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- Essential Management Skills
- Human Resource Management
- Strategy & Operations
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# Essential Management Skills

## 1. Introduction

**Welcome to Essential Management Skills!**
Good management skills are vital for any organization to succeed and achieve its goals. To be a great manager, you must have an extensive set of skills – from planning and delegation to communication and motivation.

Because this skill set is so wide, it's tempting to build skills in the areas of management that you're already comfortable with. But, for your long-term success, it's wise to analyze your skills in all areas of management – and then challenge yourself to improve in all of these areas. This course will help you to do so.

**What are the main functions of managers?**
Management is often expressed as the process of achieving an organization's objectives through guiding development, maintenance, and allocating resources. The four primary functions of managers are **planning**, **organizing**, **leading**, and **controlling**.


**1. Planning**
Planning is the process of determining a course of action for future conditions and events with the goal of achieving the company's objectives. Effective planning is necessary for any business or organization that wants to avoid costly mistakes. There are different types of planning:

- **Strategic planning** involves creating long-range goals and determining the resources required for achieving these goals. Strategic planning is the most far-reaching level of planning and involves plans with time frames from one to five years. Strategic planning includes analyzing the external environment and the organization's readiness to react.
- **Tactical planning** denotes the implementation of the activities defined by the strategic plans. Generally, tactical planning involves shorter-range plans with time frames of less than one year.
- **Operational planning** involves the creation of specific methods, standards, and procedures for different functional areas of an organization.
- **Contingency planning** involves the creation of alternative courses of action for unusual or crisis situations.

**2. Organizing**
Managers have to figure out how many people are needed to get the jobs done. This management role involves blending human and capital resources in a formal structure as well as determining how the job flow happens. The manager will divide and classify work by determining which specific tasks need to be carried out in order to accomplish a set of objectives.

**3. Leading**
Managers also have the role of leading or directing employees and plans. The goal of leading is to guide and motivate employees in order to accomplish organizational objectives.

**4. Controlling**
Managers must monitor what's going on in the company. Controlling allows a manager to measure how closely an organization is adhering to its set goals. Important steps are: setting performance standards, measuring the performance, taking corrective steps if necessary and using information from the process to set future performance standards.

The primary functions of managers are:
1. Planning, 2. Organizing, 3. Leading, and 4. Controlling.

# 2. Leadership

People who lead teams in the workplace are commonly seen as leaders and managers. In this chapter, we will address the difference between management and leadership, cover the important concept of “emotional intelligence”, and discuss different leadership styles.

## Leaders and Managers

Although sometimes used synonymously, leadership and management can be quite different. Leaders may be managers, but not all managers are leaders. So just what are the differences?

While **managers** tend to have their eyes on the bottom line, **leaders** are more often looking toward the horizon, trying to find new opportunities for growth and development. A manager is usually satisfied with the status quo, whereas the leader is often challenging it.

| Management (structure) | | Leadership (flexibility) |
|---|---|---|
| A function | ↔ | A relationship |
| Planning | ↔ | Selecting talent |
| Budgeting | ↔ | Motivating |
| Evaluating | ↔ | Coaching |
| Facilitating | ↔ | Building trust |

Leadership often involves reinventing the job; strong leaders create their role in an organization or in the world system. Managers are often responsible for executing the task at hand, not thinking of future goals.

Managers are responsible for maintaining, but leaders look to innovate. Managers may involve employees in their activities, but often on a “need to know” basis. Leaders, in contrast, work to inspire those around them by trying to help others gain personal growth and development from their activities and by turning weaknesses into strengths. Companies that have “leader-managers” throughout the corporate hierarchy are the most successful.

Remember: Leaders may be managers, but not all managers are leaders!

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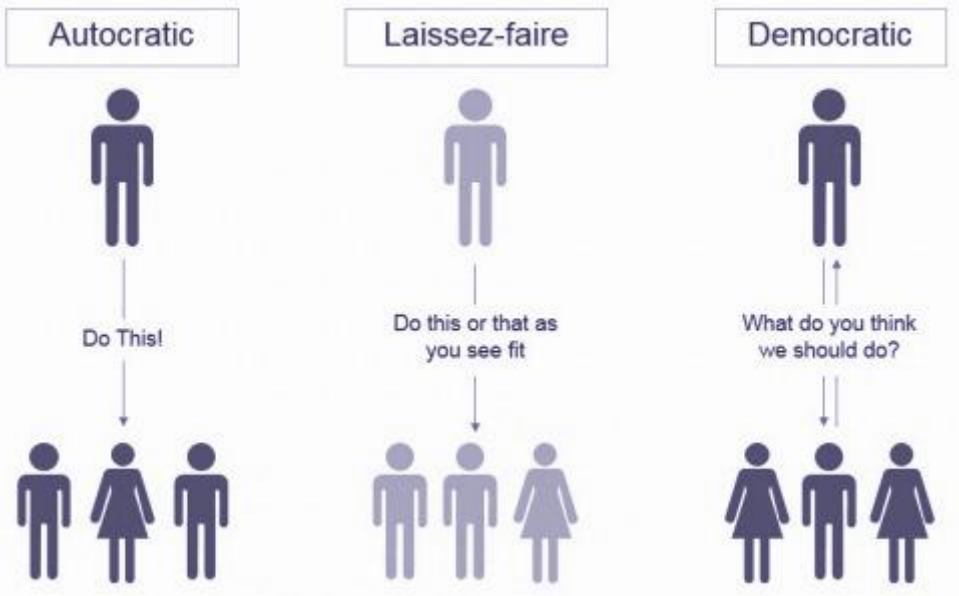
# Leadership Styles

Individual managers have their own styles of managing, and within organizations, there is often a predominant style of leadership. The predominant leadership styles – autocratic, democratic, and laissez-faire – have many variations. We can compare and contrast the effectiveness of each of these styles as it affects employee performance.




**Autocratic Leadership**
This style of leadership is directive and controlling. The leader will make

all decisions without consulting employees. The autocratic style of leadership limits employee freedom of expression and participation in the decision-making process. It will not serve to create trust between managers and subordinates. Further, creative minds cannot flourish under autocratic leadership. Autocratic leadership may best be used when companies are managing less experienced employees. But managers should not use the autocratic leadership style in operations where employees expect to voice their opinions.

**Laissez-Faire Leadership**
This style of leadership makes employees responsible for most of the decisions that are made. This form requires extensive communication. Laissez-faire leadership may best be used when employees are educated, knowledgeable, and self-motivated. Employees must have the drive and ambition to achieve goals on their own for this style to be most effective. Laissez-faire leadership is not a good idea in situations where employees feel insecure.

**Democratic Leadership**
This style of leadership is centered on employee participation and involves decision making by consensus. The leader will involve employees in the decision-making process and they will be encouraged to give input and delegate assignments. Democratic leadership often leads to empowerment of employees because it gives them a sense of responsibility for the decisions made by management. Democratic leadership may best be used when working with highly skilled employees. It is most useful for implementing organizational changes and when the leader requires input from knowledgeable employees. One of the down-sides of democratic leadership is that it may lead to endless meetings.

As with many categories that describe business concepts, an organization and its leadership may apply any or all of these leadership styles. For instance, a company may utilize an autocratic leadership style with the lower levels but employ a democratic leadership style with its professional staff in the upper levels.
Two additional styles of leadership worth exploring are transformational and transactional. Both have strong ethical components and philosophical underpinnings.

**Transformational Leadership**
Leaders who have a clear vision and are able to articulate it effectively to others often characterize this style of leadership. Transformational leaders look beyond themselves in order to work for the greater good of everyone. This type of leader will bring others into the decision-making process and will allow those around them opportunity to learn and grow as individuals. They seek out different perspectives when trying to solve a problem and are able to instill pride into those who work under them. Transformational leaders spend time coaching their employees and learning from them as well.

**Transactional Leadership**
This leadership style is characterized by centralized control over employees. The transactional leader will control outcomes and strive for behavioral compliance. Employees under a transactional leader are motivated by the transactional leader's praise, reward, and promise. They may also be corrected by the leader's negative feedback, threats, or disciplinary action.

The most effective leadership style is using a combination of styles. Leaders should know when it is best to be autocratic and when to be democratic. They can also be transformational and transactional at the same time; these are not mutually exclusive styles and in fact can complement one another extremely well.

# Leadership Trends

In today's competitive environment, leaders are continually searching for new ideas and approaches to improve their understanding of leadership. Here are thumbnail descriptions of current leadership trends.


**Coaching**
A new trend in effective leadership, coaching, has become extremely popular throughout different organizations. This style of leadership involves guiding employees in their decision-making process.

When coaching, management provides employees with ideas, feedback, and consultation, but decisions will ultimately be left in the hands of the employees. Coaching prepares employees for the challenges they will face. The lower an employee's skill and experience level, the more coaching the worker will require. The interactions that an employee has with the manager are the best opportunities they have for enhancing their respective skills. Coaching enables the employees to excel at their tasks. Instilling confidence in employees is extremely important.

**Employee Empowerment**
As organizations and companies become increasingly borderless, employee empowerment becomes ever more important. This trend in leadership has allowed employees to participate in the decision-making processes. Employee empowerment is also a method for building employee self-esteem and can also improve customer satisfaction. It also ties them more closely to the company goals and will serve to increase their pride in their work and loyalty to the organization.

**Global Leadership**
As corporations become increasingly international in scope, there is a growing demand for global leaders. Although many of the qualities that make a successful domestic leader will make a successful global leader, the differences lie in the abilities of the leader to take on a global perspective. Global leaders are often entrepreneurial; they will have the ambition to take their ideas and strategies across borders. They will also have to develop cultural understanding; global leaders must be sensitive to the cultures of those working under them, no matter where they are based.

**Equitable Treatment**
An important trend in leadership is the equitable treatment of employees. This does not mean that each employee will be treated the same; it means that every employee will be given the amount of individual attention they require, and it will involve leadership knowing his or her employees. A good leader will get to know employees well enough to give them what they need in order to best perform. For some employees that may mean more structure; for others it may mean more freedom.

**Feedback**
Employees thrive on feedback, and by providing feedback and communicating effectively, managers can give employees the tools they need to improve their performance. Providing feedback will not dampen employee morale in most cases, but will allow opportunities for employees to learn from their mistakes and move on to perform their tasks better. Positive reinforcement should be used to encourage employees' positive behavior, but when criticism is necessary, make sure it is constructive.

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# 3. Team Development

In today's complex business environment driven by globalization, working in teams is more important ever. But not all teams are identical. Are there different types of teams? How do teams develop? And can we divide the process of team development into specific stages?

# Teamwork

**Teamwork** is defined as a group of people working together to achieve a common goal. Team members are mutually responsible for reaching the goal toward which they are working. Team building is a process meant to improve the performance of the team and involves activities designed to foster communication and encourage cooperation. Additionally, the objective is to avoid potential disputes and problems and to keep the morale of team members high.

Many different industries and organizations use teams to accomplish goals because people working together can often achieve more than they could individually. How do you know if you need a team to complete a project? Ask yourself the following questions:

- Can I achieve this goal by myself?
- Do I have the resources and time to undertake this project?
- Can a team of people be more effective than I would be in achieving this goal?

If your answers favor the involvement of others, it's time to consider forming a team.

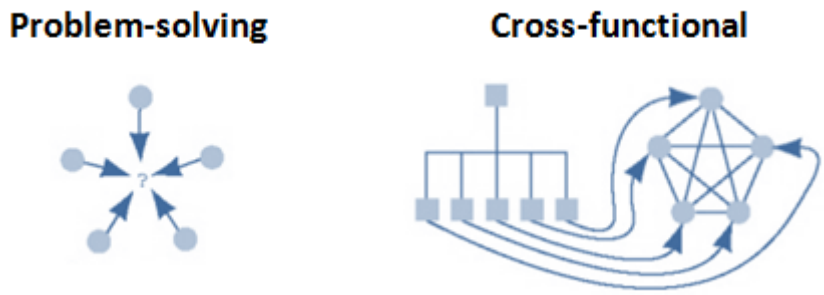
In an increasingly complex environment, organizations are using a team approach to bring a diverse set of skills and perspectives into play. An effective use of teams often draws upon a creative approach of bringing together specialists who combine their efforts and develop intrateam synergies to meet the challenges of their often complex organizational environment.

An example of an industry that often uses teamwork is the construction industry. A successful construction project cannot take place without the formation of teams. A design team will be formed at the beginning of the project and is made up of architects, engineers, and project consultants. The design team alone, however, will not be

able to complete the project. They will also need to form a team with the owner of the project and the contractor.

# Types of Teams

Throughout different organizations, there are different types of teams that are used to accomplish goals. Two of the most common team varieties are problem-solving teams and cross-functional teams.




**Problem-Solving Teams:** These teams are formed only for a specific time period until a problem is solved. Team members often consist of one level of management.

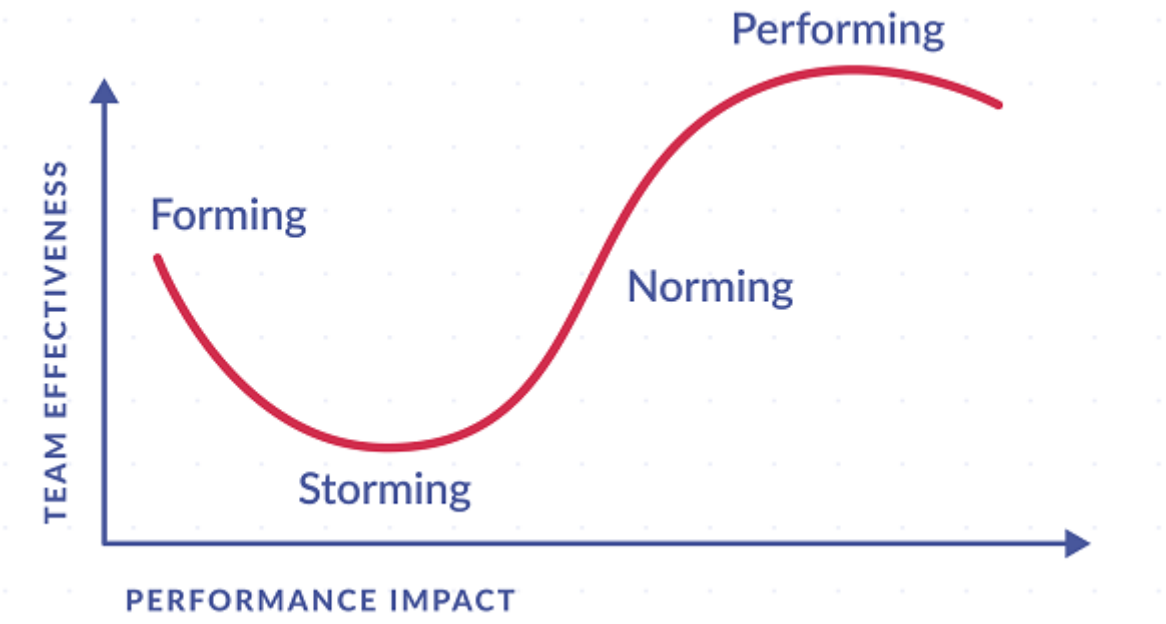
Let's say Corporation ABC has lost 10 percent of its North American market share. All of ABC's regional salespeople will be called in to form a team to regain that market share. Although their regional focus will remain, they will have to work together to solve the problem of regaining that market share, and when they achieve that goal, they will individually work on maintaining their hold in their market.

**Cross-Functional Teams:** This type of team is made up of members from different areas of the business and often from a common managerial level.

If a car company wants to bring a new car to market, a team will be formed and its members will consist of managers from different departments such as engineering, design, brand management, product development, market research, marketing, and finance.

