,000 per year
- The variable costs of the business are \$3 per unit of output (a pair of sports shoes)
- Each pair of shoes is sold at \$8
- The factory can produce a maximum output of 2,000 pairs of shoes per year

The simplest way to calculate the break-even is by using contribution. It is the amount of money that is left over after the variable cost is deducted from the selling price. The contribution in this case is:

Contribution    Selling price    Variable cost

Contribution       \$8                               \$3

Contribution       \$5

To calculate the number of sport shoes the company needs to sell to break-even, the following formula can be used:-

Break-even point        $\frac{\text{Fixed costs}}{\text{Contribution}}$

$$= \frac{\$5000}{\$5}$$

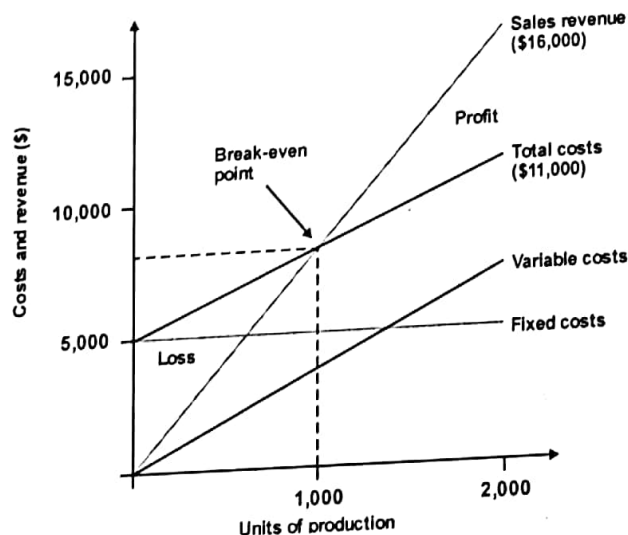
1,000 shoes

The sports shoes business will break-even when 1,000 pairs of shoes are sold. The sports shoes business will break-even when 1,000 pairs of shoes are sold. The sports shoes business will break-even when 1,000 pairs of shoes are sold.

**Break-even charts** are graphs which show how costs and revenues of the business change with sales.

They show the level of sales a business must make in order to break-even. Consider the case of the shoe company, the break-even chart should be drawn in the following way:-

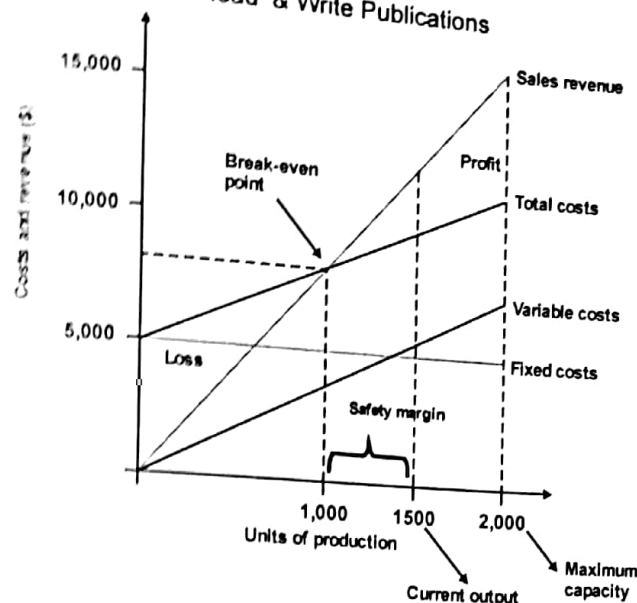
- ✓ When output is \$2,000, variable costs will be:    \$2,000    \$3,000    \$6,000
- ✓ Assuming all output is sold, total revenue will be: \$2,000    \$8,000    \$16,000



- The 'y' axis (vertical axis) measures money amounts.
- The 'x' axis (horizontal axis) shows the number of units produced and sold.
- The fixed costs do not change at any level of output.
- The total cost line is the addition of variable and fixed costs.

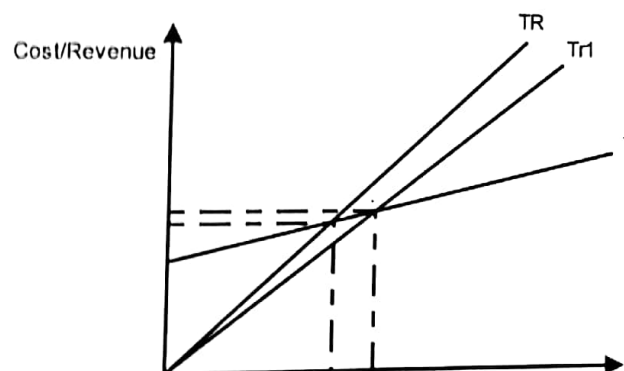
#### Calculation of the margin of safety

Margin of safety is the amount by which sales exceed the break-even point, or in other words the range of output over which a profit can be made. The margin of safety can be identified on the break-even chart by measuring the distance between the break-even level of output and the current (profitable) level of output. In the case above, if the current level of output is 1500 units and the break-even is 1,000 units, then the margin of safety will be 500 units.



### Uses and limitations of break-even analysis

Break-even analysis can be used by the managers to find out the expected profit or loss to be made at any level of output. The break-even chart can alter marketing decisions by showing the effect on the break-even point of a change in price. An increase in price would mean that the total revenue function has also increased from TR1 to TR2. The break-even level of production would decrease but the profit level will rise (Shown in figure A).



The biggest drawback of the break-even graph is that it is based on the assumption that all output that the business produces, it will be able to sell. Realistically, there are times when businesses are unable to sell the entire stock they have. A break even chart cannot cope with a sudden change in wages or technology. Many businesses produce a range of products. So it is difficult to allocate the total fixed cost for each product separately. Break-even chart is less useful in such situations.

### Approaches to costing:

The term "costing" describes the process of measuring the likely monetary consequences of a business activity. Costing systems benefit a business in a number of ways. They provide managers with financial information on which to base decisions. They help identify the profitable activities, avoid waste and provide information for cost cutting strategies. Costing can also assist the marketing department in setting the price of products.

The following costing approaches are used by firms in order to ensure that the above mentioned objectives can be pursued.

### Absorption Costing:

This technique requires that all the direct and indirect costs associated with business operations are charged individually to a "cost centre". A cost centre is a point where costs occur and can be easily recorded. Some businesses use the Absorption Method to set the price of their products. Once the cost of each unit has been calculated, a profit percentage is added to determine the selling price.



This method is popular in practice, although there is some criticism of its use. It is difficult to apportion indirect costs accurately to each unit when a firm produces a wide range of products.

### Marginal Costing:

As mentioned above, marginal cost is the cost of increasing output by one more unit. The Marginal Costing approach used in business is based on this idea, since all the direct costs (likely to be variable) and not the indirect costs (likely to be fixed) are allocated. In marginal costing, decisions are based upon the value of "Contribution" that a product or process makes to the indirect costs and profit. The contribution is the amount of money left over after a sale after all the direct costs have been met.

**Contribution** = Selling price - Marginal Costs (direct costs) or

**Contribution** = Revenue - Direct Costs

In business, if a product makes a positive contribution, then it is worth producing. However, even when a product or contract makes a negative contribution, then all the relevant factors must be given due consideration before the management decides to continue with the ongoing operations.

## 5.4 ACCOUNTING FUNDAMENTALS

### Income statement

**Contents of an income statement including: cost of sales, gross profit, profit (before tax) for the year, retained profit**

Income statement also called the trading and profit and loss account shows how the net profit of the business is calculated. It includes the trading as well as the appropriation account. (Discussed in detail in 5.AL.7 "contents of published accounts")

XYZ COMPANY	
PROFIT AND LOSS ACCOUNT	
Y/E 31.1.09	
\$	
Turnover	1,532,000
Cost of sales	451,000
<b>Gross profit</b>	<b>1,081,000</b>
Overheads	900,000
<b>Operating profit</b>	<b>181,000</b>
Non-operating income	2,000
<b>Profit before interest</b>	<b>183,000</b>
Interest (net)	152,000
<b>Profit on ordinary activities before tax</b>	<b>31,000</b>
Taxation	11,000
<b>Profit for the year after tax</b>	<b>20,000</b>
Dividends	8,000
<b>Retained profit for the period</b>	<b>12,000</b>

The following terms should be studied when constructing an income statement.

#### a) Cost of sales (cost of goods sold):

This is the direct cost of purchasing the goods that have been sold during the financial year. It is calculated by the formula:

<b>Cost of goods Sold</b>	<b>Opening Stock + Net Purchases</b>	<b>Closing</b>
<b>Stock</b>		

**Gross profit:**

b) It is the difference between sales turnover and cost of sales. Gross profit is not the true profit, for no account has been taken of the expenses incurred in selling the goods such as rent, wages, dividend payments, etc...

$$\text{Gross profit} = \text{Sales Revenue} - \text{Cost of goods Sold}$$

**Profit (before tax) of the year:**

c) This is also called net profit or operating profit of a business. This profit is made, before tax payments, but after all costs of sales and overheads have been deducted from the sales turnover. Net profit figures are important for income tax purposes.

$$\text{Net profit} = \text{Gross Profit} - \text{Overhead Expenses}$$

**Profit after tax:**

d) This is the profit left after all deductions, including dividends and taxes have been made. This can also be termed as the *retained profit* or the *ploughed back* profit of the business as it is reinvested into the company as a source of finance.