# Stages of Team Development

The **forming–storming–norming–performing** model of group development was first proposed by Bruce Tuckman in 1965, who said that these phases are all necessary and inevitable in order for the team to grow, face up to challenges, find solutions, plan work, and deliver results.




**Stage 1: Forming**
The first stage involves assembling the team and defining the goals, which should provide focus and be attainable. It is important that the team leader understands the strengths of each of the team members in order to assemble a cohesive team. Often in the forming stage, team members will be extremely polite to one another; they will be feeling each other out. An example of a goal that the team may set would be the project schedule. For a construction team, for example, there are many stages of the project that should be completed in a certain time frame to ensure that the project is completed on time for the owner. The design team designates the appropriate amount of time for the construction phase in which the builder will make a profit. It is important to agree upon and set this schedule from the beginning.

**Stage 2: Storming**
The second phase involves coordinating efforts and solving problems. If the teamwork starts to slip because of a difficult problem, it is necessary for the team members to get the project back on track. Team members should be conscious of the team's health and whether the team is taking steps in the right direction to reach the goals. It may be necessary to

think creatively about approaches to solving a problem. Communication is extremely important to effective team performance in the storming stage. Effective teams communicate clearly and openly about problems. Ineffective communication can cause unnecessary tension and stress to team members. It is important that communication be relevant and responsive. Relevant communication is task-oriented and focused. Responsive communication involves the willingness of team members to gather information, to actively listen, and to build on the ideas and views of other team members.

**Stage 3: Norming**
The project norms are an informal standard of conduct that guides the behavior of team members. This stage involves defining team roles, rights, and responsibilities. It is important to establish these norms at the beginning of the team-building process in order to avoid problems along the way. In addition to allocating responsibilities, it may also be necessary to allocate the risk that is to be undertaken by each team member. Each member of the team should have a sense of ownership of the project. Allocating responsibility also means establishing a team leader. Team leadership should not be a top-down effort but should be more of a coaching role. The team leader must act as a cheerleader, encouraging the team members to work together, providing ideas, and serving as a role model. There is often a period after the team has been formed when a conflict of personalities or ideas will arise. Team members begin to show their own styles; they are no longer worried about being polite. At this stage, there will be pessimism on the part of team members in relation to the project and there may also be confusion.

**Stage 4: Performing**
By this stage, the team is working together effectively, problems have been smoothed out, and achievements begin to become evident. A great deal of work will be accomplished at this stage. The team will be able to tackle new tasks easily and confidently. They will be comfortable using creative means. It is essential at this point to evaluate and report on the progress that has been made.

The four stages of team development are:
1. Forming > 2. Storming > 3. Norming > 4. Performing

# 4. Decision-Making

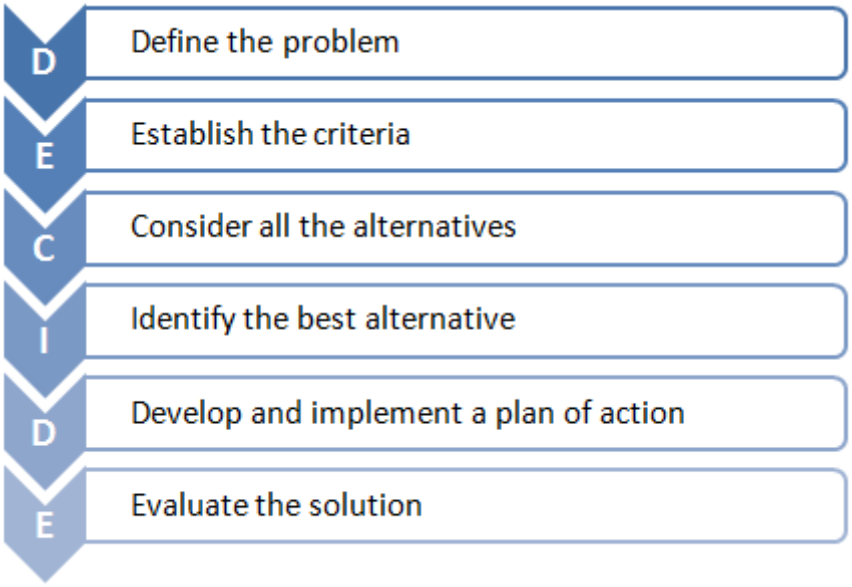
We all have to make decisions every day. Some of them are quite simple, others are more difficult. The best way to make a decision is to use an effective process. Clear processes usually improve the quality of our decisions and lead to high-quality results.

# Decision Making Process

Some decisions are easy ones. But in the professional world, you will face complicated and high-impact choices that can affect your business's bottom line. Decision making is the process of making choices by identifying a decision, gathering information, and assessing alternative resolutions. Using a step-by-step decision-making process can help you make more deliberate, thoughtful decisions by organizing relevant information and defining alternatives. A variety of researchers have formulated similar prescriptive steps aimed at improving decision-making.

In this chapter, we want to introduce the **DECIDE model** by Kristina Guo. The DECIDE model was intended as a resource for health care managers when applying the crucial components of decision making, but it also enables managers to improve their decision-making skills, which leads to more effective decisions.

The DECIDE model is the acronym of **6 particular activities** needed in the decision-making process:




**Step 1: Define the Problem**
Firstly, make sure to define what you want to achieve. Also, pay attention to involving the right people and encourage participants to contribute to the discussions. You can use your creativity right from the start – thinking from a different perspective might deliver the best solutions.

**Step 2: Establish the criteria**
Collect some information: what information is needed, the best sources of information, and how to get it. This step involves both internal and external "work." Some information is internal: you'll seek it through a process of self-assessment. Other information is external you'll find it online, in books, from other people, and from other sources.

**Step 3: Consider all the alternatives**
The more good options you consider, the more comprehensive your final decision will be. When you generate alternatives, you force yourself to look at the problem from different angles. If you do so, you're more likely to make the best decision possible. Generating ideas through brainstorming and considering different perspectives will help you and your team develop good alternatives: Evaluate the feasibility, risks, and implications of each choice. By evaluating the risk involved with various options, you can determine whether the risk is manageable. Determine if resources are adequate, if the solution matches your objectives, and if the decision is likely to work in the long term.

**Step 4: Identify the best alternative**
The next step is to choose between the alternatives. Compare all the choices you have and determine the relative importance of various factors. This helps you compare unlike factors, and decide which ones should carry the most weight in your decision. You may even choose a combination of alternatives.

**Step 5: Develop and implement a plan of action**
Once you've made your decision, it's important to explain it to those involved in implementing it. Talk about why you chose the alternative. The more information you provide about risks and projected benefits, the more likely people are to support the decision.

**Step 6: Evaluate the solution**
In this final step, consider the results of your decision and evaluate whether or not it has resolved the need you identified in Step 1. If the decision has not met the identified need, you may want to repeat certain steps of the process to make a new decision. For example, you might want to gather more detailed or somewhat different information or explore additional alternatives.

No one makes perfect decisions all of the time. Business environments are constantly changing and there are lots of unknowns and what-ifs at play. Challenge yourself to go beyond the perfect hypothetical stable business environments, and include other people in your decision-making process to get new and different perspectives.

# Hidden Traps

Bad decisions can often be traced back to the way the decisions were made – the alternatives were not clearly defined or we missed the right information. But sometimes the fault lies not in the decision-making process but rather in the mind of the decision-maker. The way the human brain works can sabotage the choices we make. Harvard Professor John S. Hammond formulated six decision making traps.

Each of these traps can influence how we make decisions. Being aware of the potential traps and building tests and disciplines into our decision-making processes can assist.

| Anchoring | Status Quo | Sunk Cost |
|---|---|---|
| Initial impressions anchor subsequent judgments | Bias towards perpetuate status quo | Investments now irrecoverable |
| **Confirming Evidence** | **Framing** | **Estimating Forecasting** |
| Bias to current point of view | Highlight other traps | Clouded ability to asses probabilities |

**Trap 1: Anchoring**
We tend to give disproportionate weight to the first information we receive on a particular issue. In negotiating, for example, people will often center around the first offer even if this is not necessarily reasonable.
*Tip: Avoid judging on the first impression and seek information from a variety of sources!*

**Trap 2: The Status Quo**
In most cases, our decision making is biased towards the current situation (status quo), because it is the "safe" and comfortable option.
*Tip: Ask yourself if you'd choose the status quo choice if it weren't the status quo!*

**Trap 3: Sunk Cost**
Sunk costs have little to do with making a decision today as they relate to past costs and experiences, but they still are in our minds and often lead us to make inappropriate decisions. This trap relates to making choices in a way that justifies past, flawed choices.
*Tip: Get views of people who weren't involved in the previous decisions!*

**Trap 4: Confirming Evidence**
We often look for evidence or opinions that will support and justify our own position or decisions and place more weight on these issues than they deserve.
*Tip: Ask somebody to play Devils' Advocate (taking the counter position)!*

**Trap 5: Framing**
How a question is framed can have an impact on the answer you select. A common framing trap is to frame a question in terms of gains or losses. People tend to pick the decision that is formulated least risky regardless of the real content.
*Tip: Pose questions in a neutral manner!*

**Trap 6: Estimating and Forecasting**
Even though most of us are not very good at making proper forecasts, we actually tend to be overconfident about our accuracy. Additionally, we are overly influenced by vivid memories of past events when estimating.
*Tip: Be disciplined in forecasting and use statistics instead of personal impressions!*

The six traps can all work in isolation. But, even more dangerous, they can work in concert, amplifying one another. A dramatic first impression might anchor our thinking, and then we might selectively seek out confirming evidence to justify our initial inclination. We make a hasty decision, and that decision establishes a new status quo. As our sunk costs mount, we become trapped, unable to find a propitious time to seek out a new and possibly better course. The psychological miscues cascade, making it harder and harder to choose wisely.

The best protection against all psychological traps – in isolation or in combination – is awareness. Forewarned is forearmed. Even if you can't eradicate the distortions ingrained into the way your mind works, you can build tests and disciplines into your decision-making process that can uncover errors in thinking before they become errors in judgment.

# 5. Project Management

This chapter provides a practical approach to what many consider a complex process: the management of projects. We will define project management and simplify the processes required to manage a project successfully from beginning to end.

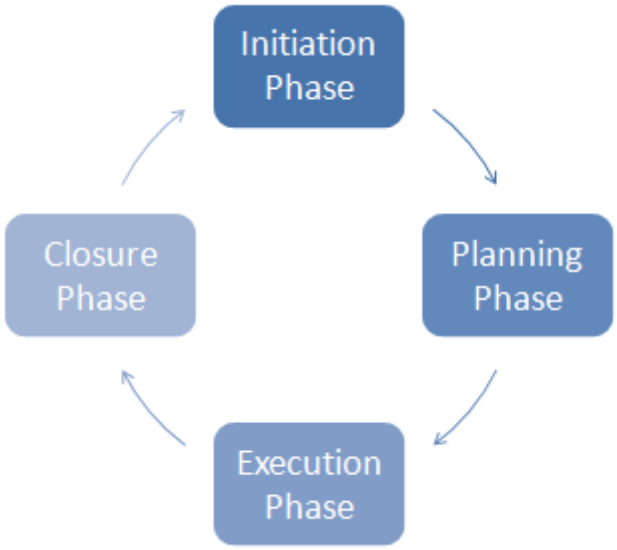
# Project Definition

**What is a Project?**
A project is “a unique endeavor to produce a set of deliverables within clearly specified time, cost and quality constraints”. A project can be as small as moving your office or as complicated as moving your entire company from one location to another. It can involve one person or hundreds of people. There are, however, certain characteristics that most projects have in common. Some typical projects are launching a new product or process, implementing a new company software, replacing existing manufacturing equipment or reorganizing a department, division, or organization. Project Management is the skills, tools and management processes required to undertake a project successfully.

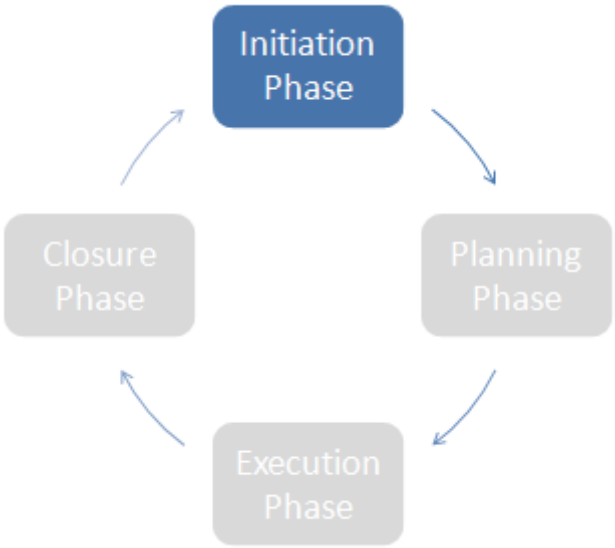
Projects differ from standard business operational activities:

- Projects are **unique** in nature. They are one-time events and they do not involve repetitive processes. Every project undertaken is different from the last, whereas operational activities often involve repetitive processes.
- Projects have a defined **timescale**. Projects have a clearly specified start and are required to be completed by a certain deadline.
- Projects have limited **resources**. An agreed budget as well as amount of labor, equipment and materials are allocated to the project. This limitation requires effective coordination of different people, resources, and processes.
- Projects involve an element of **risk**. Projects entail a level of uncertainty and therefore carry business risk should the project fail.
- Projects achieve beneficial **change**. The purpose of a project, typically, is to improve an organization through the implementation of business change.

A simple way of approaching project management is to see it as a process with four major phases. We will explain each of these four phases on the following pages.




# Phase 1: Initiation




The **Initiation Phase** is the first phase of the project. Before work on the project can be started, it's necessary to clearly define what the outcomes of the project will be. This involves not only what specifications and criteria the final project must meet, but when it must be completed and what the budget is. This will probably require some study and analysis, addressing questions about the project such as:

- What's the objective?
- What are the expected, required, and desired results?

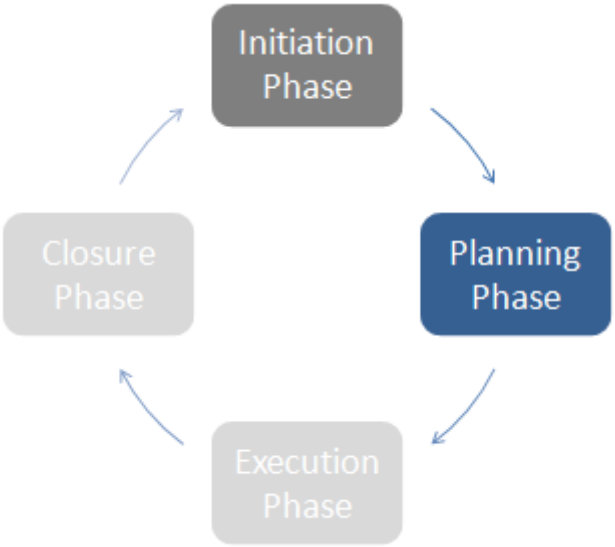
- How will success be measured?
- What's the timeframe?
- What are the resource implications?

Essential to effective project management is a clear description of the **scope of the project** – what is included in the project, what is not included, and where the boundaries between the two are set – established at the start of the project. 'Scope creep' is the term for what may occur when the scope is not well defined: as the project progresses, it grows. It thus becomes more difficult to complete the project or satisfy the client.

Imagine you are a project manager in an American construction company and your firm won a contract to design and build the first copper mine in Northern Argentina. There is no existing infrastructure for either the mining industry or large construction projects in this part of South America.

During the initiation phase of the project, you should focus on defining and finding a project leadership team with the knowledge, skills, and experience to manage a large complex project in a remote area of the globe. You decide to open two offices: One in Buenos Aries to establish relationships and Argentinian expertise, and the second in Catamarca – the largest town close to the mine site. With offices in place, the project start-up team began developing procedures for getting work done, acquiring the appropriate permits, and developing relationships with Argentine partners.