**Balance sheet**

- Contents of a balance sheet including: non-current assets, current assets, current liabilities, working capital, net assets, non-current liabilities, reserves and equity

ABC ENTERPRISES  
BALANCE SHEET AS AT 30/4/09  
\$

<b>Fixed assets</b>	
Buildings	210,000
Machinery	167,000
	377,000
<b>Current assets</b>	
Stocks	36,000
Debtors	27,000
Cash at bank	5,000
	68,000
<b>Creditors: amounts falling due in one year</b>	36,000
<b>Net current assets</b>	32,000
<b>Total assets less current liabilities</b>	409,000
<b>Creditors: amounts falling due after one year</b>	(56,000)
<b>Net assets</b>	353,000
<b>Capital and reserves</b>	
Share capital	100,000
Retained profit	218,000
Other reserves	35,000
	353,000

**Balance sheet** shows the financial position of a business at a particular point in time. It contains information about the assets of the business, its liabilities and its capital. In other words it is the evaluation of the net wealth of the business.

**Non-current assets:**

These include the fixed assets that are owned by a business and are likely to be kept and used for more than one year. These are all the tangible assets. Businesses can also have intangible assets such as trademarks, copyrights, goodwill, etc. The reputation and prestige of a business that has been operating

for some time also gives value to the business over and above the value of its physical assets. This is called the goodwill of the business and should normally only feature on balance sheet just after it has been purchased for more than its assets are worth, or when the business is being prepared for sale.

#### Current assets:

Current assets are those assets that are converted into cash within one year. The most common examples are stocks, debtors and cash.

**Current liabilities:-** Current liabilities are debts that are likely to have to be repaid within one year. These include trade creditors, bank overdrafts, etc.

#### Working Capital:

(Discussed under 5AS.1/AL.1 "Working Capital").

#### Net assets:

This is the difference between fixed assets and long-term liabilities.

#### Non-current liabilities:

(Long-term liabilities) These are the long term loans owed by the business. These are supposed to be paid over a period of time which is more than one year. It includes loans, mortgages and debentures.

#### Reserves and equity:

These are collectively called *shareholders' funds*. They represent the capital originally paid into the business when the shareholders bought the shares (share capital) or the retained profits of the business. Reserves can also appear on the balance sheet if the company believes that its fixed assets have increased in value.

#### • Significance of budgeting

A *budget* is defined as a financial plan setting out expected income and expenditure over a future period. The budgeting process provides an invaluable insight into the interrelated nature of business activity. Budgets are plans of action expressed in quantitative terms. Their essential characteristics are that they: are prepared and agreed in advance cover a specific time period are expressed in either financial or real physical terms relate either to the firm as a whole or to a part of it, e.g., the marketing department. Preparation of a budget helps managers in **enhancing their perspective**. They give due consideration to all the relevant factors during the budgetary process and therefore are in a position to take rational and productive decisions for the organisation. Budgeting is also useful in **identifying problems that may arise in future** and can have a negative impact on the performance of the company. As a result, the management can come up with solutions to such problems beforehand and avoid any possible financial crisis. A budget is finalised with the help of the input given by all the major functional areas such as marketing, production, administration, purchasing and research and development. That is why it brings about an **improvement in the coordination** between various departments operating within the business. Finally, it is worth mentioning that the budget serves the purpose of a gauge for measuring and **evaluating the performance** of the workforce. Financial parameters are clearly defined when tasks are assigned to subordinates and the senior management can keep a check on the degree of cost effectiveness maintained as an activity is carried out.

#### Liquidity ratios

- **Acid test ratio, current ratio / how each of these ratios is used/ ways in which businesses might try to improve the ratio results**
- **Liquidity** is the ability of the firm to pay its short-term debts. Liquid capital consists of that part of the current assets that are in the form of cash and current assets which can be converted to cash quickly.

#### Current ratio:

The current ratio focuses on current assets and current liabilities. It is also called the working capital ratio and is calculated using the following formula:-

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Although working capital requirements differ greatly according to the nature of the trade and complexity of production processes, most financial analysts regard a current ratio of at least 1.5-2 as indicating financial stability for most businesses. A current ratio less than 1 would mean that the business could have real cash flow problems. It is unable to pay its short-term debts from existing current assets. It might also indicate that the trader is over-trading. He is buying too much on short-term credit, much more than he can sell. Too high a current ratio could mean idle cash balances or persistent under-trading. As the current ratio indicates the liquidity position of the business a low current ratio would give an early warning to the business to improve its liquidity position for example by reducing current liabilities by decreasing the number of short-term creditors, sale of redundant assets, cancelling capital spending plans, etc... However, in a few cases where the current ratio is negative it does not necessarily mean that the business is insolvent, as cash can be raised by the business by mortgaging its premises. But the business would have to pay interest on the bank loan; moreover, the principal amount of the loan would have to be repaid as well.

#### Quick ratio/acid test ratio:

This ratio is obtained by dividing current assets (excluding stock) by current liabilities.

$$\text{Quick ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

Stock has to be excluded because it is very difficult to convert stock to cash very quickly. This ratio is a stricter financial criterion, for it seeks to compare the liquid assets with the current liabilities which must be paid off. The ideal range for this ratio is 1:2. It can be used to reflect the solvency position of the company. Firms with very high stock levels will record very different current and acid test ratios. This is not a problem if stock levels are always high for this type of the business, such as a furniture retailer. It would be a cause for concern for other types of businesses, such as computer manufacturers where stocks lose value rapidly due to technical changes. Selling stocks for cash would lead to an improvement in the acid test ratio.

### Profitability ratios

- Gross profit margin, net profit margin/ how each of these ratios is used/ ways in which businesses might try to improve the ratio results

Gross profit margin:

This is also known as gross profit as a percentage of the turnover. The gross profit percentage shows the average profit made from trading.

$$\text{Gross profit Margin} = \frac{\text{Gross Profit}}{\text{Turnover}} \times 100$$

Like all averages, the gross profit percentage could be misleading since it may conceal substantially different gross profit margins where total sales include different products. It can serve as a guide to pricing policy; it can be used to test the profitability of sales. An increase in sale does not necessarily mean that the gross profit has increased. An increase in absolute sales may be accompanied by a reduced gross profit margin. This may be due to increase in the overhead costs.

#### A drop in the gross profit percentage may be due to several reasons:

Perhaps the goods being sold have cost more but the selling price has not risen to the same extent, or in order to boost sales reductions have been made in the selling price of the product. This could also mean that there is theft of stocks or of money from sales.



**Net profit margin:**

This is also known as net profit as a percentage of turnover

$$\text{Net profit Margin} = \frac{\text{Net Profit}}{\text{Turnover}} \times 100$$

The net profit percentage shows the actual average profit made, after taking into account all the costs and expenses incurred. The net profit percentage has a particular value in controlling expenses. Where gross profit percentage has remained constant, the net profit margin shows that expenses have increased more than proportionately to sales. Perhaps, the company is spending too much on salaries as it might be overstaffed. Perhaps, some members of the staff may be using the telephone for their personal calls outstation. Perhaps, there is overspending on advertising, etc. Each item of expenses may be calculated separately as a percentage of turnover. Any excessive rise for any one time can be easily spotted and steps should be taken to control it.

**Main users of account****Identification of the kind of information that individual stakeholder groups might seek**

The following list describes the uses of published accounts for various internal as well as external stakeholders:

**Managers:**

They can control the operation of each department through these accounts. They can measure the performance of the company by comparing the results with their expected targets. This can also help in making investment decisions.

**Banks:**

They can judge the financial position of the company through the accounts and decide upon the loan applications accordingly.

**Suppliers:**

They can see if the business is liquid enough to pay off its debts and check if the business has good credit history.

**Customers:**

They can see if the business is capable of ensuring of future supplies of the good they are purchasing, and to decide if they will be provided with service facilities.

**Government:**

This will help them in the calculation of taxes and keeping a check if the business is staying within the law in terms of accounting regulations. It can also help them in determining if the business is producing employment opportunities.

**Shareholders:**

In this way they can assess the value of their investment in the business. By analysing the information in the accounts, they can see if they want to further invest in the company by buying more shares. They can even compare the accounts of different companies before making a decision of investing in the company. It will also enable them to determine their share of profits.

**Workforce:**

They can check if the business is financially stable and can pay them the required wages and salaries. They can attain job security by this. They can even see if the profits are high, so that they can claim higher wages.

## Limitations of published accounts

**Limitations of the usefulness of published accounts:** historical, may not reflect the future, may be out of date, does not reflect qualitative aspects of the workforce, possibility of "window dressing", may not have details regarding individual parts of the business

The data that does not have to be included in these accounts would be: plans of the business regarding future investment, research and development plans of the business, details of the sales of each individual good, evidence of the company's impact on the community as a whole. In addition, the data given is based on "past" records of the business and this information could be several months old before the accounts were published. Only the internal management of the business can have access to the future planning of the business.

Stakeholders are often concerned about the accuracy of the published accounts. When companies try and present their accounts in a favourable manner in order to influence any of the stakeholders, such as a bank in order to get a loan more easily or encourage investors to buy shares, the company can be accused of "window-dressing" (already discussed earlier in 5AS.3/5AL.3). A company can commit this crime by overstating the value of their assets, ignoring the facts that some debtors who have not paid for the goods, may never pay, delaying paying bills until the accounts have been published, etc...

### Distinction between financial and management accounting

Financial accounting requires the accountants to prepare the published accounts of the business, whereas, management accounting requires the accountants to prepare detailed and frequent information for internal use by the managers of the business who need financial information to control the firm and take decisions for the future success.

## VARIANCES: ADVERSE, FAVOURABLE

### The meaning of variances/calculated and interpretation of variances

Variance can be defined as the deviation of actual results from expected, budgeted or standard results. This deviation could be in terms of costs, material usage, labour efficiency, volume and many other factors. Some variances may lead to major planning related issues for a business but are unavoidable and cannot be foreseen. Other variances are within the margin of acceptability. A particular variance could be categorised as *favourable* or *unfavourable*, keeping in mind the viewpoint and interests of the management and the business. For instance, if the actual cost is \$50000 whereas the budgeted figure for cost was \$42000, the cost variance (\$8000) would be classified as *unfavourable* or *adverse*. This is illustrated clearly in the following example.

Q/N 06, P3 (LoCost Airways), Q2(a)

	Budget\$000	Actual\$000	Variance\$000
Sales Revenue	55	46	9(Adverse)
Variable Costs	33	36	3(Adverse)
Promotion Costs	5	3	2(Favourable)
Other Overheads	13	15	2(Adverse)
Net Profit	4	(8)	12(Adverse)

A Variance Analysis should be conducted to separate out various elements causing the deviation of actual from expected performance. These reasons for variance must then be investigated to reduce the danger of recurrence.

## 5.7 CONTENTS OF PUBLISHED ACCOUNTS

### Depreciation:

It is the decline in the value of a fixed asset either due to physical deterioration resulting from usage or owing to obsolescence. The term "obsolescence" describes a situation in which a piece of machinery or equipment loses value since better substitutes are available in the market. In terms of the balance sheet, the purpose of recording depreciation is to account for the loss in value. In terms of profit and loss account, depreciation reflects the matching principle of allocating the cost of an asset over time. Depreciation can also be seen as providing a fund for replacement. Depreciation can be calculated with the help of different techniques including the following, termed as the "Straight-Line Method".

In this method, a fixed sum is deducted per year from the value of the asset. The sum is calculated by dividing historical cost less expected residual value (the value of the asset at the time of its retirement from use) by the time in years that the business expects to own the asset.

$$\text{Annual Depreciation} = \frac{\text{Cost} - \text{Residual Value}}{\text{Years Of Useful Life}}$$

This can be explained with the help of the following numerical example:

Historical Cost: \$800000, Expected Residual Value: \$200000, Expected Life: 6 Years

Annual Depreciation = \$100000

## 5.8 ANALYSIS OF PUBLISHED ACCOUNTS

- Profitability ratios
- Return on capital employed

Return on capital employed is also called the yield on funds invested in the business. This is an extremely important ratio and tells the business as to how much it is getting from the investment in the business.

$$\text{Return on capital employed} = \frac{\text{Net profit}}{\text{Capital Employed}} \times 100$$

The higher the value of this ratio, the better it is for the company as it would be getting a higher return on its investment. The ROCE of a business can only be improved by increasing the profitable, efficient use of the assets owned by the business which were purchased by the capital employed. This ratio does not take into account the risk factor of the business as a high return might be due to successful undertaking of risk rather than true business or managerial efficiency. The method used for the calculation is not universally agreed, that is why it is not a very helpful method when comparing between businesses.

## FINANCIAL EFFICIENCY RATIOS

### Inventory turnover, debtor days

**Inventory/stock turnover** is the number of times in a year the average stock can be sold off. It measures the speed at which stocks are cleared.

$$\text{Stock turnover ratio} = \frac{\text{Cost Of Goods Sold}}{\text{Average Stock Holding}}$$

This ratio may vary from trade to trade. For example, the rate of stock turn would be very high for a newspaper vendor as daily newspaper must be cleared off the same day. The rate of stock turn for a furniture shop would be lower as not everyone buys furniture every day. If two businesses in the same trade have different stock turn ratios, then the business with a higher ratio would be considered to be more efficient. This is because it would mean that less capital is tied up in stocks. As the rate of stock turn increases expenses are spread over a larger volume of sales. Hence the unit cost falls leading to economies of scale. A higher rate of stock turn would minimise losses due to changes in trends and

Unit-5

as goods kept for a very long time become shop soiled or damaged and must be sold at a loss. The rate of stock turn could be increased in a number of ways;

- I. By reducing the size of average stock needed to maintain a given volume of sales such as by placing small orders with suppliers.
- II. By cutting prices, especially on luxury goods, if demand is price elastic (a change in price of the product may lead to a proportionately higher change in the quantity demanded).
- III. By offering credit facilities.
- IV. By advertising and sales promotion techniques.

**Debtor days ratio** also known as debt collection period, measures how long, on an average, it takes the business to recover the payment from the customers who have bought goods on credit (the debtors).

$$\text{Debtor days ratio} = \frac{\text{Debtors}}{\text{Sales Turnover}} \times 365$$

There would be no right or wrong result as it would vary from business to business. It would be ideal for the business if the period is less than 30 days, moderate figure would be between 30 and 60 days, whereas if it exceeds 60, it is considered to be a negative sign for the company. Sometimes, a higher debtor day's ratio might be a deliberate management strategy in order to attract customers by extending credit.

## Gearing

### Gearing ratio:

This measures the degree to which the capital of the business is financed from long-term loans. The greater the reliance of a business on loan capital, the more "highly geared" the business is said to be.

$$\text{Gearing ratio (\%)} = \frac{\text{Long - Term Loans}}{\text{Capital Employed}} \times 100$$

Results above 50% would indicate a highly geared business. If the ratio is high, the higher would be the borrowings of the business and it would mean that it will affect the ability of the firm to pay dividends, as the interest rate would also be increasing. And if the business does not have enough cash to repay the loans then the shareholders might not get back their investment if the company goes into liquidation.

A low gearing ratio indicates a "safe" business strategy. The gearing ratio of the business could be improved by non-loan sources of finance, such as issuing more shares or retaining more profit. These increase shareholder's funds and capital employed and lower the gearing ratio.

## Investor ratios

### Dividend yield:

This measures the rate of return the shareholder gets at a current share price.

$$\text{Dividend yield ratio (\%)} = \frac{\text{Dividend Per Share}}{\text{Market Share Price}} \times 100$$

### Dividend cover ratio:

This represents the number of times the ordinary share dividend could be paid out of current profits. The higher the ratio, the more able the company is to pay the proposed dividends.

$$\text{Dividend cover ratio} = \frac{\text{Profit After Tax and Interest}}{\text{Dividend (paid and proposed)}}$$

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## 5.9 INVESTMENT APPRAISAL

### The concept of investment appraisal

#### The need for investment appraisal

**Investment appraisal** means evaluating the profitability or desirability of an investment project. This is usually undertaken by using quantitative techniques that assess the financial feasibility of the project.

#### The significant of risk in investment decisions

The decision to invest in the business involves a high degree of risk. There may be a considerable choice of projects from which the business can choose from. If the costs and revenue data is accurate or the budgeted figures are always correct, then almost all the businesses in the world would survive without any difficulty. Investment decisions mostly fail because they are based on uncertainty. Investment is also considered to be risky as it is funded by borrowed money. And this would involve cost of borrowing as well. So if the business fails, the business will have to repay the loans borrowed from the banks.

#### The meaning, calculation and interpretation of payback, ARR and NPV

**Payback period** is the length of time it takes for the business to recover its investment. It is important to take payback into consideration when making investment decision as a long payback period will increase the interest payments. The speedier the payback, the quicker the capital is made available for the other projects. A payback period more than 50% of the useful life would be a negative indicator (in case comparative data is not available).

$$\text{Payback period (Month)} = \frac{\text{Additional Cash Flow needed}}{\text{Annual Cash Flow}} \times 12$$

Example from year May/June 2002, paper 2, Eating Shop, c(i).

Investment = 200,000

Year 1 = 60,000

Year 2 = 70,000

Year 3 = 100,000

Therefore, investment will be recovered between the second and third year.

The amount required after the second year starts would be 70,000.

$$\text{Therefore; } \frac{70000}{100000} \times 12 = 8.4 \text{ months}$$

So the payback period would be 2 years, 8.4 months.

Payback is easy to calculate. It is particularly useful for businesses where liquidity is of greater significance than overall profitability. The emphasis on the speed of return of cash flows gives the benefit of concentrating on more accurate short-term forecasts of the project's profitability.

However, payback does not measure the overall profitability of the project and does not take into account cash flows after the payback period. The concentration on the short-term return may lead the business to reject very profitable projects only because they take time to repay the capital.

#### Average rate of return (ARR):

ARR may also be termed as accounting rate of return. It measures the overall profitability of an investment as a percentage of the initial investment, unlike the payback method.

$$\text{ARR} = \frac{\text{Average Annual Profit}}{\text{Initial Capital Cost}} \times 100$$

Example from year May/June 2002, paper 2, Eating Shop, c(ii).  
 Total profit = \$40,000 + 70,000 + 100,000 + 150,000 + 150,000 = \$200,000  
 = \$200,000

$$\text{Annual profit} = \frac{240,000}{5} = 48,000 \quad \frac{48,000}{200,000} \times 100 = 24\%$$

The higher the result the better it is for the company. If ARR is lower than 25%, (if comparison is not available) it is considered to be a discouraging figure. ARR takes into account all the cash flows. It focuses on the profitability of the firm, which is the main objective of any firm. The result can be easily understood and is easy to compare with other projects. ARR ignores the timing of the cash flows. The time value of money is also ignored. The technique is based on the incorrect assumption that the value of currency remains constant over time.

#### Net present value:

The net present value (NPV) is the total discounted cash flows less the initial cost of investment. Discounted cash flows take into account the fact that interest rates affect the present value of future income. NPV considers both the timing of the cash flows and the size of them arriving at an appraisal. The rate of discount can be changed according to the prevailing economic situation. It considers the time value of money while a long-term project or investment is being considered. However, it is not easy to calculate. The final result depends on the rate of discount and interest rate expectations might not be accurate. Net present value should be as high as possible but it can be compared more effectively with other projects if the initial cost is the same.

Example from Oct/Nov 2002, Paper 3, Tanroh's Dilemma, Q5 a(ii).

Net Book Value = net cash flow / discounted factors

$$= (5,000 \times 0.91) + (15,000 \times 0.83) + (20,000 \times 0.75) + (24,000 \times 0.68) \\ = 43,320$$

Initial investment = \$20,000

Net Present Value

= Net Book Value - Initial Investment

$$43,320 - 20,000 = \$23,320$$

The meaning of internal rate of return

IRR is that rate of discount which yields a net present value of zero.