# Phase 2: Planning




Once the outcome of the project has been defined, the project enters the detailed **planning phase**. It's important to develop a plan of what work needs to be done, what resources are needed, who will do it, and when.

The level of detail needed in the plan will be determined by the complexity of the project and the number of people involved. The plan will probably not be followed exactly – things will happen that lead to adjustments and modifications. One reason for having the plan is to be able to see what needs to be adjusted when a task takes longer than expected or people or other resources are not available when needed.

In developing the plan, consider the specifications from the client and any required completion date, the budget, the best sequence of events (and whether any steps can be carried on concurrently), the staff needed and the need for any staff training for their part in the project.

The planning phase involves the creation of:

- a Project Plan (that outlines the activities, tasks, dependencies, and timeframes);
- a Resource Plan (that lists the labor, equipment, and materials required);
- a Financial Plan (that identifies the labor, equipment and materials costs);
- a Risk Plan (that highlights potential risks and actions taken to mitigate them); and

- a Communications Plan (that lists the information needed to inform stakeholders).

Two key components of any plan are **milestones** and **status reports**. A milestone marks the end of a stage or period of the project, and may also be tied to a project deliverable, a specific product provided to the client. During the planning, identify and establish milestones along the way to provide an indicator of progress and successes, and the impact of difficulties or delays that have been encountered. Also, establish a schedule and procedure for communicating the status and progress of the plan on a regular basis. Regular timely sharing of this information will allow the opportunity to adjust the plan and re-balance the quality, time and cost constraints.

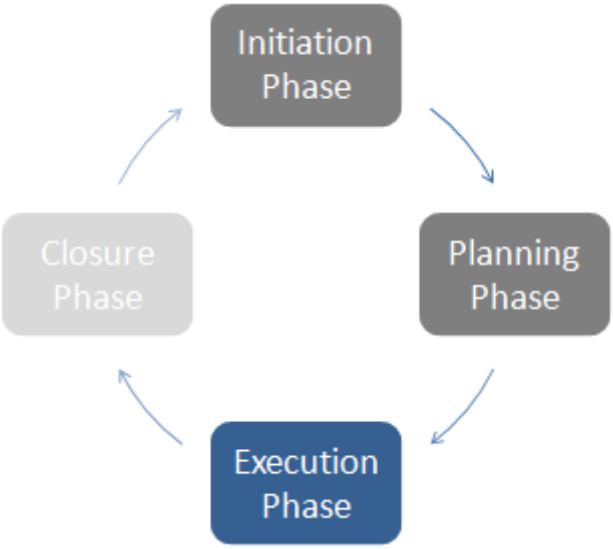
During the planning phase, your project team develops an integrated project schedule that coordinates the activities of the design, procurement, and construction teams.

- The project controls team also develops a detailed budget that enabled the project team to track project expenditures against the expected expenses.
- The project design team builds the conceptual design and developed detailed drawings for use by the procurement team.
- The procurement team uses the drawings to begin ordering equipment and materials for the construction team; develop labor projections; refine the construction schedule; and set up the construction site.

Although planning is a never-ending process on a project, the planning phase focused on developing sufficient details to allow various parts of the project team to coordinate their work and allow the project management team to make priority decisions.

At this point, the project has been planned in detail and is ready to be executed.

# Phase 3: Execution

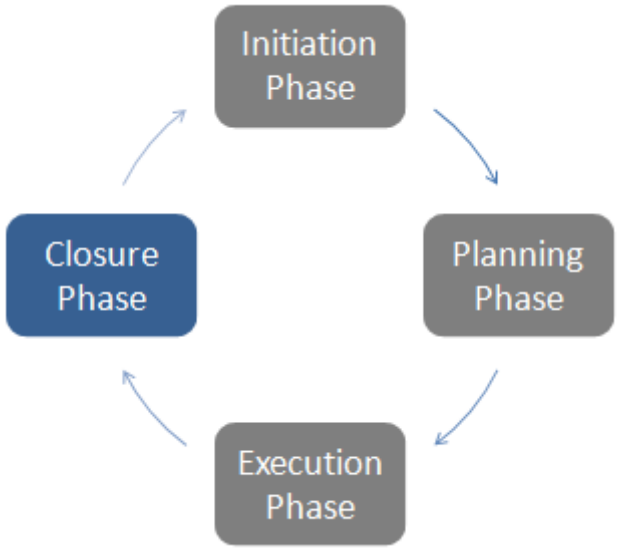



The **execution phase** may be the longest and most visible phase of the project. It is during this stage that activities move from paper to more tangible components. It's important to monitor progress, track milestones, and regularly communicate the progress, delays, or detours, both internally to the project team and organization, and externally to the client.

Monitoring progress and tracking milestones can mean inspecting and testing interim, partial, or pilot products, auditing work records, or holding progress review meetings to compare the original plan of what would be done when and by whom to the actual work and output.

During the execution phase, your project team accomplishes the work defined in the plan and makes adjustments when the project factors changed. Equipment and materials are delivered to the worksite, labor is hired and trained, a construction site is built, and all the construction activities, from the arrival of the first dozer to the installation of the final light switch, are accomplished.

# Phase 4: Closure




The project **closure phase** involves releasing the final deliverables to the customer, handing over project documentation, terminating supplier contracts, releasing project resources and communicating the closure of the project to all stakeholders.

While whatever has been created or developed may go on, the project team's work is done. Activities at the closing of the project can be split into two categories: those for the client or stakeholder, and those for the team and organization.

- **For the client**: Those who will be using the product need information to do their job effectively. This information includes training and documentation to be turned over to those responsible on a daily, ongoing basis for the new or revised process, system, or product. Also included is a formal sign-off that indicates the client has accepted the product or system.
- **For the project team**: Evaluate how the project management process worked and record lessons learned. Celebrate the completion of the project and the team's accomplishments. Then release or reassign the resources (staff, equipment, and facilities) to their regular jobs or to new projects.

The closure phase includes turning over the newly constructed plant to the operations team of the client. A punch list of a few remaining construction items is developed and those items completed. You close the office in Catamarca and the office in Buenos Aries archives all the

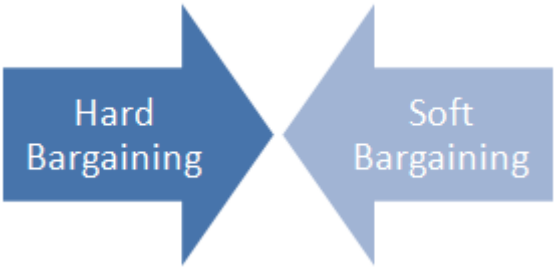
project documents. You close the accounting books, write the final reports, and start with your next project. Good job!

# 6. Negotiation

A negotiation should never be a conflict in which one party wins and one party loses. Negotiation is about cooperation. Both parties should have the feeling that they have won something. The primary goal should be to achieve a deal that both parties can live with and that accomplishes your goals.

## Negotiation Styles and Preparation

There are two major negotiation styles: **hard** and **soft bargaining**. Hard bargainers use a relatively aggressive negotiation style. The focus is on achieving own goals, whereas the other party's situation is unimportant. Soft bargainers, on the other hand, try to find solutions that appease all parties. They act more patient and more trustworthy.




Roger Fisher and William L. Ury, both Professors from Harvard Law School, recommend a negotiation style called **win-win negotiation**. As the name suggests, this technique fits into the category of soft bargaining styles. They base their principled negotiation, also called the Harvard method, on the following four points:

1. Focus on the interests of all parties, not their positions.
2. Separate the people from the issue.

3. Make a list of creative options that meet the interests of both parties.
4. Base the end result on an objective standard.

Here are some steps you should consider before the negotiation process starts:

- Choose a meeting location where you feel comfortable.
- Establish your goals and make sure, that they are realistic.
- Research the other party's members and their positions.
- Gather facts and information about the subject of the negotiation.
- Focus on the other side's interests to find win-win solutions.
- Try to find options that meet the interests of both parties.
- Define your "best alternative to a negotiated agreement" (BATNA)

What does the "best alternative to a negotiated agreement" (BATNA) mean? It is the exact point when the deal the other side is offering is no longer beneficial to you. For example, if you are negotiating about getting a job at firm A and you already have a job offer from firm B worth $40,000 per year, this salary is your current BATNA.

# Negotiation Process and Traps

Regarding the negotiation process, there are some strategies and tricks you should consider:

- Make the other side feel comfortable and use small talk to break the ice.
- Use "active listening" (listen carefully, be patient, ask questions, show interest). Periodically repeat and summarize what they are saying so they will realize that you are taking them seriously and actually listening to them.
- Begin with those points most likely to be agreed upon and then proceed in descending order of what is likely to be agreed upon.
- Never give up "something for nothing." Always link something that you are asked to give up with something that you want.
- Try to see the other person's side and separate the people from the issue. Let the other party know that you are seeking a win-

win resolution so that both parties gain rather than one party winning at the expense of the other.
- Don't be afraid to walk away, when you can't find an agreement.

Finally, there are some **traps in negotiating** that people may use while negotiating with you:

- In many cases, parties try to make even very small changes after both parties already agreed to all parts of a contract. This trick, often used to make minimal changes, is called **nibbling**.
- Using the **good guy, bad guy**-trick, one individual you are dealing with is a hard, aggressive bargainer whereas another one will try to make you believe he is working as a mediator.
- A party could set you an **ultimatum** to intimidate you and get you to sign the agreement quickly.
- By using the trick of **limited authority**, people may also offer you a deal, agree with you on it and pretend shortly before signing the contract, that their supervisor will only approve the deal for a slightly higher price.
- You should also be prepared for checking **statistical data** the other side shows you. Not all data is trustworthy.

# 7. Change Management

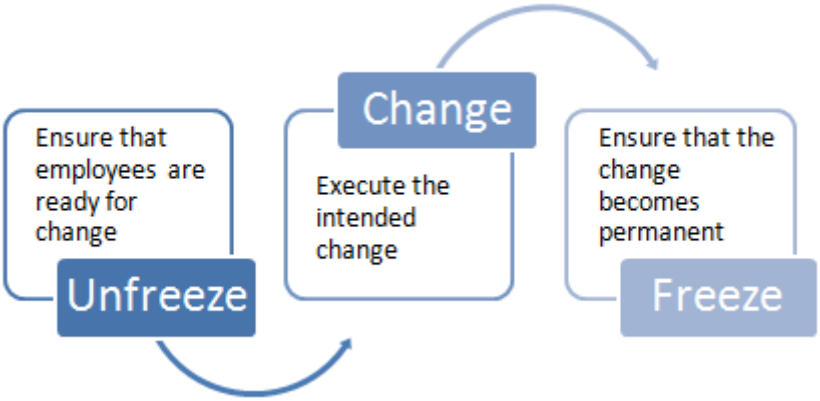
We live in a world where "business as usual" is change. New initiatives, technology improvements, staying ahead of the competition – these things come together to drive ongoing changes to the way we work. Here we will introduce the most important change management models.

## Lewin: Three Phases Change Model

One of the most popular models for understanding organizational change was developed by Kurt Lewin. Lewin explained change using the analogy of changing the shape of a block of ice in three steps. If you want to change a cube of ice towards a cone of ice, you must…

- melt the ice (**unfreeze**),
- mold the water into the shape you want (**change**), and
- solidify the new shape (**refreeze**).

Therefore, his model is known as **Unfreeze-Change-Refreeze** model.




**Stage 1: Unfreeze**
The first stage is about getting ready to change. It involves getting to a point of understanding that change is necessary and getting ready to move away from our current comfort zone. Key to this is developing a compelling message showing why the existing way of doing things (status quo) cannot continue. The more we feel that change is necessary, the more urgent it is, the more motivated we are to make the change. This first stage involves moving ourselves, or a department, or an entire business towards motivation for change. “Unfreezing” is usually difficult and stressful. When you start cutting down the way things are done, you put everyone and everything off balance.

**Stage 2: Change**
Change is not an event, but rather a process. That’s why the second stage can also be called “transition”. People are now moving towards a new way of being. They start to believe and act in ways that support the new direction. This is not an easy time as people are learning about the changes and need to be given time to understand and work with them. People need time to understand the changes and they also need to feel highly connected to the organization throughout the transition period. It’s

important to keep communicating a clear vision of the desired change and the benefits to people.

**Stage 3: Refreeze**
This stage is about establishing stability once the changes have been made. The changes are accepted and become the new norm. This means making sure that the changes are used all the time; and that they are incorporated into everyday business. With a new sense of stability, employees feel confident and comfortable with the new ways of working. As part of the Refreezing process, make sure that you celebrate the success of the change – this helps them believe that future change will be successful.

Lewin's change model is a simple and easy-to-understand framework for managing change. You start by creating the motivation to change (unfreeze). You move through the change process by promoting effective communications and empowering people to embrace new ways of working (change). And the process ends when you return the organization to a sense of stability (refreeze), which is so necessary for creating the confidence from which to embark on the next, inevitable change.

# Kotter: 8-Step Change Model

Although Lewin's model helps to describe and understand change management, there are more detailed models that focus on how to "do" change. John Kotter, a professor at Harvard University and world-renowned change expert, identified eight stages of change a company must successfully complete to achieve lasting, sustainable business improvements.


**Step 1: Create Urgency**
During this first step, it is essential to ensure that the employees are motivated to participate. A change is only successful if the whole company really wants it. If you are planning to make a change, then you need to make others want it. Develop a sense of urgency around the need for change. This may help you spark the initial motivation to get things moving. Open an honest and convincing dialogue about what's happening in the marketplace and with your competition. If many people start talking about the change you propose, the urgency can build and feed on itself.

**Step 2: Form a Powerful Coalition**
Convince people that change is necessary. This often takes strong leadership and visible support from key people within your organization. You can find effective change leaders throughout your organization – they don't necessarily follow the traditional company hierarchy. To lead change, you need to bring together a coalition, or team, of influential people whose power comes from a variety of sources, including job title, status, expertise, and political importance. Once formed, your "change coalition" needs to work as a team, continuing to build urgency and momentum around the need for change. Make them feel that they are important within the team.

**Step 3: Create a Vision for Change**
Create a vision that clearly defines where the organization is going. When you have a clear vision, your team members know why they are working on the change initiative and the rest of the staff know why your team is doing the change. A clear vision can help everyone understand why you're asking them to do something. When people see for themselves what you're trying to achieve, then the directives they're given tend to make more sense.

**Step 4: Communicate the Vision**
Creating a vision is not just enough for you to implement the change. You need to communicate your vision frequently and powerfully, and embed it within everything that you do. Talk about it every chance you get – this could be in meetings or just talking over the lunch. When you keep it fresh on everyone's minds, they'll remember it and respond to it. However, what you *do* is far more important than what you *say*. Demonstrate the kind of behavior that you want from others.

**Step 5: Remove Obstacles**
No change takes place without obstacles. Always, there are people, who resist the change. Watch out for obstacles and remove them as soon as they appear. Put in place the structure for change and continually check for barriers to it. Removing obstacles will increase the morale of your team, and it can help the change move forward.

**Step 6: Create Short-Term Wins**
Give your company a taste of victory early in the change process. Quick wins are the best way to keep the momentum going, because nothing motivates more than success. Create not just one long-term goal but also short-term targets. By quick wins, your team will have great satisfaction and the company will immediately see the advantages of your change initiative.

**Step 7: Build on the Change**
Many change projects fail because victory is declared too early. Real change runs deep. Quick wins are only the beginning of what needs to be done to achieve long-term change. Each success provides an opportunity to build on what went right and identify what you can improve.

**Step 8: Anchor the Changes in Corporate Culture**
Finally, the change should become part of the core of your organization. “In the final analysis, change sticks when it becomes *the way we do things around here*, when it seeps into the bloodstream of the corporate body” (John Kotter). Use mechanisms to integrate the change into people’s daily life and corporate culture. It’s also important that your company’s leaders continue to support the change. If you lose the support of these people, you might end up back where you started.