#### COMPARISON OF INVESTMENT APPRAISAL TECHNIQUES:

The Payback method is the simplest, quickest and the "easiest to apply" investment appraisal method. It is particularly recommended in case of machinery and equipment that is threatened by "obsolescence". The investor is able to judge whether he will be in a position to recover the investment before the piece of machinery becomes outdated or not. However, the critics of this technique suggest that it may sometimes lead to inaccurate results since it primarily focuses on the payback period or the time factor and overlooks the fluctuation in cash flow over a longer period of time. The ARR investment appraisal technique assists the investor in analysing a situation in monetary terms by calculating the expected return as a proportion of capital outlay. It may prove to be a more effective and realistic method as compared to payback since it takes into consideration the variation in the cash flow on a long-term basis; something found missing in the previous approach. The drawback associated with the ARR method is that it is based on the incorrect assumption that the value of currency will be consistent over the useful life of the asset. The NPV method proves to be quite useful for long-term projects owing to the fact that it gives due importance to the "discount factors", or the predicted changes in the value of currency over time. However, accuracy may sometimes be compromised due to the difficulties and uncertainty involved in the determination of the value of currency in future, which obviously is affected by a host of macro-economical factors that are beyond the control of the business.

## RELEVANT QUESTIONS FROM PAST PAPERS (SECTION 5)

May/June 2013, P2 (b)(i) (Trendy Paints),

- (b) (i) TP sells its paints at an average price of \$10 per litre. Using Table 1, calculate the breakeven level of production per year for TP's proposed new production system. [3]

Oct/Nov 12, P3, 2(a), 4(a),

- 2 (a) Refer to Appendix A. Calculate for the delivery service proposal the:  
(i) Average rate of return (ARR) [3]  
(ii) Net Present Value (NPV). [3]
- 4 (a) Refer to Appendix B. Calculate the:  
(i) Return on Capital Employed (ROCE) for ADC [3]  
(ii) gearing ratio for BSL. [3]

Oct/Nov 2009:- PAPER 1, Q4 (a), (b),

- 4 (a) What is a cash flow forecast? [2]  
(b) Explain one way of improving a business' cash flow. [3]

Oct/Nov 2009:- PAPER 2, PHONEQUIP b(i),(ii),(iii). PEDRO'S FISH (PF), a(ii), b(i), (ii), (c),

- (b) (i) Calculate the acid test ratio for 2009. [2]  
(ii) The acid test ratio for 2008 was 1.5. Briefly comment on the significance to PQ of the change in the acid test ratio. [2]  
(iii) With reference to the data provided by the Finance Director in Table 1, briefly explain one reason for the change in the acid test ratio. [2]
- (a) Explain the following terms:  
(ii) retained profit (lines 4-5). [3]
- (b) (i) Calculate the payback for the boat conversion investment. [2]  
(ii) Explain the usefulness to PF of your answer to (i). [2]
- (c) Briefly examine sources of finance that might be useful to PF. [6]

Oct/Nov 2009:- PAPER 3, CHAN BEAUTY COMPANY, Q2, Q4(a) (i), (ii), (b).

- 2 Using the data in Appendix B, calculate the impact on the company's annual profit of closing the Cityville hairdressing shop. [8]
- 4 (a) Calculate for Option 2 the:  
(i) Average Rate of Return (ARR) [4]  
(ii) Net Present Value (NPV) using the 10% discount factors in Table 1. [4]
- (b) Which of the two options would you advise June to choose? Fully support your answer by referring to your results from 4(a) and other information. [16]

May/June 2009:- PAPER 1, Q2 (a), (b), Q7(a),

- 2 (a) Define 'capital expenditure'. [2]  
(b) Describe two external sources of finance that might be used to fund the capital expenditure of a business. [3]
- 7 (a) Discuss the problems a new business might experience in its first year of trading. [8]

May/June 2009:- PAPER 2, BOB'S BAND a (i), b(i), (ii), (c), CHEAPO AIR a (i), b(i), (ii),

- (a) Explain the terms:  
(i) margin of safety (line 10) [3]
- (b) (i) Calculate the price that FB should charge in order to break even at 150 ticket sales. [4]  
(ii) Explain the usefulness to FB of using break even analysis. [4]
- (c) Briefly analyse why FB may have difficulty getting finance for the concert. [6]
- (a) Explain the following terms:  
(i) profit margin (line 2) [3]  
(ii) Calculate the price that CA would have to charge business customers to achieve the same operating profit per flight as for low cost flights. [3]

- (ii) Briefly comment on your answer to (b)(i). [3]

**May/June 2009:- PAPER 3, CAR MANUFACTURER AT A CROSSROADS, Q4 a (i), (ii), (b), (c)**

- (a) Using data from Appendix A, calculate the following ratios for EM in 2008:  
(i) Gross profit margin [3]  
(ii) Net profit margin. [3]  
(b) Analyse two possible reasons for EM's falling gross profit margin. [6]  
(c) Evaluate any two ways in which EM might increase its net profit margin. [8]

**Oct/Nov 2008:- PAPER Q2(a), (b), Q6, PAPERCLIPS, b(i),(ii),(iii),**

- (a) Explain the terms:  
(i) Stakeholders (line 7). [3]  
(ii) Market research (line 20). [3]  
(b) (i) If sales in month 4 are \$800, calculate the closing balance in Table 1 for that month. [2]  
(ii) State two reasons why the directors of PC might have difficulty raising the \$200 cash shortfall needed in month 2. [2]  
(iii) Explain the difference between cash and profit. [4]

**Oct/Nov 2008:-PAPER 3 TANROH'S DILEMMA, Q1,Q5 a (i), (ii), (b).**

- 1 Analyse the benefits to Tanroh of producing cash flow forecasts. [8]  
5 (a) Calculate for the safari lodge option, using the data in Appendix A:  
(i) The annual average rate of return [3]  
(ii) The net present value at a 10% discount rate. [3]  
(b) Using your results from 5(a) and other information, recommend to Tanroh which of the two options he should choose. Justify your recommendation. [16]

**May/June 2008:- PAPER 1 ,Q3, Q4(a), (b),**

- 3 Explain how two different stakeholder groups might use the published accounts of a business. [5]  
4 (a) Define the term 'working capital'. [2]  
(b) Describe one method a business might use to manage its working capital. [3]

**May/June 2008:-PAPER 2, EAST FARM WILDLIFE PARK, a (ii), d (i),**

- (a) Explain the following terms:  
(ii) internal sources of finance (line 17). [3]  
(d) (i) Calculate the value of X (ARR) in Table 1. [4] Calculate the value of X (ARR) in Table 1. [4]

**May/June 2008:-PAPER 3 PYRAMID TELEVISIONS(PT), Q5.**

- 5 Assume you are PT's bank manager. Discuss the accounting data and ratios you would need before deciding whether to lend PT the finance needed for expanding production capacity. [14]

**Oct/Nov 2007:- PAPER 1, Q4(a), (b),**

- 4 (a) State two sources of finance which could be used to finance revenue expenditure. [2]  
(b) Explain the term 'capital expenditure'. [3]

**Oct/Nov 2007:- PAPER 2, ZETA OIL a(i),(ii), EXCELLENT TRAINING, a(ii), b(i),(ii),(iii),**

- (a) Explain the following terms:  
(i) Stock Exchange (line 11) [3]  
(ii) average rate of return (lines 12-13). [3]  
(a) Explain the terms:  
(ii) variable costs (Table 1). [3]  
(b) (i) Using Table 1, calculate how many people ET need on each course to break even. [3]  
(ii) Calculate the profit if 20 people attend a course. [3]  
(iii) Briefly comment on the usefulness to the management of ET of the results in (b)(i) and (ii). [2]



**Oct/Nov 2007:- PAPER 3, CURRY CUISINE, Q3 (a), (b), Q4.**

- 3 (a) Draw up a forecasted Profit and Loss Account for 2008, using the data in Appendix A and the management consultant's estimates. (lines 68-74) [8]  
 (b) Briefly assess **two** ways in which the gross profit margin could be raised for the take-away products (calculations not needed). [8]
- 4 To what extent do you agree with Ling that the business would have problems raising the capital needed for the "ready made meals" project either from internal sources or from a loan? The use of relevant accounting ratios (based on the data in Appendix B) to support your judgement will be rewarded. [14]

**May/June 2007:- PAPER 1, Q2 (a), (b), Q3, Q6 ,**

- 2 (a) State the formula for an accounting ratio that might be used to measure the profitability of a business. [2]  
 (b) Explain two factors that might affect the profitability of a business. [3]
- 3 Briefly explain two ways in which a manufacturer of tinned foods might find break-even analysis useful. [5]
- 6 Discuss the suitability of the various sources of finance a large business might use when replacing old machinery. [20]

**May/June 2007:- PAPER 2, BEE'S MEAL, a(ii), b(i),(ii), (c),**

- (a) Explain the terms:  
 (ii) multinational (line 3). [3]
- (b) (i) Calculate the percentage change in sales of components between 2005 and 2006. [2]  
 (ii) How does your answer to (b)(i) and other information in Table 1 support Tariq's idea of focusing more on the sale of components? [6]
- (c) Discuss the marketing and other factors that Tariq should consider before deciding whether to sell components on the Internet. [10]

**May/June 2007:- PAPER 3, CRAFT DESIGNS , Q2(a), (b), Q4 (a), (b),(c).**

- 2 (a) Calculate the effect on the company's profit of stopping production of the stone sculptures. Show your calculations and state any assumptions you make. [6]  
 (b) Using your result from (a) and any other useful information from the case, recommend whether Ade should stop production of the stone sculptures. [10]
- 4 (a) Using the two ratios suggested by the Finance Director, analyse and comment on the financial efficiency of Craft Designs. [10]  
 (b) Outline two drawbacks to the ratio analysis that you have conducted. [4]  
 (c) Discuss two ways in which the Finance Director could improve the financial efficiency of the company. [8]