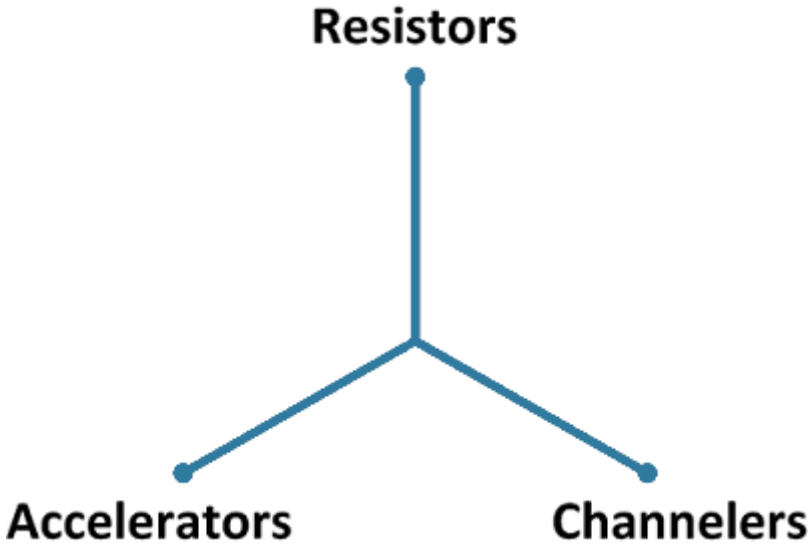
Each of the steps that Kotter outlines in his process is important, but none may be as crucial as the first one. Kotter noted that for change to happen at least 75% of the company’s management has to be on board. That’s why it is so important to take the time and effort to build the urgency necessary to get others to buy-in to your change-related projects.

# Responses to Change

In the constantly changing corporate world, the one who welcomes the changes stays ahead of the competition. But you have to work hard to change an organization successfully. When you plan carefully and build the proper foundation, implementing change can be much easier, and you’ll improve the chances of success. If you’re too impatient, and if you expect too many results too soon, your plans for change are more likely to fail.

Create a sense of urgency, train powerful change leaders, build a vision and effectively communicate it, remove obstacles, create quick wins, and build on your momentum. If you do these things, you can help make the change part of your organizational culture. That’s when you can declare a true victory.

Individuals often have three different **responses** to change. Some will be obvious in either their support (accelerators) or their opposition (resistors), while others accept the fact that some degree of change is inevitable (channelers).




- **Accelerators:** People in this group are interested in accelerating the changes they see coming. These are the people who typically feel marginalized or unfulfilled by the status quo and actually want change. Accelerators want to put the pedal to the metal for change, to really pour it on.
- **Resistors:** The second group are the Resistors who, as their name implies, are conservative with regard to some potential change and will resist that change. Resistors are typically those who derive their sense of self and place from the status quo (like Elites) and for whom any change from the current state of affairs is undesirable.
- **Channelers:** The third group are the Channelers. These are the stakeholders who recognize that change is coming, typically accept that some degree of change is inevitable, and therefore attempt to channel it as much as possible to align with their preferences and values.

Identifying resistance to change and managing it quickly is vital to your change management process; failure to do so can derail even the most carefully planned change. Reinforcing supporters alone will not guarantee a successful change process.

The first step to **overcoming resistance** is to understand why the resistance is there. The primary reason for resistance is that change requires employees to alter their existing individual and organizational identities. Once you have identified the true sources of resistance to the change, you can work to address them. This may require individual

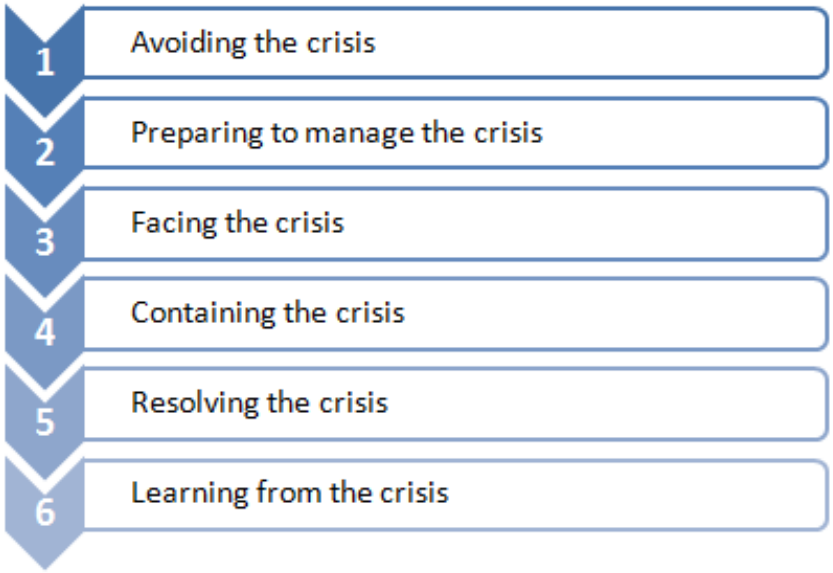
attention. Following are some tips for dealing with resistance once you've identified the cause.

- Ask the resisters to explain why they are resistant. You might learn something that you didn't know before and you could even improve the change process.
- Demonstrate the benefits of adapting to change. You might use personal gains such as potential salary increase, recognition, promotion opportunities, etc.
- If resistance is due to a general fear of what the change might mean to them, consider putting the resister on a team that is determining how to implement the change. For example, a front-line person may be afraid that upper-level decision-makers won't understand exactly how the change will impact them on a day-to-day basis. Putting this person on the implantation team lets them understand the process and can also provide valuable information.
- Discuss the change in broad-based meetings to put everyone on the same page and provide everyone with the same information.
- Although it is unpleasant to consider, individuals who stay resistant may have to leave the organization. However, training new employees is more expensive and knowledge will be lost. Remember that most employees will eventually adapt to change if given the right incentives, the right information, and support.

# 8. Crisis Management

Crisis management is the process by which an organization deals with a major threatening event. Whether an earthquake destroys infrastructure, computer hackers attack a company's website, or a key manager leaves the company with no replacement – all these events must be addressed immediately.

Many different models of Crisis Management exist in the public and private sectors. This section argues that Crisis Management can best be defined by the following six-stages process model:




**Stage 1: Avoiding the Crisis**
Crises are unpredictable, but they do not have to be entirely unexpected. As a manager, you have to prepare for crises when things are going well. Key to good preparation is not only crisis management planning but also the implementation of training and exercising.

- Include crisis planning in your overall strategic planning process and talk to people from other areas of your company about risks in your industry.
- Perform the SWOT analysis: Find strengths and weaknesses of your company as well as, environmental opportunities and threats for your business.
- Develop a crisis-risk list: What are the worst things that could go wrong? And what are the most likely crises that could occur?

**Stage 2: Preparing to Manage the Crisis**
In the second step, a manager should develop a crisis plan. Consider everything that might go wrong, and assess the costs if it should. After selecting a what-if scenario and possible consequences he/she should brainstorm the kinds of decisions that will have to be made.

- Perform a reality check on your plan by brainstorming possible side effects.

- Form a crisis-management team and create a communications plan with key persons.
- Think about what resources will be needed to handle the crisis.

**Stage 3: Facing the Crisis**
In this stage, you have to face unpleasant situations – things get serious! But is the current situation a crisis? In this stage, you have to characterize the event and evaluate the size of the crisis. Furthermore, you have to evaluate honestly how you manage the situation.

- Estimate the size of the crisis: How many people are involved? Who and where are they?
- Get a team in place as quickly as possible.
- Get all the information you can get about what's happening.

**Stage 4: Containing the Crisis**
The fourth stage is about damage control and communicating. You have to make decisions – and you have to make them quickly. Be on the scene and show physical presence, respond to your people and communicate critical information to them.

- Stop rumors and false information. Inform key people who need to know and do so quickly.
- Stick to the facts and Make your message straightforward and confident.
- Communicate honestly (otherwise people may blame you for failure).

**Stage 5: Resolving the Crises**
A crisis requires fast, confident decision making. Therefore, managers should not be paralyzed when there are no standard operating procedures. Often, they just have to trust their judgment and take action. By making decisions, ensure that the safety of the people is always prioritized and that you grasp new developments.

- Focus on what is in your control and ignore what is not.
- Help everyone work together and draw people together to act as a team.
- Avoid blaming others.

**Stage 6: Learning from the Crisis**
Once the crisis has passed, you can use the experience and make

changes to prepare for a similar crisis. A manager should review how the crisis was handled and plan ahead.

- Try to find out, if there were warning signals that you may have ignored.
- Evaluate what you did right and what you could improve.
- Get input from everyone.

# 9. Business Ethics

Business ethics deal with moral guidelines and good corporate governance. Companies are supposed to set high standards and adhere to certain common business practices. In this chapter, we will cover the essentials of business ethics, social responsibility, and sustainability.

## Ethics and Law

**Ethics** are moral guidelines which govern good behavior. Today, many people believe that business is in some way unethical or amoral. Various scandals all around the world concerning undesirable business activities, such as the despoiling of rivers with industrial pollutants, the exploitation of sweatshop workers, the payment of bribes to government officials, and the deception of unwary consumers have highlighted the unethical way in which some firms have gone about their business.

However, just because such malpractices take place, does not mean that there are not some kinds of values or principles driving such decisions. After all, even what we might think of as ‘bad’ ethics are still ethics of a sort. And clearly, it makes sense to try and understand why those decisions get made in the first place, and indeed to try and discover whether more acceptable business decisions and approaches can be developed.

Many everyday business activities require the maintenance of basic ethical standards, such as honesty, trustworthiness, and co-operation. Business activity would be impossible if corporate directors always lied; if buyers and sellers never trusted each other; or if employees refused to ever help each other.

**Business ethics** is the study of business situations, activities, and decisions where issues of right and wrong are addressed.

It is worth stressing that by 'right' and 'wrong' we mean morally right and wrong as opposed to, for example, commercially, strategically, or financially right or wrong. Moreover, by 'business' ethics, we do not mean only commercial businesses, but also government organizations, pressure groups, not-for-profit businesses, charities, and other organizations.

So behaving ethically is doing what is morally right. But the law is also about issues of right and wrong, correct? This is true, and there is an overlap between ethics and the law. Nevertheless, the two concepts are not equivalent and behaving ethically is not quite the same thing as behaving lawfully:

- **Ethics** are about what is morally right and what is morally wrong.
- **Law** is about what is lawful and what is unlawful.

Many moral issues are not explicitly covered by the law. For example, in many countries, there is no law preventing businesses from testing their products on animals, selling weapons to oppressive regimes, or preventing their employees from joining a union – decisions which many people would define as unethical.

Similarly, there are issues that are covered by the law, but are not really about ethics. For example, the law whether you should drive on the right or the left side of the road is not an ethical decision.

The problem of trying to make decisions in the areas of business ethics, or where values may be in conflict, means that many of the questions posed are ambiguous. There simply may not be a definitive 'right' answer to many business ethics problems. And as is the case with issues such as the animal testing of products, executive pay, persuasive sales

techniques, or child labor, business ethics problems also tend to be very controversial.

So business ethics is not about learning specific procedures and facts in order to make objectively correct decisions – but it should help you to make *better* decisions.

# Social Responsibility

Some managers believe that business's sole duty is to make profits. In their view, it is up to the government to determine what the laws should be. A profitable business benefits society by creating jobs, increasing the standard of living of its owners and its employees. Corporations pay the taxes that support government's social action.

Today, more and more experts tend to discourage this view. Business ethics rests on the assumption that businesses ought to adhere to a socially responsible approach to decision making called the social responsibility approach. Proponents of this approach believe that corporations have societal obligations that go **beyond maximizing profits**.

**Corporate Social Responsibility (CSR)** deals with actions that affect a variety of parties in a company's environment. A socially responsible company shows concern for all its stakeholders—anyone who, like owners, employees, customers, and the communities in which it does business, has a "stake" or interest in it.

Corporate Social Responsibility (CSR) is a self-regulating business model that helps a company be socially accountable — to itself, its stakeholders, and the public.

Recognizing how important social responsibility is to their customers, many companies now focus on and practice a few broad categories of CSR:

- **Environmental efforts:** One primary focus of corporate social responsibility is the environment. Businesses regardless of size have a large carbon footprint. Any steps they can take to reduce those footprints are considered both good for the company and society.

- **Philanthropy:** Businesses can also practice social responsibility by donating money, products or services to social causes. Larger companies tend to have a lot of resources that can benefit charities and local community programs.
- **Ethical labor practices:** By treating employees fairly and ethically, companies can also demonstrate their corporate social responsibility.
- **Volunteering:** Attending volunteer events says a lot about a company's sincerity. By doing good deeds without expecting anything in return, companies can express their concern for specific issues and support for certain organizations.

To accomplish various CSR goals, the founders of the American ice cream manufacturer **Ben & Jerry's**, Ben Cohen and Jerry Greenfield, created the "Ben & Jerry's Foundation." The company has set the bar high by giving 7.5% of its pretax profits to charitable organizations around the world. Ben and Jerry's strives "to show a deep respect for human beings" whether they work for the company or not. The foundation awards more than $1.8 million per year to fund community action, social change, and other sustainability initiatives.

# Sustainability

Faced with growing global problems like environmental pollution, climate change, or waste disposal, it has been widely suggested that the goals and consequences of business today require radical re-thinking. One concept, in particular, appears to have been widely promoted as the new frame for assessing not only business activities, but industrial and social development more generally. That concept is sustainability.

For a long time, sustainability as a concept was largely synonymous with environmental sustainability. Today, the concept of sustainability has been broadened to include not only **environmental** considerations, but also **economic** and **social** considerations.

**Sustainability** refers to the long-term maintenance of systems according to environmental, economic and social considerations.
All businesses must make money. But some companies realize that they can do more. The triple bottom line (TBL) is a concept which broadens a business' focus on the financial bottom line to include social and environmental considerations. The concept was introduced in 1994 by

John Elkington and the three bottom lines are often referred to as the three P's:


**People:** Companies that follow the triple bottom line way of doing business think about the impact their actions have on all the people involved with them. This can include everybody from farmers supplying raw materials, on up to the CEO of the company. Everyone's well-being is taken into consideration. The company offers health care, good working hours, a healthy, safe place to work, and opportunities for education.

**Planet:** Triple bottom line companies take pains to reduce or eliminate their ecological footprint. They strive for sustainability, recognizing the fact that "going green" may be more profitable in the long run. But it's not just about the money. Triple bottom line companies look at the entire life cycle of their actions and try to determine the true cost of what they're doing in regards to the environment.

**Profit:** The financial bottom line is the one that all companies share, whether they're using the triple bottom line or not. When looking at profit from a triple bottom line standpoint, the idea is that profits will help empower and sustain the community as a whole, and not just flow to the CEO and shareholders.

In 2016 the Swedish furniture giant IKEA reported sales of $37.6 billion. The same year, the company turned a profit by recycling waste

into some of its best-selling products. Before, this waste had cost the company more than $1 million per year.

Sustainable organizations recognize that *profit* isn't opposed to *people* or *planet*. According to J. Yarrow, IKEA's head of sustainability for the UK, "We don't do this because we're tree huggers, we do this because it's very cost-effective."
Though the triple bottom line has been around for decades, events such as the 2008 financial crisis, the BP oil spill, and climate change cast an almost constant spotlight on corporate ethics and corporate social responsibility.

For companies, changing operations to minimize risk and fight climate change, requires a lot of time and money. But an upfront investment in corporate sustainability can pay off. Various studies prove that companies that treated sustainability seriously – by making a business case for it and setting concrete goals – were the ones that profited from sustainable activities.