**Oct/Nov 2006:- PAPER 1, Q1 (a),(b), Q7 (b),**

- 1 (a) Distinguish between assets and liabilities in a balance sheet. [2]  
 (b) Briefly explain why businesses depreciate their fixed assets. [3]
- 7 (b) Evaluate the usefulness to a business of the Payback and Average Rate of Return techniques in deciding whether to invest in changing its production method from batch to flow. [12]

**Oct/Nov 2006:- PAPER 2. ELDORADO RESTAURANTS, a(i), b(i),(ii),**

- (a) Explain the following terms:  
 (i) sales revenue (line 6) [3]
- (b) (i) Using the figures from Table 1, calculate the missing value of X in Table 2:  
 Table 2

	2005	2006 forecast
Gross profit margin	X	44%
Net profit margin	15%	4%

Unit 5

- Using your answer to (b)(i) and other information, comment on trends in ER's profits. [4]
- Oct/Nov 2006:- PAPER 3 LoCOST AIRWAYS, Q2 (a), (b), (c), Q4.**
- (a) Using the data in Appendix A, calculate variances for the car hire division. [5]
- (b) Using your results from (a), analyse briefly why profits for the car hire division were less than budgeted. [5]
- (c) Discuss two ways in which this division might be made more profitable. [8]
- Using the data in Appendix C and any other relevant information, recommend which city LoCost Airways should locate their next base in. Justify your answer. [16]

- May/June 2006:- PAPER 1, Q5 (a),**
- (a) Examine the different sources of finance which a car manufacturer might use in order to fund investment in new technology. [8]

- May/June 2006:- PAPER 2, STAR PHARMACEUTICALS, a(ii), d(i), HOME FARM, c (i), (ii),**
- (a) Explain the following terms:
- (ii) variable cost (line 22). [3]
- (d) (i) The break even level of production for the factory in Country A is 1.5 million units. Using the data from the case, calculate the break even level of production for the factory in Country B. [2]
- (c) (i) Calculate the values of X and Y in the following table:

- May/June 2006:- PAPER 3 RAVE CONFECTIONERY, Q3.**
- Using Appendix A and appropriate accounting ratios, analyse the likely reasons for declining profitability at Rave over the period shown. [14]

- May/June 2005:- PAPER 1, Q2 (a), (b), Q4(a), (b),**
- (a) Explain liquidity. [2]
- (b) Explain one way in which a business might improve its liquidity. [3]
- (a) With an appropriate example, explain what is meant by variable costs. [2]
- (b) Explain why it is sometimes difficult to separate costs into variable costs and fixed costs. [3]

- May/June 2005:- PAPER 2, b(i), (ii), (iii), OUR NEWS Ltd b(i),**
- (b) (i) Calculate the forecast net profit for 2006 if the new product is introduced. [2]
- (ii) Calculate the net profit margin after the new product is introduced. [2]
- (iii) How might John use the result in (ii)? [2]
- (b) (i) Calculate the percentage (%) change in total revenue of monthly magazines from 2002 to 2004. [2]

- May/June 2005:- PAPER 3, WOTTON COLLEGE, Q2 a (i), (ii), (iii), (iv), (b).**
- (a) Assuming Paula makes the changes outlined in Option 1, calculate for 2006:
- (i) the revenue from student fees, assuming the price elasticity of demand estimate is correct. [4]
- (ii) teachers' salary costs [1]
- (iii) material costs [1]
- (iv) net profit. [2]
- Show all workings.

- Oct/Nov 2005:- PAPER 1, Q5 (a), (b),**
- (a) Explain the purposes of a company's Balance Sheet and Profit & Loss Account. [8]
- (b) Discuss the usefulness of published company accounts to both managers and shareholders. [12]

- Oct/Nov 2005:- PAPER 2, READ AND LEARN BOOKSHOP, a (i), THE SUN HOTEL Ltd, a (ii), b (i),**
- (ii), (iii),
- (a) Explain the following terms:
- (i) contribution (line 8) [3]
- (a) Explain the following terms:
- (ii) working capital (line 15). [3]

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- (b) (i) Calculate the current ratio. [4]  
 (ii) Briefly explain the significance of your result. [2]  
 (iii) Explain two ways in which Padman might improve the management of working capital. [4]

Oct/Nov 2005:- PAPER 3 MERCADO PLC, Q2 a (i), (ii), (b), Q3 (a), (b).

- 2 (a) Use Appendix A to calculate for both options:  
 (i) The Average Rate of Return. [4]  
 (ii) The Net Present Value (at 10% discount) [4]  
 (b) How useful might these results be to Mercado's directors? [4]  
 3 (a) Calculate financial efficiency ratios for Mercado plc using the data in Appendix B. [6]  
 (b) Evaluate any **two** ways in which the business might improve its financial efficiency. [8]

Oct/Nov 2004:- PAPER 1, Q2,

- 2 Briefly explain the importance for a manufacturer of managing working capital. [5]

Oct/Nov 2004:- PAPER 2, BALJIR THE BUILDERS, a(i), RITEON CLOTHES Ltd, a (i), b (i), (ii),

- (a) Explain the following terms:  
 (i) profit margin (line 6) [3]  
 (a) Explain the following terms:  
 (i) capacity utilisation (line 7) [3]  
 (b) (i) Capital employed is \$40 million for both years. Calculate the return on capital employed for both 2002 and 2003. [3]  
 (ii) Briefly comment on your results. [3]

Oct/Nov 2004:- PAPER 3, FOOD2U Ltd, b (i), (ii), (iii), c (i), (ii), (d).

- (b) (i) The Insert shows Food2U's existing break-even graph. Using the data from **Appendix A**, draw the new break-even graph on the Insert. [5]  
 (ii) State the new break-even level of output and new level of profit (at full capacity) in the spaces provided on the Insert. [3]  
 (iii) On the basis of your graph and the other information available, recommend to Neema and Min Chul whether to accept the new proposal. [10]  
 (c) (i) Using the data in Appendix B, calculate the current gearing ratio for Food2U. [2]  
 (ii) Evaluate possible methods of financing the purchase of the machines and the lease of the new premises. [10]  
 (d) Advise Min Chul on how to depreciate the new machinery. Justify your answer. (No calculations are required.) [8]

May/June 2004:- PAPER 1, Q4 (a),(b),

- 4 (a) Briefly explain the purpose of the Cash Flow Statement in company accounts. [2]  
 (b) Briefly distinguish between internal and external sources of finance. [3]

May/June 2004:- PAPER 2, CANDY SHOWS, b (i),(ii), LASTING MEMORIES, a(ii),

- (b) (i) Using information from the text and Table 1, calculate the forecast profit for a large event [5]  
 (ii) Comment on your result. [3]  
 (a) Explain the following terms:  
 (ii) capital expenditure (line 10). [3]

May/June 2004:- PAPER 3, DECISION TIME AT TOPAZ, b (i), (ii), d (i), (ii), (iii),

- (b) (i) Using **Appendix A**, calculate the contribution per toy that Topaz would receive from the Adams order. [4]  
 (ii) Using all of the evidence, recommend to the directors of Topaz whether the Adams order should be accepted. [10]  
 (d) (i) Outline **two** problems of forecasting cash flows for Strategy C. [4]  
 (ii) Using **Appendix B** and the discount factors provided, calculate the Net Present Value of Strategy C. [4]  
 (iii) Explain whether your result to (ii) might influence the directors to choose Strategy C. [4]

Unit 5

**May/June 2003:- PAPER 1, Q4(a),(b),**

- (a) Distinguish between revenue expenditure and capital expenditure. [2]  
(b) Briefly explain why different sources of finance might be needed for revenue expenditure and capital expenditure. [3]

**May/June 2003:- PAPER 2, TEE BUSINESS Ltd, a(i), b(i), (c),**

- (a) Define the following terms:  
(i) fixed costs (line 9) [3]  
(i) Calculate break-even output, if the new payment system were to be introduced. [3]  
(b) Analyse one method of investment appraisal Ratan might use. [6]  
(c)

**May/June 2003:- PAPER 3, FAST FOOD FRANCHISE, c(i), (ii).**

- (i) Refer to the insert. Complete the cash flow forecast for this business for the first four months of trading. [8]  
(c) (ii) Evaluate the usefulness of a cash flow forecast to Rashid and Shivani. [6]

**Oct/Nov 2003:- PAPER 1, Q6 (a),**

- (a) Outline the main contents of published company accounts. [8]  
6

**Oct/Nov 2003:- PAPER 2, ROUND PLC, b(i),(ii),(iii), AKSHAY COMPANY Ltd, c(i),(ii),**

- (b) (i) Using the straight-line method, calculate the annual depreciation of the new machine. [2]  
(ii) Explain the effect of this depreciation on Round plc's balance sheet. [2]  
(iii) Calculate the average rate of return (ARR) of the investment in the new machine. Briefly explain what your result means. [4]  
(c) (i) Calculate the return on capital employed for 2002. [2]  
(ii) Using your answer to (c)(i) and other data, analyse the performance of the business between 1999 and 2002. [6]

**Oct/Nov 2003:- PAPER 3, ORIENTAL ENGINEERING Ltd, (d).**

- (d) Assume that the business goes ahead with the new project and relocation.  
Recommend how the business might raise the finance needed, using relevant accounting ratios to help you. [12]

**Oct/Nov 2002:- PAPER 1, Q4 (a),(b),**

- (a) Why do businesses depreciate fixed assets? [2]  
(b) Explain why the payback period might be an important factor in deciding whether to invest in new fixed assets. [3]  
4

**Oct/Nov 2002:- PAPER 2, THE TRAVELSTOP HOTEL, (b), c(i),(ii),(iii),**

- (b) Using the information in Table 2, explain why there might be a cash flow problem in the business and suggest one possible remedy for this situation. [4]  
(c) (i) Calculate the number of rooms Travelstop must sell per month in order to break-even. [2]  
(ii) Calculate the expected profit for November assuming the booking for JDJ plc is accepted. [3]  
(iii) Using your answers to (i) and (ii) and any other information, advise Paul Ho whether to accept the order from JDJ plc. [5]

**Oct/Nov 2002:- PAPER 3 CASTLE LODGE, b(i), (ii), (c).**

- (i) Conduct an investment appraisal of the new conference centre using the payback and net present value methods of appraisal. You may assume that all costs are paid and revenue is received in cash. [10]  
(ii) Recommend whether Nikolai and Christina should proceed with this new investment. Using your results from (b)(i) and any other information available to you, explain the reasons for your recommendation. [10]  
6



**May/June 2002:- PAPER 1, Q3 (a),(b), Q4(a),(b),**

- 3 (a) Why is break-even analysis a useful tool for managers? [2]  
(b) By use of a diagram, show how break-even quantity is established by graphical method. Label the axes and lines. [3]
- 4 (a) Briefly explain the difference between a Balance Sheet and a Profit and Loss Account. [2]  
(b) What additional information does the Cash Flow Statement give about the financial position of a business? [3]

**May/June 2002:- PAPER 2, EATING SHOP, a(ii), c(i),(ii),(iii), THE SMART TILE COMPANY, a(i),**

- (a) Define the following terms:  
(ii) Net cash flow (line 16). [3]
- (c) For the proposed new restaurant:  
(i) Calculate the payback period. [2]  
(ii) Calculate the average rate of return. [3]  
(iii) Comment on your results. [3]
- (a) Define the following terms:  
(i) Return on capital (line 3) [3]

**May/June 2002:- PAPER 3, SPORTWIZE Ltd, b(i),(ii), c(i),(ii).**

- (b) (i) Analyse and comment on the liquidity of this business. [8]  
(ii) Evaluate **two** ways in which the business could improve its cash flow position. [10]

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**UNIT 6**

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# **strategic Management**

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A Level  
Business  
Teacher's Notes

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## **Syllabus 2016 –18**

6.1 What Is Strategic Management?

6.2 STRATEGIC ANALYSIS

- Swot analysis:
- Pest or external environment
- analysis:
- Business vision/mission statement & objectives
- Boston's matrix
- Core competences
- 6.3 strategic choice
- Ansoff's matrix
- Force-field analysis
- Decision trees

6.3 Strategic Choice

- ansoff's matrix
- force-field analysis
- decision trees

6.4 strategic implementation

- contingency planning and crisis management
- contingency planning and crisis management
- developing a change culture / managing and controlling strategic change
- corporate culture and strategic
- business plans

## UNIT 6 STRATEGIC MANAGEMENT

### 6.1 WHAT IS STRATEGIC MANAGEMENT?

The term refers to a process through which managers formulate and implement strategies that would enable the business to achieve its long term goal in the given macro and micro-environmental conditions.

#### **Corporate Strategy:**

It is a type of strategy that addresses what businesses the organisation will operate and how strategies of those businesses can be coordinated. The objective is to strengthen the organisation's competitive position through an effective allocation of resources among businesses.

#### **Need and importance of strategic management:**

Strategic management helps organisations identify and develop a competitive advantage, or a significant edge over competitors. Strategic management is also important because it provides direction to everyone in the organisation and they know where to expend their efforts. Without a strategic plan, managers may concentrate on day-to-day activities, only to find that a competitor has achieved a more favourable position by taking a longer term view of a situation. Strategic management can also show a need for innovation, providing an organised approach for encouraging new ideas related to strategies. Moreover, the process can involve managers at various levels in planning that ensures a better understanding of a given situation and results in an improvement in the commitment level also.

### 6.2 STRATEGIC ANALYSIS

#### **SWOT ANALYSIS**

SWOT Analysis is the study of the elements of strengths(S), weaknesses (W), opportunities (O) and threats (T) in connection with a particular organisation. "S" and "W" represent the internal or the micro-environment whereas "O" and "T" the external or macro-environment of a business. It is recommended that a business carries out SWOT Analysis not only before it starts working on a new project or launches a new product but also as a regular feature for bringing about an improvement in the overall performance. The management should develop a system that allows the workforce and various departments to identify their strong and weak areas so that appropriate measures can be adopted accordingly. Competent and motivated workers, strong financial position of the business and a sound infrastructure of the company can all be regarded as strengths that must be maintained. For example, if the management knows they have skilled workers, they should offer every possible financial and non-financial reward to them in order to keep them motivated and reduce labour turnover. Similarly, if a weakness is highlighted such as low performance level of the employees, an immediate action needs to be taken. It could be in the form of better training services or issuance of warning letters. Once the company has looked into the micro environment related strengths and weaknesses, it should analyse the external environment and focus on the existing opportunities that can be availed as well as threats posed to the business. A business that shows promptness in identifying an opportunity and then formulating a strategy for availing it, always has a better chance of being successful. Opportunities such as low competition, soft government policies and favourable weather conditions must not be missed out on. We have evidence that companies that managed to become pioneers in a particular field, maintained their lead and market share for decades and achieved phenomenal success. The best possible examples in this context are market leaders including Coke, Microsoft, Kodak and Xerox. On the other hand, it is equally important to identify elements that threaten the growth or success of a business. For instance, factors such as intense competition, high tax rates or inconsistent government policies ought to be taken seriously and business policies chalked out accordingly.

## PEST OR EXTERNAL ENVIRONMENT ANALYSIS

The external or macro environment of a business should be analysed carefully in order to ensure that a business strategy is realistic and objective-oriented. The PEST Analysis is a study of the political, economic, social and technological factors that have an impact on the performance of a business. The political environment refers to the extent to which a country is enjoying political stability. In a politically stable country, the government has consistent policies in connection with taxation, subsidies, consumer protection, labour protection etc. This gives a sense of security to businesses and they can formulate a strategy on a long-term basis. This is regarded as an encouraging and healthy sign by investors. The political environment overlaps with the legal framework of the country also. The prevailing rules and regulations in the country influence businesses to a great extent. For example, the government in Singapore is planning to impose a ban on the use of billboards by firms since they distract drivers and cause accidents. Similarly the Norwegian government legislated against numerous sales promotion schemes since they believe that incentives like "lucky draws" force customers to take irrational decisions. It is rather obvious that such policies will go a long way in shaping the marketing and overall business strategy adopted by firms. The economic environment is divided into two parts. Firstly, it represents the living standards and the purchasing power of the customer. Once the company manages to establish a realistic position regarding the income group it is targeting, it will not be difficult to design, price and distribute the product, whether it is a luxury item or a fast moving consumer good (FMCG), in a market-oriented way. Secondly, the role of banks is also extremely important in moulding the economic set up of a country. Japanese banks, for instance, are preferred by businessmen as compared to American financial institutions since they offer loans at lower interest rates. These two factors must be considered seriously by businesses in order to conduct a more effective strategic analysis. It is imperative for the management of a business to study and respect the social norms and traditions of a particular country or community. Social and ethical issues are sensitive and it can prove to be disastrous for a business if it tries to challenge the social or religious beliefs of people. It will be unwise, for instance, to offer alcoholic drinks in a society where it is unacceptable due to social or religious factors. That is why manufacturers worldwide modify their products strictly in accordance with the requirements of the social set up of the potential customers. Introduction of dolls with scarves in the Middle Eastern countries is an example of the adaptability shown by the manufacturers. Production of environmental friendly items and steps taken by manufacturers for the abolition of child labour also fall in same category. Finally, information regarding the status of technology is also an important part of business strategy. The technological environment influences all the qualitative and quantitative aspects of a business. Availability or absence of a particular kind of technology can have a major impact on issues pertaining to production, distribution, management of funds, human resource management and marketing. In today's competitive business world, a firm that has an access to advanced technology will definitely be in a better position to successfully explore the existing opportunities with an edge over its competitors.

## BUSINESS VISION/MISSION STATEMENT & OBJECTIVES

It is impossible for organisations to function without at least some goals and plans. A goal is a future target or end result an organisation wishes to achieve. A plan, on the other hand, is the means devised for attempting to reach a goal. Planning builds on the organisation's mission which can be defined as the organisation's purpose or fundamental reason for existence. "Mission Statement" is a broad declaration of the basic, unique purpose and scope of operations, distinguishing the organisation from others of its type. A mission statement serves many purposes. For employees, it defines a common purpose and helps develop a sense of community for workers. For managers, it is a benchmark for evaluating success. For external parties, such as the investors, government and public, it provides a unique insight into the organisation's values and future direction.