# 10. Time Management

Time management is the process of planning and exercising control over the amount of time spent on specific activities – especially to increase effectiveness or efficiency. Traditionally, time management referred to just work activities, but today the term often includes personal activities as well.

A good time management system is a designed combination of processes, tools, techniques, and methods. Finding a time management strategy that works best for you depends on your personality, ability to self-motivate and level of self-discipline. By incorporating some of the ten steps below, you can more effectively manage your time:

**1. Know How You Spend Your Time**
Figure out how much time you usually spend on your activities and

evaluate the results. Determine which tasks require the most time; determine the time of day when you are most productive; and analyze where most of your time is devoted.

**2. Set Priorities**
One of the easiest ways to prioritize is to make a “to-do” list. Put the most important tasks at the top and tackle them first. Just be careful not to allow the list-making to get out of control and do not keep multiple lists at the same time.

**3. Use a Planning Tool**
Use a personal planning tool to improve your productivity – and keep it with you. Examples of personal planning tools include electronic planners, pocket diaries, calendars, computer programs, notebooks, and your smartphone.

**4. Get Organized**
Disorganization results in poor time management. Implement a system that allows you to handle information effectively. This is not only true for your desk and office bookcase, but also for your computer files and your emails.

**5. Schedule Your Time Appropriately**
Plan your most challenging tasks for when you have the most energy and block out time for your high priority activities. However, try to limit scheduled time to 70% of your day, leaving some time for creative activities such as planning, thinking, and reading.

**6. Delegate: Get Help from Others**
Identify tasks that others can do and then select the appropriate person to do them. Be specific in defining the work, but allow the person some freedom to personalize the task. Finally, don’t forget to reward the person for a job well done.

**7. Stop Procrastinating**
Some tasks seem overwhelming, some seem unpleasant. Try breaking down the tasks into smaller segments that require less time commitment and result in realistic deadlines. If you’re having trouble getting started, ask some colleagues for help.

**8. Manage Time Wasters**
Decrease or eliminate time spent on activities imposed by other people

(e.g., don't schedule meetings unless they are necessary and ask employees to make appointments during periods when you have a lot of work to do).

**9. Avoid Multi-tasking**
Multi-tasking does not actually save time. In fact, the opposite is often true: You lose time when switching from one task to another, resulting in a loss of productivity. Stay focused on your current problem instead of trying to deal with ten problems at once.

**10. Get time for yourself**
The care and attention you give yourself is an important investment of time. Scheduling time to relax can help you rejuvenate both physically and mentally.

Regardless of the time management strategies you use, you should take time to evaluate how they have worked for you. Try to find a **healthy balance** between work and home life. Focus on the tasks that are most important in your life. Invest enough time in your own personal well-being. Always remember that successful time management today can result in greater personal happiness, greater accomplishments at home and at work, increased productivity, and a more satisfying future.

# 11. Case Studies & Conclusion

To complete this course and highlight its core concepts, we will take a closer look at the leadership approaches of Steve Jobs at Apple and Bill Gates at Microsoft. After that, we will discuss how the University of Oxford promotes sustainability. Finally, we will summarize the key takeaways of the course.

# Case Study: Microsoft & Apple

Apple and Microsoft are two of the biggest companies in the world with each firm taking a different business approach from an organizational

and philosophical perspective. The spectacular rise of both technology companies is directly linked with the history of their founders.

In 1955, two of America's most brilliant minds, Bill Gates (left) and Steve Jobs (right), were born and grew up in different environments which reflected on their leadership skills. However, both became successful business owners and they had a major thing in common: a passion for innovation in the world of computing technology.

## Two Geniuses with Visions

**Steve Jobs** was a successful entrepreneur who co-founded **Apple**. His beginnings were humble pushing him to be self-made. In 1976, Steve Jobs and his friend Steve Wozniak launched their individual company in the garage of Jobs's home. They named it Apple Computer Company, in memory of happy summers which Jobs had spent picking apples. Jobs resigned at Apple in 1985 but returned in 1997 and served as the company's CEO until 2011.

**Bill Gates** was the chairman and CEO of **Microsoft**. He co-founded the company with his childhood friend Paul Allen in 1975. In 1980, Gates had his greatest opportunity, when IBM approached him to develop an operating system for its personal computer. In the early 1990s, Microsoft had sold more than 100 million copies of MS-DOS. Gates became the chief architect of Microsoft Windows and in 2014 he stepped down the chair to focus on his charity work.

## Different Personalities

**Bill Gates** was driven by numbers, equations, and even economics. He was a software developer who always tried to develop new software using new technologies. Slowly, he pushed himself into the management role. Microsoft's philosophy under the leadership of Gates was "A computer on every desk in every house, running Microsoft software". Bill Gates was never as creative as Steve Jobs. Instead, he utilized the ideas and advice of his team to produce some of the biggest technology game-changers in the market.

**Steve Jobs**, on the other hand, was driven by studying people and finding out what makes their lives easier. His approach was futuristic; he thought about the future when he worked on his innovations. Apple's philosophy under the leadership of Jobs was "Make computer accessible to everyone and make it very easy to use". Jobs had a creative design mindset: He wanted to develop his products how he saw best fit.

## Different Leadership Styles

**Bill Gates** used a **democratic leadership style**. He believed in the value of input from his employees for overall company success. He understood that in business you will have fluctuations and changes that you must adapt to in order to succeed. Through the process of delegation of tasks, Gates was able to develop a company that utilizes the skills of his team members to the fullest.

**Steve Jobs** used an **autocratic leadership style**. He used to be the main person in charge of decision making and typically decided based on his ideas without collecting any inputs from his team members. Jobs understood the importance of taking risks and could be considered one of the biggest risk-taking leaders in the world. His rudeness was accompanied by an ability to inspirit Apple employees with a passion to create groundbreaking products and a belief that they could accomplish what seemed impossible.

## Different Organizational Structures

The original organizational structure of **Microsoft** under the leadership of Bill Gates was **functional**. Through the process of delegation of tasks, Gates was able to develop a company that utilizes the skills of his team

members. Bill Gates also created a management system known as “stack ranking” to control and motivate Microsoft employees. This program classified employees as top performers, good performers, average, and poor. It turned out to be a destructive process and Microsoft decided to ditch the stack ranking system in 2012.

The organizational structure of **Apple** under the leadership of Steve Jobs was **highly centralized**. Jobs was in charge of all final tasks, supervisions and decision makings. This had definite impacts on the corporate culture of the company with specific levels of responsibility for employees. His top employees were more loyal to him than those at most other companies. CEOs who study Jobs and decide to emulate his roughness without understanding his ability to generate loyalty make a dangerous mistake.

### Conclusion

Microsoft and Apple both created some of the most successful products and services in the world. Apple’s business model was always based on innovation and consumer-centric devices. Microsoft built its success on the licensing of software such as Windows and Office. However, the management approaches of Steve Jobs and Bill Gates were quite different. In the end, both were able to convert high-quality ideas into successful products.

## Case Study: University of Oxford

The University of Oxford is a famous research university in Oxford, England. The history and influence of the University of Oxford have made it one of the most prestigious universities in the world. As of 2019, Oxford has educated many notable alumni, including 28 prime ministers of the United Kingdom and 72 Nobel Prize winners.

With more than 23,000 students, 14,000 employees, and 230 buildings, the University of Oxford is a large organization. Through its activities and actions, the university recognizes its impact on the environment, locally, nationally and globally.

The university currently works to enhance its positive impact and reduce its negative impacts. It made a commitment within the Oxford University Strategic Plan to continue to deliver its sustainable targets. These targets will be met through continual improvement and evaluation.

The Sustainability Steering Group (SSG) of the university is responsible for the development of sustainability strategy and monitoring its delivery, while the day-to-day implementation of the sustainability initiative is managed by the Environmental Sustainability team.

During the last years, the university has identified seven key areas through which environmental sustainability shall be approached. These are:

- **Energy and Carbon Management** – by encouraging energy-efficient practices and investing in its estate to reduce carbon emissions. For example, it was able to decrease carbon intensity (carbon emissions/m²) from 2005 to 2015 by 33%. In the year 2016, the university also installed its 1000th solar photovoltaic panel to generate renewable energy.
- **Water Management** – by reducing water consumption through water-efficient practices and technologies. However, reducing consumption significantly remains extremely challenging for a large research organization. Rainwater harvesting captures rain and uses it for operations such as flushing toilets.
- **Material Resources** – by encouraging preventing waste. As well as recycling and recovering waste, the university is also working to reduce waste production through reuse. The university developed a reuse platform through which University resources can be shared.

- **Sustainable Travel** – by reducing emissions from work-related travel and university-owned vehicles. The university seeks to reduce the number of car journeys and to improve the range of travel options. For example, the university decided to increase the cycle-share program Oxonbike and to upgrade its vehicle fleet.
- **Sustainable Buildings** – by making full use of available space and designing and refurbishing buildings in line with the university's Sustainable Building Philosophy.
- **Biodiversity** – by enhancing wherever possible wildlife habitat on university-owned land and supporting wider initiatives as appropriate.
- **Community** – by increasing awareness and understanding of environmental sustainability by staff and students and serving society by contributing and promoting the university's research and knowledge transfer on sustainability.

The university sets clear objectives and targets reviewed annually and supported by long-term strategies and plans. Every year, it publishes a detailed report about its current performance on these fields – including measurements of positive progress (targets achieved) as well as negative progress (targets missed).

The university received numerous awards and prizes for its sustainable initiatives by the Environmental Association for Universities and Colleges (EAUC) and the International Sustainability Campus Network since 2010.

Additionally to its internal sustainability program, the university cooperates with city authorities and other stakeholders in a network "to work towards Oxford City becoming a carbon-neutral city and a center of excellence for climate change adaptation and mitigation initiatives."

# Summary

To be a great manager, you must have an extensive set of skills – from leadership skills to time management.

Management skills can be defined as certain attributes or abilities that an executive should possess in order to fulfill specific tasks in an organization. They include the capacity to perform executive duties in an organization while avoiding crisis situations and promptly solving

problems when they occur. Management skills can be developed through learning and practical experience as a manager.

While different roles and organizations require the use of various skillsets, essential management skills help a professional stand out and excel no matter what their level. In top management, these skills are essential to run an organization well and achieve desired business objectives.

A manager who fosters good management skills is able to propel the company's mission and vision or business goals forward with fewer hurdles and objections from internal and external sources. Good management skills are vital for any organization to succeed and achieve their goals and objectives.

We hope that this course gave you a good understanding and a complete overview of the most important management skills and that this will help you to succeed in today's business world and become a better manager.

# Economics and International Business

## 1. Introduction

**Welcome to Economics & International Business!**
"Economics" is the science that studies the choices of individuals, households, and organizations, in allocating scarce resources. Scarcity means that individuals and societies have limited resources.

Although many people don't recognize it, we all make economic decisions every day – we decide what products or activities fit into our budgets and needs. Through these decisions, we define what we want to be available on the market and at what price. The economic system is

the place, where goods and services are produced, distributed, and consumed.

Economists study how people make decisions about buying, selling, saving, and investing. We study how people interact with one another in markets. We also study the economy as a whole when we concern ourselves with total income, unemployment, and inflation.

For businesses, creating a long-term global strategy is a complicated but important task. As is evident throughout this course, no country is an economic island, and the economy truly is global. A growing number of businesses have become true multinational firms, with operating facilities around the world. They have figured out how to mitigate their risks both politically and economically, but they have also found how events in one nation can reverberate around the world.

As businesses contemplate and engage in global expansion, there are endless opportunities, but also potential risks. The home market is also attractive to foreign firms. For an organization to be successful in today's global economy, its owners and stakeholders must look across borders and understand the global community.

Economics is the social science that studies how societies manage their scarce resources.

# 2. Ten Principles of Economics

Although the study of economics is complex, the field is unified by several central ideas. The famous **Ten Principles of Economics** by Gregory Mankiw are the principles of how the global economy works. These principles include basic concepts used by economists around the world.

# How People Make Decisions

**Principle 1: People face trade-offs.**
Economists often say, “There ain’t no such thing as a free lunch.” This means that there are always trade-offs: To get one thing, you have to give up something else. For example, if you spend money on a new computer, you won’t be able to spend it on a new television. This principle also works for nations. There is the classic trade-off between “guns and butter”: if society spends more on national defense (guns), then it will have less to spend on social programs (butter). Recognizing that trade-offs exist does not indicate what decisions should be made.

**Principle 2: The cost of something is what you give up to get it.**
Making decisions requires comparing the costs and benefits of alternative courses of action. For instance, if a firm spends $100 on electrical power, they can’t use that money to buy new office equipment. Economists say the firm’s opportunity cost is $100. The **opportunity cost** of an item is whatever you give up to get that item. Thus, opportunity costs are not restricted to financial costs: By seeing a movie in a cinema, your opportunity cost is not just the price of the ticket, but the value of the time you spend in the theater. Put another way, opportunity costs are the benefits you could have received by taking an alternative action. When making decisions, managers should always consider the opportunity costs of each possible action.

**Principle 3: Rational people think at the margin.**
Economists generally assume that people are rational – that means, their

decisions are based on facts and reasons. Rational people make decisions by comparing marginal benefits and marginal costs. For example, you should only attend college for another year if the benefits from that year of schooling exceed the cost of attending that year. Furthermore, a car company should only produce more cars if the benefit exceeds the cost of producing them.

**Principle 4: People respond to incentives.**
Because rational people weigh marginal costs and marginal benefits of activities, they will respond when these costs or benefits change. For example, when the price of cars rises, buyers have an incentive to buy fewer cars. Public policy can alter the costs or benefits of activities. Some policies have unintended consequences because they alter behavior in a manner that was not predicted.

# How People Interact

**Principle 5: Trade can make everyone better off.**
Trade is not a contest in which one side wins and one side loses. Trade can make each trader better off. Trade allows each trader to specialize in the activities he or she does best, whether it be farming, building, engineering or manufacturing. By trading with others, people can buy a greater variety of goods or services. This is true for both individuals and countries. You are likely to be involved in trade with other individuals and companies on a daily basis: Most people do not make their own clothes or grow their own food – but by trading you are able to get all those products.

**Principle 6: Markets are usually a good way to organize economic activity.**
In a market economy, the decisions about what goods and services to produce and how much to produce are made by millions of firms and households in the marketplace. Political economist Adam Smith made the famous observation that although individuals are motivated by self-interest, an **invisible hand** guides this self-interest into promoting society's economic well-being. Consequently, centrally planned economies have mostly failed because they did not allow the market to work.

**Principle 7: Governments can sometimes improve market outcomes.**
When a market fails to allocate resources efficiently, the government can change the outcome through public policy. One kind of market failure is **externality** – it occurs when the actions of one person affect the well-being of other people. The second kind of market failure is **market power** – when a single actor has so much power, that he can influence the price. In these cases, the government may be able to intervene. Examples are regulations against monopolies. The government may also intervene to improve equality with income taxes and welfare.

# How the Economy Works

**Principle 8: A country's standard of living depends on its ability to produce goods and services.**
There is great variation in living standards across countries today as well as within the same country over time. These are largely attributable to differences in productivity. **Productivity** is the number of goods and services produced from each unit in a specific time period. As a result, public policy should improve education and improve access to the best available technology.

**Principle 9: Prices rise when the government prints too much money.**
When a government creates large quantities of the nation's money, the value of the money falls. In this process, called **inflation**, prices increase and consumers require more of the same money to buy goods and services. High inflation is costly to the economy. Policymakers wishing to keep inflation low should maintain slow growth in the quantity of money.

**Principle 10: Society faces a short-run trade-off between inflation and unemployment.**
In the short run, an increase in the quantity of money (inflation) stimulates spending, which raises production. The increase in production requires more hiring, which reduces unemployment. The result is a temporary trade-off between inflation and unemployment. Understanding this trade-off is crucial for understanding the short-run effects of changes in taxes, government spending, and monetary policy.

# 3. The Invisible Hand

Adam Smith's famous book **The Wealth of Nations**, published in 1776, provides the basis for today's market economy. Why do market economies work so well? Is it because all people treat one another with love and kindness? No, Smith argues that all participants are motivated by self-interest.

Although a marketplace with millions of participants may appear to be chaotic, the “invisible hand” of the marketplace guides this self-interest into promoting desirable social outcomes and general economic well-being.

In his book, Smith wrestled with a paradox:

“How is it that water, which is so very useful that life is impossible without it, has such a low price — while diamonds, which are quite unnecessary, have such a high price?”

The answer is connected to the **principle of scarcity**: Water is not a scarce item relative to diamonds. Smith recognized that “value in use” isn’t the same as “value in exchange.” Basically, we can’t price an item higher simply because it’s more useful. In fact, quite the opposite is true. A product’s highest price is determined by its marginal utility, which is the value of its last usable unit.

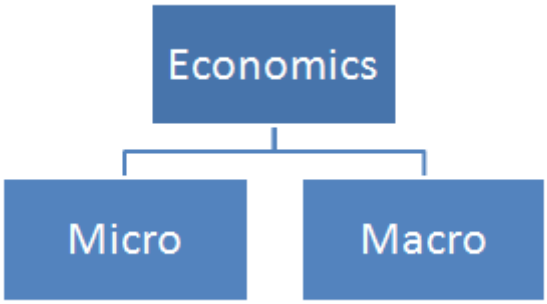
So, water has a relatively low price because it’s everywhere and is so useful. Diamonds, on the other hand, have a relatively high price because they’re scarce by comparison and not a necessity. You can take **two rules** away from this case:

- If you produce very useful products (e.g. shampoo), the products will become commodities and the price will come down. Consequently, you have to sell in large volumes to make a profit.
- If you produce products that are limited in their use (e.g. most luxury goods), the price will go up. You’ll probably sell fewer products, but you’ll make more money on each product.

The “invisible hand” is a term used by Adam Smith to describe the unintended social benefits of individual self-interested actions.

# 4. Micro and Macro

In every area of science, there's a big picture and a little picture, the macro and the micro. Macroeconomics and Microeconomics are simply two different points from which the economy can be observed – just think about them as useful tools like a microscope and a telescope.




**Microeconomics** is the study of small economic units such as individual people, families, and firms. It tries to explain how **individuals and firms** respond to changes in price and why they demand what they do at particular price levels. Briefly speaking, microeconomics analyzes all the small parts that make up the whole economy.

**Macroeconomics** looks at the total output of a **nation** and the way the nation allocates its limited resources of land, labor, and capital in an attempt to maximize production levels and promote trade and growth for future generations. After observing the society as a whole, Adam Smith noted that there was an "invisible hand" turning the wheels of the economy: a market force that keeps the economy functioning.

Microeconomics is the study of small economic units, macroeconomics is the study of the whole economy.
Both approaches are interrelated, as macroeconomic issues help shape the decisions that affect individuals, families, and businesses. Therefore, we will cover the most important concepts of both fields in this course.

# 5. Supply and Demand

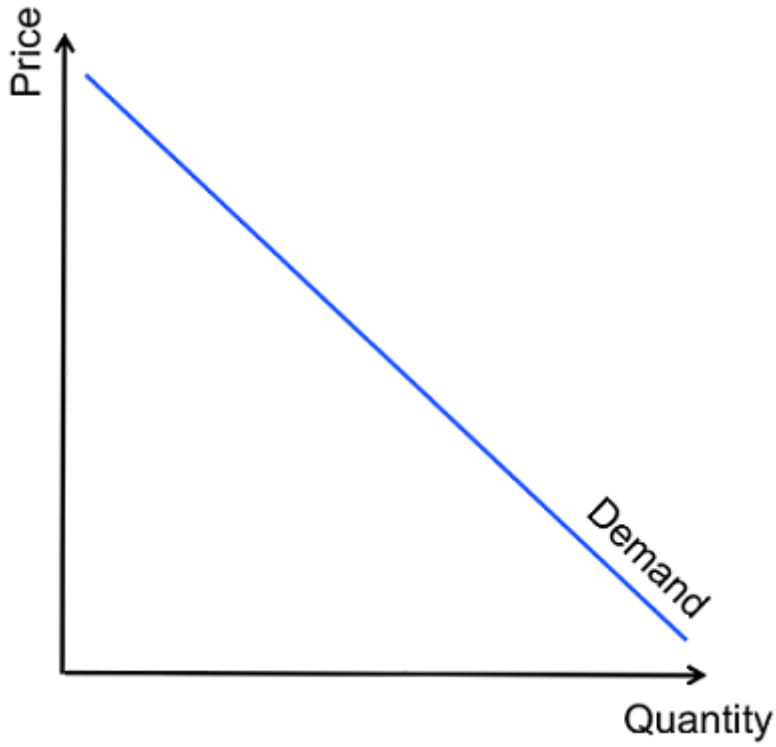
“Supply” and “Demand” are perhaps the most fundamental elements of economics and the market economy. Supply points to the willingness of sellers to provide goods and services for sale. Demand points to the ability of buyers to purchase goods and services.

# Demand

**Demand** refers to how much (quantity) of a product or service is desired by buyers. Typically demand rises as the price of a product falls and demand decreases as prices rise.

The **law of demand** states, all other factors being equal, as the price of a good or service increases, consumer demand for the good or service will decrease, and vice versa. The law of demand says that the higher the price, the lower the quantity demanded, because consumers’ opportunity cost to acquire that good or service increases, and they must make more tradeoffs to acquire the more expensive product.

Economists graphically represent the relationship between product price and quantity demanded with a **demand curve**:




The sensitivity of the changes in price and demand is called **price elasticity**. Products and services have different degrees of price elasticity. For example, if gasoline increases in price, overall demand may not be proportionately reduced, as people still need gas to fuel their vehicles (low degree of price elasticity). If, however, the price of airline travel increases greatly, it may be likely that demand for air travel will have a greater than proportionate decline (high degree of price elasticity).

Businesses need to carefully monitor the factors that may affect demand. If they aren't keeping a careful eye on these different demand elements as related to their business, their competitors will find a competitive advantage that can affect an organization's long-term survival.

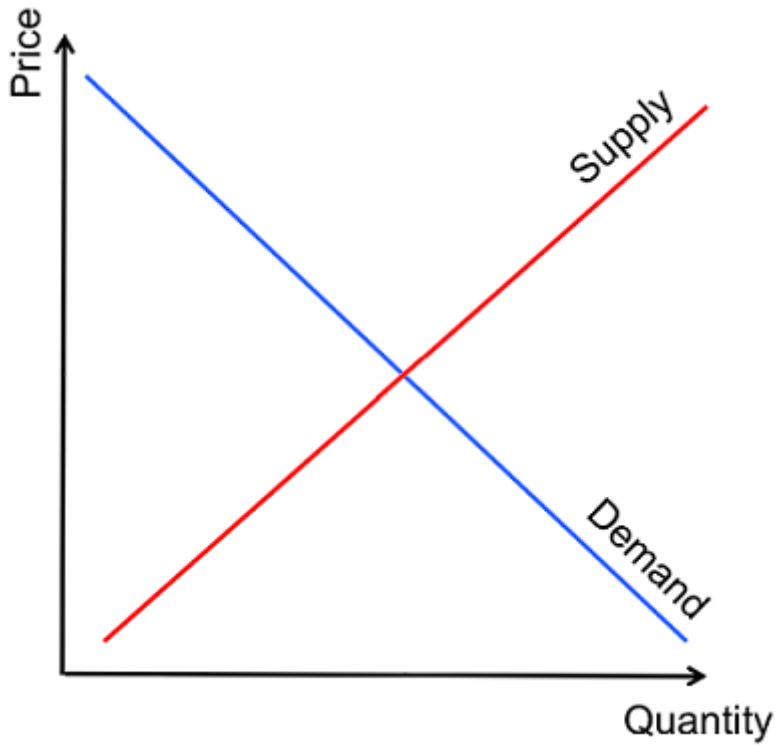
# Supply

**Supply** refers to the relationship between different prices and the quantities that sellers will offer: Generally, the higher the price, the more of a product or service that will be offered.

The **law of supply** states, all other factors being equal, as the price of a good or service increases, the amount of goods or services that suppliers offer will increase, and vice versa. The law of supply says that

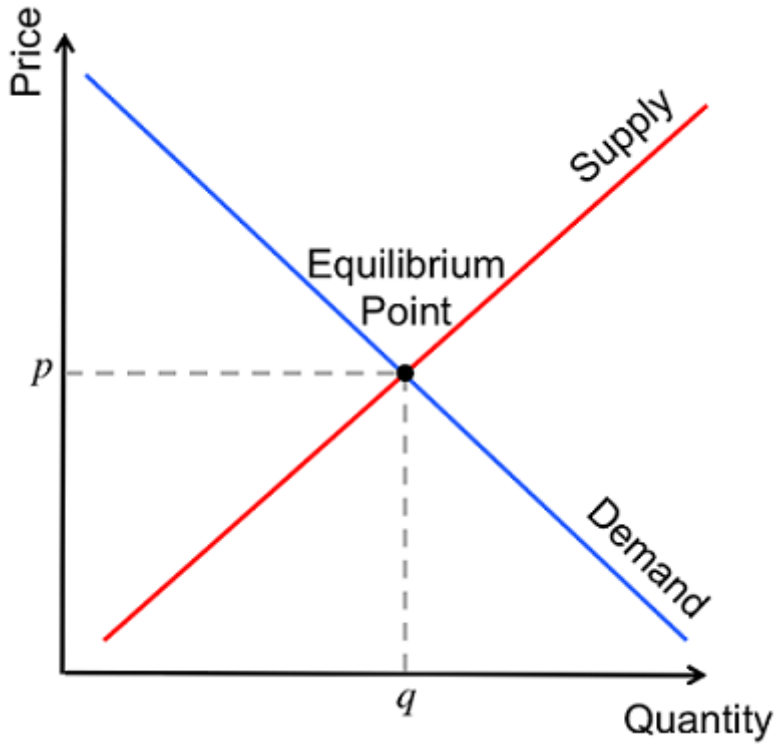
as the price of an item goes up, suppliers will attempt to maximize their profits by increasing the quantity offered for sale.

You can see the relationship between product price and quantity supplied in a **supply curve**:




# Market Equilibrium

The **law of supply and demand** states that prices are set by the intersection of the supply and the demand. The point where supply and demand meet identifies the prevailing market price at which you can expect to purchase a product:




This state where supply and demand are balanced is called the **equilibrium price** or **market equilibrium**. The market forces described here, working through the price mechanism, are the essence of Adam Smith's "invisible hand": Supply and demand come into balance without central planning.

The market price is established through competition such that the amount of goods or services sought by buyers is equal to the amount of goods or services produced by sellers.

When the supply and demand curves intersect, the market is in equilibrium. This is where the quantity demanded and quantity supplied are equal.

# 6. Economic Systems

In the twentieth century, there were primarily two economic systems that provided answers to the questions of what to produce and for whom, given limited resources: **planned economies** directed by a centralized government and **market economies** based on private enterprise.

# Market Economies


The market economy (private enterprise system) is centered on the economic philosophy of capitalism and competition.

**Capitalism** is an economic system in which businesses are rewarded for meeting the demands of consumers. It allows for private ownership of all businesses. Entrepreneurs, desiring to earn a profit, create businesses that they believe will serve the needs of the consumers.

Economic decisions and the pricing of goods and services are guided solely by the interactions of a country's individual citizens and businesses. There is little government intervention or central planning.

There are four different types of **competition** in a market economy:

- **Pure competition** is a market or industry in which there are many competitors. It is easy to enter the market, as there are few barriers to entry and many people/firms are able to offer products that are similar to each other. Individual firms have very little control over the price.
- **Monopolistic competition** means that there are fewer competitors, but there is still competition. In this market environment, it is somewhat difficult to enter the market. Due to the differentiation factor, individual firms are able to have some sort of control over the prices.
- **Oligopoly** is a market situation with few competitors. The few competitors exist due to high barriers to entry. The products or services in this market may be similar (telephone companies) or

they may be different (supermarkets). Here, firms do have some control over prices.

- A **monopoly** exists in the private enterprise system when there is absolutely no other competition. That means that there is only one provider that exists to provide a good or service. In this case, it is often the government that regulates who can enter the market (e.g. public transportation).

A market economy has several **advantages**: Firstly, competition leads to efficiency because businesses that have fewer costs are more competitive. Secondly, innovation is encouraged because it provides a competitive edge and increases the chance for wealth. Thirdly, a large variety of goods and services are available as businesses try to differentiate themselves in the market.

However, market economies have also **disadvantages**: Firstly, the disparity in wealth exists because wealth tends to generate wealth. It is easier for wealthy individuals to become wealthier than it is for the poor to become wealthy. Secondly, there tends to be a reduced social safety net, because social programs are mostly funded by the government.

# Planned Economies


In addition to the private enterprise system, planned economies are another market structure in the world economy. In a planned economy, the government controls business ownership, profits, and resources. Countries that existed with planned economies, however, have not been highly successful. The most common theory of a planned economy is **communism**, which purports that all property is shared equally by the people under the direction of a strong central government.

It is an economic system that involves public ownership of businesses. Rather than entrepreneurs, the government decides what products consumers will be offered and in what quantities.

Communism was proposed by Karl Marx and developed and implemented by V. I. Lenin. In Marxist theory, “communism” denotes the final stage of human historical development in which the people rule both politically and economically. The communist philosophy is based on each individual contributing to the nation’s overall economic success and the country’s resources are distributed according to each person’s needs. The central government owns the means of production and everyone works for state-owned enterprises.

A planned economy has some **advantages**: Since the government has control over all factors of production, the risk of a monopoly are next to nil under a planned economy. Also, it may help in reducing the gap between the poor and the rich because all government policies are designed to bring social equality.

However, the planned economy has some big **disadvantages**: Firstly, it leads to the destruction of entrepreneurs and innovators which in turn leads to lower productivity and also lower growth for a country. Secondly, this system leads to dissent among the citizens as the basic right of free will is challenged under this system. Finally, this system suffers from government bureaucracy. Delay in decision making on the part of government officials leads to bottlenecks in production and inefficient use of resources.

# Mixed Economies


History has proven that, worldwide, the central command-economy model has not sustained economic growth and was not able to provide long-term economic security for its citizens.

The majority of economies that we see today, however, are **mixed economies**. These are economic systems that display characteristics of both planned and market economies.