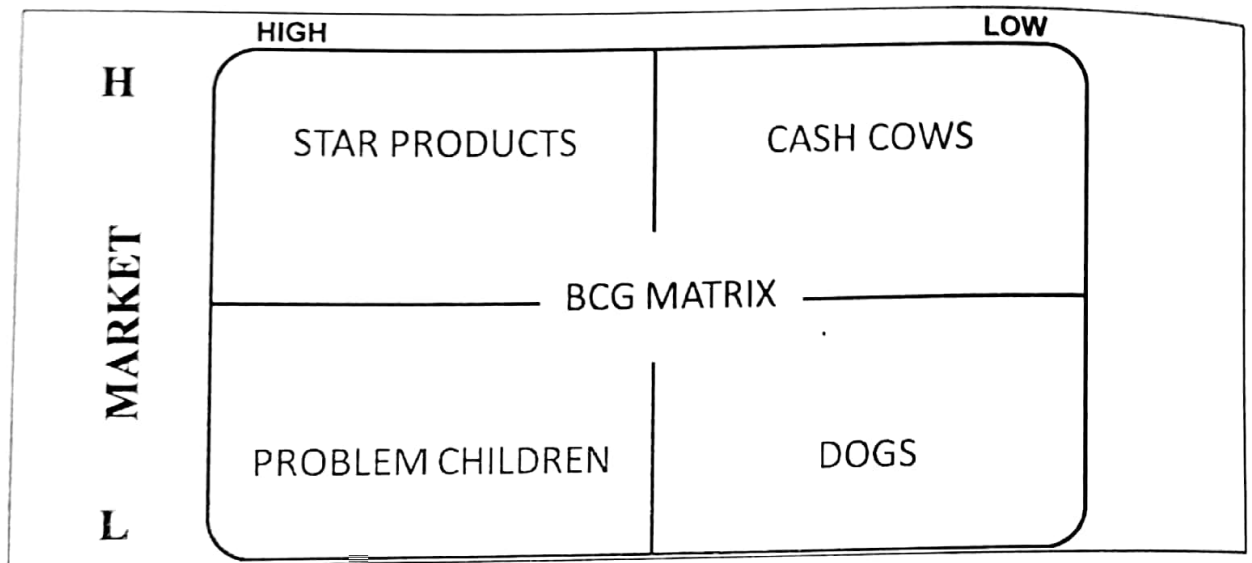
## BOSTON'S MATRIX

It is a technique of analysing a firm's product portfolio or product mix, using data on market share and market growth. The term "product portfolio" represents the complete range of products supplied by a firm. Nestle', for example, has a product mix comprising of over



1200 products. This technique was developed by the Boston Consulting Group and that is why it is sometimes termed as the BCG Matrix. This matrix places products into four categories.

### MARKET GROWTH



**Star products** are those with a large share of a high growth market.

**Problem children** or "question marks" have future potential as they are in growth markets, but currently their sales are not particularly good.

**Cash cows** are those which are able to generate funds, possibly to support other products. They are mature products with a stable market share.

**Dogs** are products that may be in decline.

The Boston Matrix provides a valuable tool to analyse a firm's product range and helps to identify strengths and weaknesses. Not only does it provide a snapshot at a moment in time, it can be adapted to forecast the position of the firm's products at some point in the future. From such an analysis, the following four alternative strategies can be developed for each product:

**Hold:** hold on to the market position.

**Build:** build and improve the market position.

**Harvest:** achieve maximum short-term cash flow regardless of the long-term effect.

**Divest:** get rid of the cash deficit problem.

### FIVE - FORCES ANALYSIS:

The "five forces model" developed by Michael Porter has been the most commonly used analytical tool for examining a competitive market. It describes the competitive environment in terms of the following five basic competitive forces:

#### The threat of new entrants:

The threat of new entrants refers to the possibility that the profits of established firms in the industry may be eroded by new competitors.

#### The bargaining power of buyers:

Buyers threaten an industry by forcing down prices and bargaining for higher quality or more services.

#### The bargaining power of suppliers:

Suppliers can exert bargaining power over participants in an industry by threatening to raise prices or reduce the quality of purchased goods and services.

#### The threat of substitute products:

Substitutes limit the potential return by placing a ceiling on the prices that firms in that industry can profitably charge.

### **The intensity of rivalry among competitors in an industry:**

Rivalry among existing competitors forces the firms to use tactics like price competition, advertising battles, product introductions and increase customer service or warranties. Each of these factors affects a firm's ability to compete in a given market. Together, they determine the profit potential for a particular industry. A manager should be familiar with the five-force model for several reasons. It helps him decide whether the firm should remain in or exit an industry. It provides a justification for increasing or decreasing resource commitments. This analysis can bring about an improvement in the firm's competitive position with regard to each of the above mentioned five forces.

### **CORE COMPETENCES**

The concept of core competence is based on the ability of a business to coordinate diverse production skills, integrate multiple streams of technology and market a variety of goods and services. The effectiveness of core competence is determined by the following three factors:

**The core competence must enhance competitive advantage by creating superior customer value:**

It must enable the business to develop strengths relative to the competition. At Gillette, for example, scientists developed Mach 3 and Sensor Excel, showing a high degree of unmatched innovation. Customers have consistently been willing to pay more for such technologically differentiated products.

**Different businesses in the corporation must be similar in at least one important way related to the core competence.**

It is not essential that the products have to be similar. Rather, at least one element in the value chain must require similar skills in creating competitive advantage if the corporation is to capitalise on its core competence. For example, Harley Davidson has focused on developing a strong brand image while promoting accessories, clothing, toys and now a cafe' in addition to its legendary motor cycles.

**The core competence must be difficult for competitors to imitate.**

It is important to note that competitive advantages will not be sustainable if the competition can easily imitate or substitute them. For instance, Sharp Corporation was the pioneer in developing the LCD (Liquid Crystal Display) technology that was successfully used in VCRs and other electronic devices.

## **6.3 STRATEGIC CHOICE**

### **ANSOFF'S MATRIX**

The An off's Matrix is a useful tool for businesses aiming for growth. It identifies four possible marketing strategies involving the combination of products and markets. As illustrated in the diagram, there are four possible ways in which products can be combined with markets for attaining growth. "Product Development" represents a situation where a company introduces a new product in an already existing market, e.g., launch of Pepsi Max by Pepsi in Pakistan. In "Market Penetration", a company increases its market share by simply bringing down the price of an existing product in an existing market, e.g., reduction of prices by Mitsubishi in the European car market. "Market Extension" is a strategy used by companies for launching their existing products in new markets, e.g., Telcel in Pakistan. Finally, the term "Diversification" describes a situation in which a new product is offered for sale in a new market. This is typical of conglomerates such as the Virgin group that is involved in a variety of unrelated business ventures based on media, airline and a host of others.

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		PRODUCT	
		EXISTING	NEW
MARKET	EXISTING	MARKET PENETRATION	PRODUCT DEVELOPMENT
	NEW	MARKET EXTENSION	DIVERSIFICATION

As illustrated in the diagram, there are four possible ways in which products can be combined with markets for attaining growth. "Product Development" represents a situation where a company introduces a new product in an already existing market, e.g., launch of pepsi max by pepsi in Pakistan. In "Market Penetration", a company increases its market share by simply bringing down the price of an existing product in an existing market, e.g., reduction of prices by Mitsubishi in the European car market. "Market Extension" is a strategy used by companies for launching their existing products in new markets, e.g., telenor in Pakistan. Finally, the term "Diversification" describes a situation in which a new product is offered for sale in a new market. This is typical of conglomerates such as the virgin group that is involved in a variety of unrelated business ventures based on media, airline and a host of others.

### FORCE-FIELD ANALYSIS

This is a method involving analysis of two types of forces, driving forces and restraining forces, that influence any proposed change, then assessing how best to overcome resistance. This was developed by Kurt Lewin, who suggested that driving forces are factors pressuring for a particular change, whereas restraining forces are the ones that exert pressure against a change. At a point in change, the two force types push in opposite directions, giving an equilibrium that defines current conditions, or the status quo. To change the status quo to a desired condition, it is necessary to increase driving forces, to decrease restraining forces, or do both. Force-field analysis can be used effectively by companies to resolve serious and complicated issues. This was illustrated in case of Xerox when the management decided to lay off 150 workers at its New York plant with the objective of reducing costs. However, the union leaders got involved in a bargaining process with the managers in order to get the lay-off decision reversed. Union leaders and the management studied ways to save money which finally led to eliminating six paid days off, medical insurance cuts and developing ways of controlling absenteeism. In return, the company promised no lay-offs for three years. Thus, by working on restraining forces, the company and union were able to agree on changes that were acceptable to both.

### DECISION TREES

It is a graphical representation of alternatives in a decision-making problem. The distinctive feature of decision trees is that both outcomes and their probability of occurrence are taken into account. A decision tree is an aid to decision making in conditions of uncertainty. This technique enables a decision maker, who is faced with a number of possible actions, to:

- set out the alternative courses of action in the form of a tree diagram,
- estimate the possible outcomes of the various actions,
- determine the probability for each outcome,
- calculate the expected monetary value with the help of the formula,

EMV = (Probability of success  $\times$  expected profit or outcome) + (probability of failure  $\times$  expected loss or outcome)

**Advantages:**

Decision trees show clearly and logically the alternative courses of action.  
They encourage managers to quantify alternative outcomes.  
They facilitate logical thinking and planning.  
New ideas are generated.

**Limitations:**

The construction of decision trees is time consuming.  
Information is not always available, or is incomplete.  
This technique may neglect non-quantifiable factors.

**Specimen question:**

May/June, 2006, P3, Q4

- I. Refer to Appendix C. Draw a decision tree to represent the decision of whether or not to market the "Fruit Choc Delight" product.

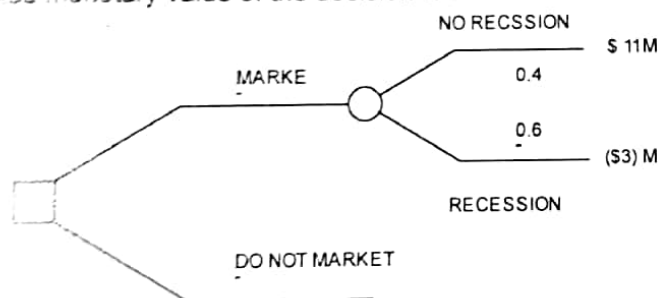
Appendix C:

	IF ECONOMY IN RECESSION	NO ECONOMIC RECESSION
ANNUAL REVENUE	6	18
ANNUAL COST	9	7

ECONOMISTS PREDICT THAT THE CHANCE OF AN ECONOMIC RECESSION IN ANY ONE YEAR IS 60%.

Solution:

- II. Calculate the expected monetary value of the decision to market the "Fruit Choc Delight" product.

**Solution:**

EMV = (Probability of success  $\times$  Expected profit or outcome) + (Probability of failure  $\times$  Expected loss or outcome)

$$(0.4 \times 11) + (0.6 \times -3) = \$2.6M$$

**Types of decisions:**

**Strategic decisions** concern the objectives and overall plans of the organisation, e.g. major capital investment, sources of finance, new product development, etc. These decisions are made by senior management and directors. Strategic decisions concern the long-term future development of a business.

**Tactical decisions** are medium-term decisions involving the use of resources to achieve the organisation's goals. Examples include minor capital investment and changes to marketing activities.

**Operational decisions** are short-term in nature and are taken by departmental managers. Examples include the day to day ordering of stock, production planning and control of credit.



## 6.4 STRATEGIC IMPLEMENTATION

### BUSINESS PLANS

A business plan is a statement that outlines the way that the business will achieve its objectives. An established business may produce a business plan to show how it will obtain the funds to pay back a loan for a new piece of machinery. On the other hand, for a business starting up, a business plan can be used to give a clear idea of its direction and operation; show a bank or other institution its likely position and its ability to pay back a loan; identify problems that may occur to allow the business to deal with them before the situation gets out of control; and highlights its major strengths and weaknesses. The **key elements** of a business plan include all the salient qualitative and quantitative features of the business, the product, the market, personnel, purchasing policies, production methods, premises and equipment, profit, cash flow and finance.

### CORPORATE CULTURE AND STRATEGIC

#### Implementation:

Corporate Culture, also known as the organisational culture, is the code of behaviour followed within an organisation. It is a set of values and beliefs that are shared by people and groups in organisations. In simple terms, it is the way things are done in a business. For example, at Microsoft, the company staff works long hours, dresses casually and communicates by e-mail. Similarly, General Electric Company has a corporate culture in which the employees feel ownership of the company and the low level managers are also encouraged to behave like entrepreneurs and take their own decisions. There are various micro and macro environmental factors that mould the corporate culture of an organisation. These include the size and nature of the business, its history, norms of the people, style of leadership, government policies and a host of others. The following four **types of corporate culture** have been identified by experts, based on particular aspects of organisation and management.

#### Power culture:

"The employee does what he or she is told."  
This type of organisation is characterised by an all-powerful head. Power is centralised, with the structure of the organisation designed in such a way that the subordinates are only required to follow the rules and regulations specified by the superiors. Success of such a system largely depends on the quality of the central figure. However, it will be difficult to maintain control if the organisation grows in size.

#### Role culture:

"The employee acts within the parameters of his job description."  
Structures and procedures are planned in a rational and logical way. The name is derived from the fact that emphasis is placed not on the individual but on the role, post or position within the firm. The main features of such a structure are an abundance of rules, the hierarchical nature of power and clear definitions of authority. It is a stable and predictable corporate culture but lacks adaptability to changing circumstances and tends to be conservative rather than innovative.

#### Task culture:

"The employee acts in the way he considers suitable for the task."

This type of culture is characterised not by a single source of power but by autonomous project teams. Stress is placed on teamwork rather than individual effort and reward. Task culture is highly flexible but ineffective in case of long-term projects.

#### Person culture:

"The individual does his own thing."  
Here, the individual is the central point. The firm, its organisation, and systems exist to serve the individuals who form it. Not only is this type of culture rare in business organisations, it is only appropriate

for small partnerships in the professions. As the organisation grows, it will take on a life of its own, independent of the interests of the members. Consequently, it will develop into a role or power culture. It is important to note that none of these cultures is right or wrong. Any one of them could be right or appropriate in the particular circumstances of the organisation.

## **DEVELOPING A CHANGE CULTURE / MANAGING AND CONTROLLING STRATEGIC CHANGE**

In today's ever-changing environment, success demands keeping a competitive advantage. To achieve this, effective managers recognise change as essential to the survival of an organisation. Therefore, it is important to consider the impact of change on organisational members and their reactions to it.

### **Diagnosing the need for change:**

A competent manager scans the internal and external environment and collects data on organisational trends. A careful watch is maintained on values, goals and activities to ensure they fit with customers' demands and needs. If there is a deficiency or gap, an effective manager works to remedy the situation. Needless to say, to manage change effectively, one must be aware of the need for change. This can be identified by analysing the internal factors such as the performance level of workforce as well as the external factors such as the activities of competitors.

### **Managing resistance to change:**

One reason it takes much managerial planning and skill to achieve innovation and change is because employees, and sometimes even the employers, often show resistance to change. Sometimes, a change is opposed even when it appears to be in the best interests of those affected.

### **Reasons for resistance:**

One of the major factors is self-interest. If someone feels that a particular change can have an adverse effect on him or his interests, resistance effort may be made. Another reason for change resistance is misunderstanding and a lack of trust. People are often against change when they don't understand it. Moreover, a low trust level between managers and employees, common in many organisations, increases the possibility of a misunderstanding. Resistance also comes from the inability of an individual to judge the importance of a particular change. Innovations involve new concepts and their value is not always clear. Hence individuals may see a change as not useful and even view it as counter-productive. Finally, people differ in their ability to adjust to new situations, and some individuals have a low tolerance for change. As a result, they resist change as they fear they will not be able to learn new skills and behaviours entailed.

### **Overcoming resistance to change:**

One approach to beating resistance has been offered by Kurt Lewin, who divides the change process into three steps. The first step, "unfreezing", means developing initial awareness of a change need. The second, "changing", focuses on learning needed new behaviours. The third step, "refreezing", centres on reinforcing new behaviours, usually by positive results, feelings of accomplishment, and rewards from others. Lewin's approach helps managers recognise that an unfreezing period is needed before individuals will change willingly. Furthermore, refreezing is important to reinforce and maintain changes. Managers can adopt the following methods to overcome initial change resistance and to facilitate unfreezing:

One strategy to overcome resistance to change is education and communication. This means giving enough information and ensuring the change is clearly communicated to those it affects. Participation and involvement is another way to overcome resistance to change. Resistance is less pronounced when those affected by change participate in planning and implementing it.

**Facilitation and support** can overcome resistance. Managerial encouragement, training, and providing proper equipment and material to the members of the workforce can help reduce resistance.

Another approach to reducing resistance to change is **negotiation and agreement**.

Negotiation can be an important strategy when one group sees it will be hurt by change and as in a position to cause a change effort to fail.

**Manipulation** is another technique that may be applied with the objective of overcoming resistance. It involves giving selected information on a change, so it seems to potential resisters to be more attractive or needed.

## CONTINGENCY PLANNING AND CRISIS MANAGEMENT

### Contingency Planning

The term refers to the development of alternative plans for use in case the environmental conditions evolve differently than anticipated, rendering original plans unsuitable or ineffective. Effective contingency planning will allow a business to cope with a variety of crises, as discussed below.

#### Finance:

In case of liquidity, large firms may have contingency funds set aside. Other solutions include finding alternative funds to deal with a short term lack of finance.

#### Production:

A business must arrange alternative sources as a solution to interruptions in production. Some of the work may be handed over or outsourced to other producers. It may also be able to switch production from one machine or factory to another. Rearranging the time of production and dealing with a pool of suppliers can prove to be useful as well.

#### Human resource management:

Effective consultation will help to minimise difficulties and may speed up the solution to industrial relations problems. Similarly, motivational rewards may be used to deal with poor staff motivation. A flexible workforce comes in handy if the business is faced with a lack of employees as a result of high labour turnover.

#### Image:

Faulty products or damage to the environment can have an enormous effect on the image of a business. A business must act quickly and effectively when faced with an image problem. Faulty products must be withdrawn immediately. The management needs to focus on extensive promotion in an attempt to alleviate any public concern for its products. Practices such as recycling may be highlighted.

#### Management and communication:

Management has a vital part to play at times of crisis. There must be strong leadership from the top of the company hierarchy and every member of the organisation should be clear about his role and responsibilities. A business also needs clear communication channels to ensure that messages are being passed on effectively. Contingency planning is important but a business must not let it affect the corporate plans of the firm. For example, keeping a large amount in a contingency fund may reduce the funds that a business has available for expansion or investment.

#### Crisis planning:

A crisis is a situation where unstable conditions exist. Crises are usually unexpected and effective planning should reduce the impact of the crisis on the business. As discussed previously, firms often have contingency plans to cope with unforeseen or changing conditions.

### Types of crises

#### Financial crises:

An example of a financial crisis might be a lack of working capital to pay immediate bills. In other words the firm is faced with a liquidity problem. This might arise because the business has too many assets that are not easily converted into cash. Long-term unpaid debts and inability to recover money owed by others are also factors that may lead to a financial crisis.

#### Production crises:

Breakdown of a crucial piece of machinery is a typical example of a production crisis. This would lead to a loss of production for the manufacturer and perhaps a failure to deliver products on time. Natural

disasters, such as crop failures may affect the supply of agricultural products. Technical problems like an inefficient computer system can also cause a delay in the production process.

**Human resources problems:**

Businesses may face problems in case of industrial action. Production may be halted and sales suffer because of a lack of supply or because the image of the business is affected. Strikes, go-slow policies, poor motivation level and high sales turnover can lead to a loss of productivity.

**Environmental problems:**

If a business is involved in an activity that causes environmental damage, this might result in opposition from a variety of pressure groups including the community and the government. Ultimately, the controversial activity may have to be halted.

**Corporate problems:**

Certain crises are capable of affecting the whole organisation. An example might be an attempted hostile takeover by a larger company. Another might be a loss of confidence in a public limited company. This would most probably lead to a fall in its share price on the stock exchange as the shareholders start selling their shares.

**Product and legal problems:**

At times, crises take place when faulty or dangerous products are manufactured that break the law. For instance, a child's toy causing harm or a food item leading to health problems could be banned.

**Image problems:**

Many of the problems mentioned above will affect the image of the business. Consumers may lose faith in its products or change their opinion about the credibility of the firm. This is likely to affect the sales and profitability of the business.