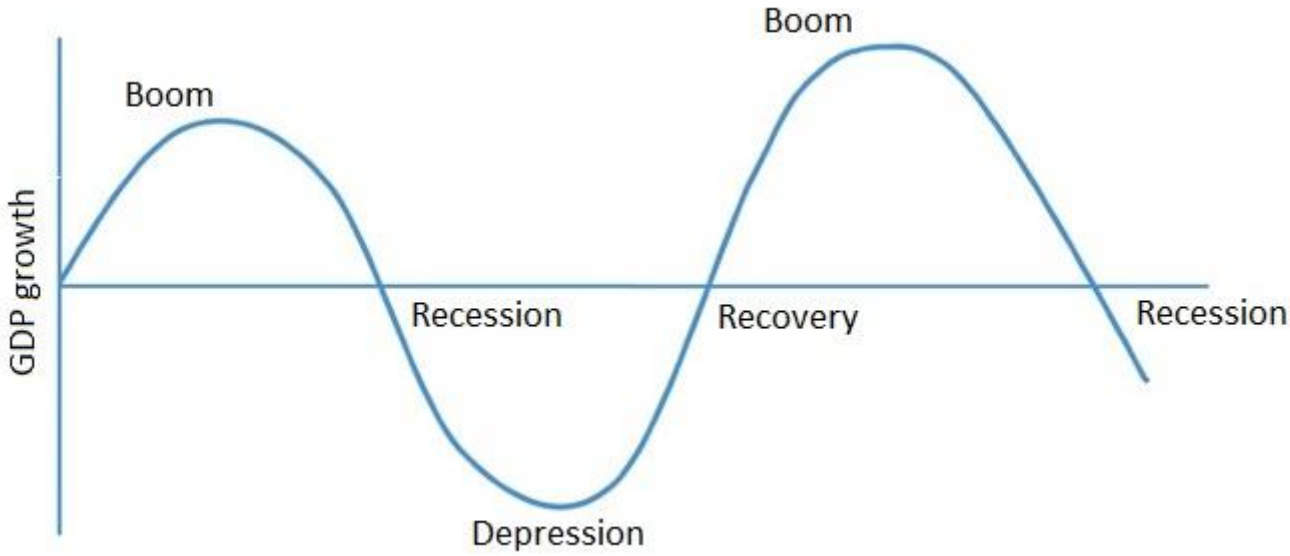
In the mixed economy, government-owned firms frequently operate alongside private enterprises. Good examples of this can be found in Europe where the respective governments have traditionally controlled certain key industries such as railroads, banking, and telecommunications.

Strictly speaking, all modern economies are mixed, though there are wide variations in the amount of mix and the balance between public and private influence.

Today, the majority of economies are mixed economies.

# 7. The Business Cycle

The business cycle is the natural fluctuation of the economy between periods of expansion (growth) and contraction (recession). Factors such as gross domestic product (GDP), interest rates, levels of employment and consumer spending can help to determine the current stage of the economic cycle.



**1. Boom**
Firstly, the boom (or prosperity) of the business cycle occurs when unemployment is low, strong consumer confidence leads to record purchases and as a result, businesses expand to take advantage of the opportunities created by the market. A good example of the market experiencing prosperity took place in Silicon Valley from 1998 to 2001. Suddenly the market identified technology as the next big business opportunity, so companies were adopting online technologies at a record pace; brick and mortar businesses were creating electronic marketplaces for the first time.

**2. Recession**
Secondly, a recession is a cyclical economic contraction that lasts for at least six months. Economists agree that a recession results in a downturn lasting for at least two consecutive quarters. During a recession consumers frequently postpone major purchases, such as homes and vehicles, and businesses slow production, postpone expansion plans, reduce inventories, and cut workers. As a result, unemployment rises and consumer demand decreases.

**3. Depression**
Thirdly, a depression is classified as a recession, or economic slowdown, that continues in a downward spiral over an extended period of time. It is also characterized by continued high unemployment and low consumer spending. Many economists suggest that sufficient government tools are available to prevent even a severe recession from turning into a depression. For example, federal, state, and local governments can make investments to improve the country's infrastructure as a means of bringing the market out of a depression. Governments can also influence the economy through regulations in fiscal and monetary policy.

**4. Recovery**
Finally, these tools contribute to the next stage in the business cycle: recovery. The recovery period is when economic activity begins to pick up. Consumer confidence improves, which leads to increased spending on big items such as homes and vehicles. Unemployment also begins to fall, and people are working and contributing to the economy again.

The business cycle is the downward and upward movement of the gross domestic product (GDP) around its long-term growth trend. The length of a business cycle is the period of time containing a single boom and

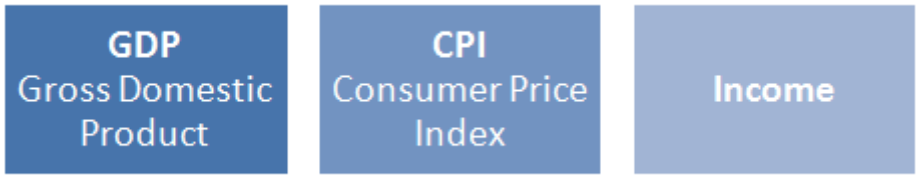
contraction in sequence. These fluctuations typically involve shifts over time between periods of relatively rapid economic growth and periods of relative stagnation or decline.

# 8. The Stability of an Economy

Economists regularly measure the health of the economy – focusing on productivity levels, inflation levels, and employment levels. Furthermore, economic policy-makers are said to have two different kinds of instruments to influence a country's economy: fiscal policies and monetary policies.

## Productivity

**Productivity** is the relationship between the goods and services produced and the inputs needed to produce them. There are three popular methods to measure a nation's productivity:




**1. Gross Domestic Product**
The Gross Domestic Product, also known as the GDP, is the total dollar value of all goods and services produced in a country each year. It's essentially a record of how much workers produced for consumers to purchase. GDP looks at only new goods – for example, new cars. It is a

very popular economic indicator and provides a benchmark for the nation's overall economic activity.

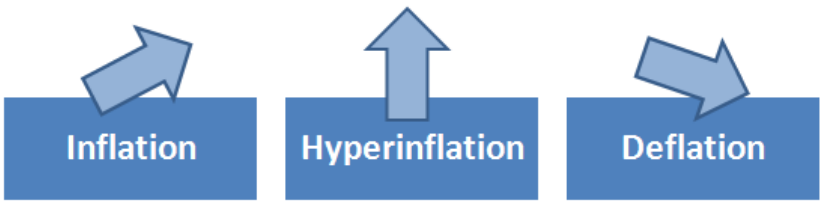
**2. Consumer Price Index**
The Consumer Price Index, also known as the CPI or the cost of living index, represents the change in price of a specific group of goods and services over time. This group of goods and services is called a market basket, and it includes about 400 items in such categories as food, housing, clothing, entertainment, medical care, and personal care. As a business owner, you need to be aware of the CPI because it affects the rent you pay on your facility or the wages you pay your employees.

**3. Income**
Income is a way of measuring how much money is available to be spent by individuals and businesses. National income includes such things as wages and salaries, self-employed income, rental income, corporate profits, and interest on savings and investments. Economists are most interested in disposable and personal income. Personal income is all income received before taxes are paid, and disposable income is what's left over after taxes.

We can measure economic productivity by checking the Gross Domestic Product (GDP), Consumer Prices Index (CPI), or Income.

# Inflation and Deflation

Inflation and deflation are two very important economic conditions. The balance between these conditions, opposites of the same coin, is delicate, and an economy can quickly swing from one condition to the other.




**Inflation** is defined as a rise in the general level of prices of goods and services over a specified period of time. Inflation is caused when goods and services are in high demand, creating a drop in availability. Consumers are willing to pay more for the items they want, causing

manufacturers and service providers to charge more. Supplies can decrease for many reasons: A natural disaster can wipe out a food crop or a housing boom can exhaust building supplies, among other situations. Inflation impacts the economy because more money is needed to sustain a given standard of living. If people receive a fixed income and suddenly the cost of bread increases dramatically, it is easy to see the negative impact caused by this increased price.

**Hyperinflation** is very high and typically accelerating inflation. It quickly erodes the real value of the currency, as the prices of most or all goods increase. Unlike regular inflation, where the process of rising prices is protracted and not generally noticeable except by studying past market prices, hyperinflation sees a rapid and continuing increase in nominal prices, the nominal cost of goods, and in the supply of money. Typically, however, the general price level rises even more rapidly than the money supply as people try ridding themselves of the devaluing currency as quickly as possible.

**Deflation** is the price-level change referred to during a period of falling prices. While deflation sounds good, it can have disastrous consequences; the Great Depression was a general period of deflation. Prices fell, but so did employment and wages for those lucky enough to be employed, as well as availability of most goods and services.

# Employment Levels

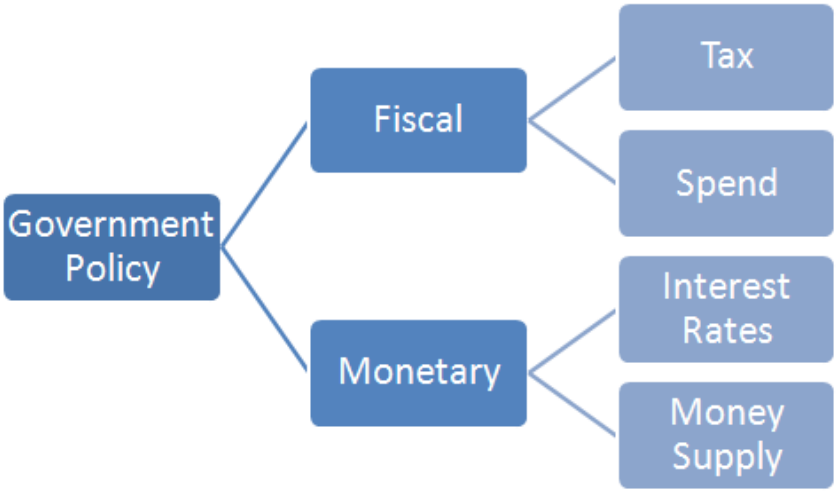
Employment levels have a major impact on a nation's economy. In fact, the unemployment rate is one of the most popular economic indicators that most people intuitively use to understand the state of the economy. The unemployment rate is usually expressed as the percentage of total workers who are actively seeking work but are currently unemployed. These indicators tend to increase during recessions and decrease during expansions.

Because the unemployment rate is so important, we're going to introduce four different categories that have been created to characterize an economy's state of unemployment:


- **Frictional unemployment** occurs when someone is temporarily not working. A good example is a recent graduate who is looking for work but has yet to find a job.
- **Seasonal unemployment** occurs when people are not working for some months, but they are not looking for a job during that period. People involved in the tourism industry or seasonal farmworkers are good examples of this.
- **Structural unemployment** occurs when people are not working because there is no demand for their particular skill set. An example might be someone who graduates with a Ph.D. in medieval economics. There is a relatively low demand for people with this skillset, so structural unemployment results for many in that field.
- **Cyclical unemployment** occurs when there is an economic slowdown and people are looking for work but there aren't enough jobs. The economic recession resulted in fewer jobs, and even highly skilled graduates with advanced degrees had difficulty finding work. The unemployment rate does not include out-of-work people who are no longer looking for jobs.

# Fiscal and Monetary Policy

Economic policy-makers are said to have two different kinds of instruments to influence a country's economy: **fiscal policies** and **monetary policies**.



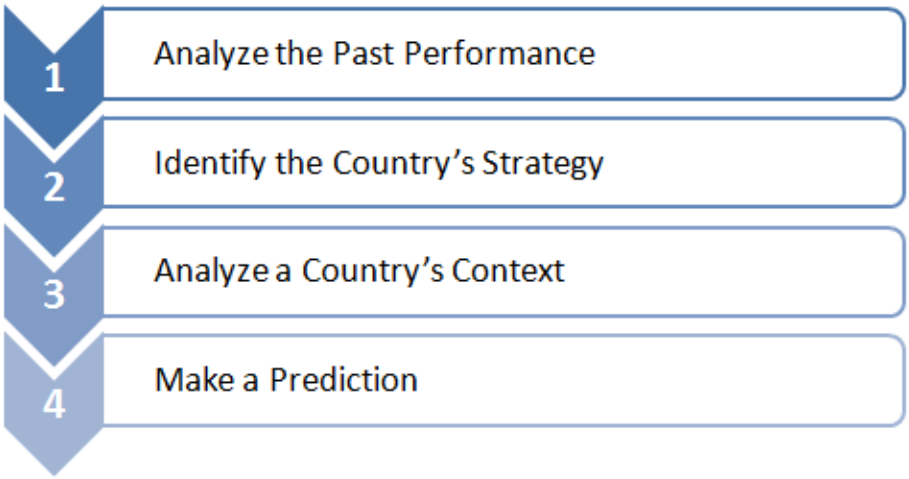

**Fiscal policy** is the decision that the government makes to spend money or increase taxes for the specific purpose of stabilizing the economy. Government increases in spending and lowering of taxes tend to stimulate economic growth, while decreasing government spending and increasing taxes tends to slow economic growth.

This makes sense when we think about the individual taxpayer's disposable income. The more money individuals have, the more they will be able to spend on goods and services in the market and therefore stimulate market growth. The primary sources of government funds to cover the costs of its annual budget are raised through taxation of its citizens, fees collected from business, and borrowing against assets.

**Monetary policy** is the regulation of the money supply and interest rates in order to control inflation and stabilize a currency. While fiscal policy is conducted by a nation's government, monetary policy is handled by the countries' central banks (which have varying amounts of independence around the world). In the United States, the U.S. Federal Reserve is responsible for managing this process; in the Eurozone, it's the task of the European Central Bank.

# 9. Tool: Country Analysis

Managers need to be able to make predictions about a country's future if they think about expanding. A country analysis, as developed at the Harvard Business School, is a four-step process that attempts to organize all available economic, social, political, and geographic data for strategy development.




**Step 1: Analyze the Past Performance**
In a first step, management should analyze all available measures, e.g. the exchange rates, GNP, inflation, employment, investment, consumption, population growth, education level, etc.

**Step 2: Identify the Country's Strategy**
After analyzing the past performance, management should try to identify the main goals of the country's government (linked to the productivity of the economy) as well as the fiscal, monetary, trade, and social policies.

**Step 3: Analyze a Country's Context**
In a third step, management has to evaluate the "basic facts" about the country, e.g. several physical indicators (size, population, geography), political indicators (government type, stability, corruption) and international indicators (trade advantages, competitiveness).

**Step 4: Make a Prediction**
Now management should be able to combine all important information and make a prediction based on steps 1, 2 and 3.

Country analysis is a multipurpose tool that provides a way to sort out all the reams of economic data that are available on a nation. By using this

analyst tool you possess the framework that global strategists use in the boardrooms of multinational corporations.

# 10. International Strategies

During the last decades, many barriers to international trade have fallen and a new wave of companies began pursuing global strategies to gain competitive advantages. Today, multinational corporations (MNC) have to deal with many cultural differences, languages and various legal and financial systems.

## Forces & Barriers

International Business is not a new phenomenon, trade across the globe is as old as business itself. A number of developments can be identified as **driving forces of international business**:

- The worldwide movement towards liberalization, privatization, and globalization is one important force that drives global integration. With the advent of MNCs (multinational corporation) culture, new opportunities have been accelerated for going global and taking the whole world as one big platform.
- Technology is a powerful, stateless and universal factor that crosses national and cultural boundaries.
- Revolutions in the field of transportation and communication have been able to reduce both time and cost barriers; making global business easier.
- Product development costs enable companies to recover investments by placing the product in varied markets.

However, businesses that intend to expand to new countries and markets still face many challenges since there are many factors that **restrict international business expansion**:

- Countries protect local enterprises by controlling market access. If the entry-level is too high, companies will not be able to enter those markets. Also, trade blocs, like NAFTA, EU, or ASEAN allow free trade among member states but make it difficult for other companies to join.
- A very high amount of capital is required to become a player in the global market. Many firms are not able to take that risk.
- Instability in the exchange rate of domestic currencies restrict the growth of international business and political instability in specific geographic regions can hinder companies to expand to those countries.

# International vs. Global

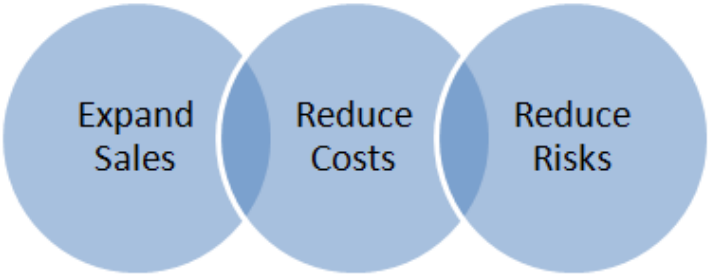
International strategies and global strategies are two categories. An **international strategy** means that subsidiaries around the world act independently and operate as if they were local companies. A **global strategy** involves a carefully crafted single strategy for the entire network of subsidiaries, encompassing many countries simultaneously and leveraging synergies across many countries.

There are three key differences between the global strategy and international strategy:

- **Coordination from the center**: An international strategy does not require strong coordination from the center. A global strategy, on the other hand, requires significant coordination between the activities of the center and those of subsidiaries.
- **Product standardization**: An international strategy assumes that the subsidiaries should respond to local business needs. In contrast, the global strategy assumes that the center should standardize its products in all the different countries.
- **Strategy integration**: The international strategy gives subsidiaries the independence to plan and execute competitive moves independently (based on the analysis of local rivals). The global strategy plans competitive battles on a global scale.

# Major Reasons

Companies go international for a variety of reasons but the typical goal is company growth or expansion. These are three major reasons why your company may want to decide to go international:




- **To expand sales by accessing new markets:** Larger markets mean the potential for greater profit, so companies go global to seek new business opportunities and to expand the range of goods and services that they offer.
- **To reduce costs:** Overseas operations are often attractive to firms seeking to reduce budgets in order to increase profit. For example, it is possible to cut business overhead costs in countries with lower costs of living.
- **To reduce risk:** Going global can reduce a company's reliance on local and national markets. So downturns in consumer

demand at home are offset by upturns in consumer demand in international markets.

There are three major reasons for going international:
1. to expand sales, 2. to reduce costs, and 3. to reduce risk.

# Different Strategies

Foreign market entry strategies differ in degree of risk they present, the control and commitment of resources they require and the return on investment they promise. How do firms go international? There are six major types of entry modes:


- **Exporting** is the process of selling goods or services produced in one country to other countries. Firms can choose between “indirect exporting” (products are carried and sold abroad by agents) and “direct exporting” (the firm sells its products directly in foreign markets).
- By **licensing**, an international firm gives the licensee patent rights or know-how on products and processes. In return, the licensee will produce the products and pay the licensor fees usually related to the sales volume of the products.
- **Franchising** is similar to licensing. Semi-independent business owners (franchisees) pay fees to a parent company (franchiser) in return for the right to become identified with its trademark, to sell its products or services, and often to use its business format and system.
- In a **Joint Venture**, cooperating firms create an independent firm in which they both invest. This type of agreement gives the international firm better control over local market knowledge.
- A **strategic alliance** is a cooperative agreement between different firms, such as shared research or formal joint ventures.

It usually between firms in high-industrialized nations and the focus is often on creating new products and technologies rather than distributing existing ones.

- A firm can also make **direct investments** in a production unit in a foreign market. It is the greatest commitment since there is a 100% ownership. Firms can make a direct acquisition in the host market or they can develop their own facilities (called Greenfield investment).

The market-entry techniques that offer the lowest level of risk and the least market control are export and licensing. The highest risk, but also the highest market control and expected return on investment are connected with direct investments.

In conclusion, **international collaboration** is a great opportunity…
– to combine resources (cross-border alliances are able to develop new products),
– to eliminate risks (companies are able to spread risk), and
– to learn (firms are able to gain important knowledge from their partners).

# 11. Case Study: EU & WTO

No country is able – nor it has the resources necessary – to produce all the needed goods on its own. Most countries share their trading business with others, exchanging material, labor force or the already produced goods. International trade creates a global market in which all countries can trade based on their individual abilities. Cooperation within a region like Europe or even worldwide provides stability, enhancing fair competition, free labor movement, and fair prices.

The **European Union (EU)** is a political and economic union of 28 European states with a total population of more than 500 million citizens. The EU was established in 1993, but the union traces its origins to the European Coal and Steel Community established after World War II in 1951 to secure peace through economic integration.

The EU has its own governmental bodies and legal institutions – for example, the European Parliament, the European Commission, the European Council, the Court of Justice, and the European Central Bank. EU legislation is binding for all EU member states and the governments of member states must incorporate EU laws into their national legislation.

The EU has developed an internal single market through a standardized system of laws. This **European Single Market** guarantees the free movement of goods, capital, services, and labor – the ‘four freedoms‘ – within the European Union.

| | |
|---|---|
| **Freedom of Goods** | Many products on the EU market are subject to harmonized rules that protect consumers health, and the environment. Once goods have been admitted into the market they canno subjected to customs duties, discriminatory taxes, or import quotas. |
| **Freedom of Capital** | Restrictions on capital movements across borders were prohibited. European citizens an companies can open bank accounts, buy company shares, raise money, or purchase real all EU countries. |
| **Freedom of Services** | EU companies, as well as self-employed persons, have the freedom to establish themsel other EU countries and the freedom to provide services in countries other than the one i they are established. |

| | |
|---|---|
| **Freedom of Labour** | EU citizens can move freely between member states to live, work, study or retire in anot country. About 1.7 million people commute to work across a European border each day, some regions, these people constitute up to a third of the workforce. |

Today, the European Single Market is the largest single market in the world, which has lead to greater competition in services, the removal of trade barriers, the reduction of business costs, and the elimination of anti-competitive practices such as monopolies.

The EU actively negotiates trade agreements with non-EU countries. These agreements grant mutually-beneficial access to the markets of both the EU and the countries concerned. Each agreement is unique and can include tariff reductions, rules on matters such as intellectual property or sustainable development, or clauses on human rights.

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The **World Trade Organization (WTO)** is an intergovernmental organization with 164 member states dealing with the rules of international trade between nations. The WTO officially commenced in 1995, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948.

The WTO provides a forum for negotiating agreements aimed at reducing obstacles to international trade and ensuring a level playing field for all, thus contributing to economic growth and development. More specifically, the WTO's main activities are:

- negotiating the reduction or elimination of obstacles to trade (e.g. import tariffs) and agreeing on rules governing the conduct of international trade (e.g. anti-dumping)
- monitoring the application of the WTO rules and the trade policies of its members

- settling disputes among its members regarding the application of the agreements

WTO supporters argue that the opening of national markets to international trade – with justifiable exceptions and some flexibility – will contribute to sustainable development, raise people's welfare, reduce poverty, and foster peace and stability. However, critics reply that the WTO has a systematic bias toward rich countries and multinational corporations, harming smaller countries which have less negotiation power.

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So far, the EU has played a central role in developing the international trading system since World War II. Currently, the EU is exploring the possibility of modernizing the WTO. Like the WTO, the EU was originally designed to remove customs barriers and promote trade between its member states.

Both the European Union and all the individual EU countries are members of the WTO. However, the EU operates as a single actor at the WTO and is represented by the European Commission rather than by the member states. The Commission negotiates trade agreements and defends the EU's interests before the WTO on behalf of all 28 member states.

The European Commission has put forward a first set of ideas to modernize the WTO and to make world trade rules fit for the challenges of the global economy. During the last decade, progress and reform initiatives have stalled due to significant differences between developed nations (led by the European Union, the United States, Canada, and

Japan) and the major developing countries (led by India, Brazil, China, and South Africa). There is also considerable contention against and between the EU and the US over their maintenance of subsidies.

Slow reform developments at the WTO are also a sign that the international trading system has changed dramatically in the past 20 years. The system has evolved, with new actors – essentially transition and developing countries – playing a central role.

Free trade and growth of imports/exports in Europe as well as in the WTO have been important factors in raising living standards and in reducing poverty. The liberalization of the international trading system has benefited some developing countries, which have experienced an unprecedented phase of sustained economic growth. However, the EU and the WTO have to ensure that developing countries become fair partners and that reforms will improve not only economic but also environmental and social conditions. Furthermore, both institutions have to be able to reform themselves constantly to stay successful international key figures.

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Economics is the study of how goods and services are produced, distributed, and consumed. It is the theory of how markets work and wealth is distributed including how scarce resources are allocated. We hope that taking this course helped you understand the wide range of topics that drive economics.

# 1. Accounting Principles

**Welcome to Accounting Principles!**
Accounting is a glorious but misunderstood field. The popular view is that it's mostly mind-numbing number-crunching; it certainly has some of that, but it's also a rich intellectual pursuit with an abundance of compelling issues.

Accountants are often stereotyped as soulless drones laboring listlessly in the bowels of corporate bureaucracies. But many accountants will tell you that it's people skills, not technical knowledge, that are crucial to their success. And although it's often thought of as a discipline of pinpoint exactitude with rigid rules, in practice accountants rely heavily on best estimates and educated guesses that require careful judgment and strong imagination.

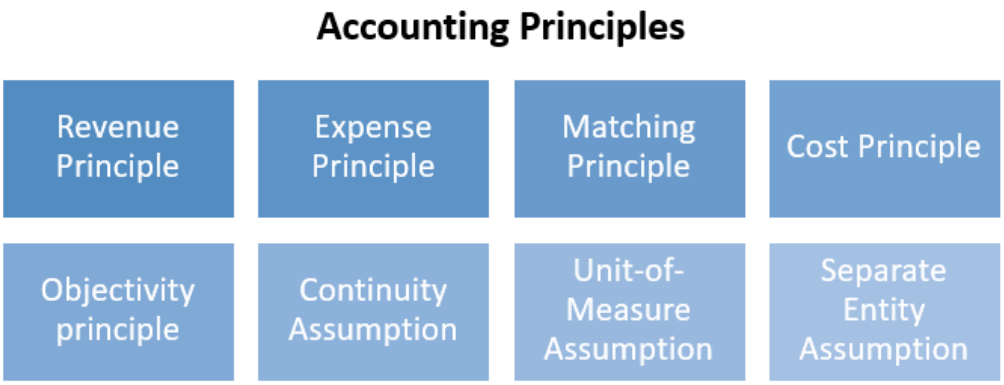
Accounting can be defined as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information."

In this course, you will learn the important **Accounting Equation** and you will get to know the three most important accounting statements: The **Income Statement**, the **Balance Sheet**, and the **Statement of Cash Flow**.

# 2. Basic Principles

Accounting rests on a small set of fundamental principles. People often refer to these fundamentals as **Generally Accepted Accounting Principles (GAAP).** These standards vary in detail across the globe and are typically overseen by governmental regulators and the private accounting profession in a country.

Here we will highlight the eight most important principles:




**1. Revenue Principle**

The revenue principle, also known as the realization principle, states that **revenue is earned when the sale is made**, which is typically when goods or services are provided. A key component of the revenue principle, when it comes to the sale of goods, is that revenue is earned

when legal ownership of the goods passes from seller to buyer. Note that revenue isn't earned when you collect cash for something.

**2. Expense Principle**
The expense principle states that an **expense occurs when the business uses goods or receives services**. As is the case with the revenue principle, if you receive some goods, simply receiving the goods means that you've incurred the expense of the goods. Similarly, if you received some service, you have incurred the expense. It doesn't matter that it takes a few days or a few weeks to get the bill. You incur an expense when goods or services are received.

**3. Matching Principle**
The matching principle is related to the revenue and the expense principles. The matching principle states that when you recognize revenue, you should **match related expenses with the revenue**.

For example, if you own a hot dog stand, you should count the expense of a hot dog and the expense of a bun on the day you sell that hot dog and that bun. In other words, match the expense of the item with the revenue of the item.

**Accrual-based accounting** is what you get when you apply the revenue principle, the expense principle, and the matching principle. In a nutshell, accrual-based accounting means that you record revenue when a sale is made and record expenses when goods are used or services are received – not when you send or receive cash.

**4. Cost Principle**
The cost principle states that amounts in your accounting system should be quantified or measured by using **historical cost**.

For example, if your business owns a building, that building shows up on your balance sheet at its historical cost; you don't adjust the values in an accounting system for changes in a fair market value.

**5. Objectivity Principle**
The objectivity principle states that accounting reports should use **objective and verifiable data**. In other words, accounting systems and accounting reports should rely on subjectivity as little as possible. An accountant always wants to use objective data (even if it's bad) rather than subjective data (even if the subjective data is arguably better).

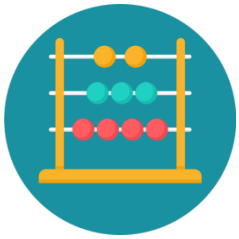
**6. Continuity Assumption**
Accounting systems assume that a business will **continue to operate** in the future. Unless there is evidence to the contrary, the accountant assumes that the business will continue to operate indefinitely. If a business won't continue, it becomes very unclear how one should value assets if the assets have no resale value.

**7. Unit-of-Measure Assumption**
The unit-of-measure assumption assumes that a business's **domestic currency** is the appropriate unit of measure for the business to use in its accounting.

For example, the unit-of-measure assumption states that U.S. businesses should use U.S. dollars and European businesses should use Euro in their accounting.

**8. Separate Entity Assumption**
The separate entity assumption states that a business entity is **separate** from its business owner. The separate entity assumption enables one to prepare financial statements just for the sole business.

# 3. Accounting Equation



The **basic accounting equation** is the foundation of all accounting concepts. It represents the relationship between the assets (what a business owns), liabilities (what it owes to others), and owner's equity (the difference between assets and liabilities). It is defined as: **Assets = Liabilities + Owners' Equity.**

## Assets

An **asset** is anything in a business that has some sort of financial value and can be converted to cash. Assets are the products you have stocked in your warehouse (they're converted into cash as you sell them), the cash in your register and all the equipment in your firm. Assets can be

grouped into two categories depending on how quickly you can convert them into cash:

- **Current assets** are assets that can be converted into cash within one year – like checks, invoices, or store inventory. Assets that you can quickly convert into cash also are called liquid assets.
- **Fixed assets** are assets that take more than a year to be converted into cash. In most cases property, plants and equipment are fixed assets.

Here's a list of the most common kinds of business assets:

| | |
|---|---|
| **Cash** | Cash includes money and money equivalents such as checks, money orders, or bank deposits. |
| **Accounts receivable** | Accounts receivable represent the money that your clients and customers owe you for purchasing your products or services. When you allow a customer to buy your goods today and pay later, you're creating a receivable. If you work strictly on a cash basis (e.g. at a hot dog stand), you don't have any receivables. |
| **Inventory** | Inventory comprises all the products that you purchase or manufacture to sell to customers, as well as raw materials and supplies used in operations. If you run a grocery store, your inventory consists of all your store items. |
| **Prepaid expenses** | When you pay for a product or service in advance, you create an asset known as a "prepaid expense". Examples include a prepaid maintenance contract on a typewriter or an insurance policy with a one-year term paid in advance. |
| **Equipment** | Equipment is the wide variety of property that your organization purchases to carry out its operations. Examples include desks, chairs, or computers. |
| **Real estate** | Real estate includes assets such as the land, buildings, and facilities that your company owns, occupies, and utilizes. Some companies have little or no real estate assets, and others have sizable ones. |

An asset is a resource with economic value for an individual or corporation There are two types of assets: 1. current assets and 2. fixed assets.

# Liabilities

**Liabilities** are money owed to others outside your organization. They may include the money you owe to the company that delivers your office supplies, the payments you owe on the construction loan that financed your warehouse expansion, or the mortgage on your corporate headquarters building. In short, assets put money in your pocket, and liabilities take money out! As with assets, there are also two types of liabilities:

- **Current liabilities** are to be repaid within one year, for example, money for employee paychecks.
- **Long-term liabilities** are to be repaid in a period longer than one year, for example, the mortgage on the company's facility.

Here are common business liabilities, from both the current and long-term categories:

| | |
|---|---|
| **Accounts payable** | Accounts payable are the obligations owed to the many individuals and organizations that have provided goods and services to your company. Examples include money owed to your computer network consultant and an out-of-house marketing advertising agency. |
| **Notes payable** | Notes payable represent loans made to your company by individuals or organizations, for example, a loan secured from a large bank. |
| **Accrued expenses** | Sometimes a company incurs an expense but has no immediate plans to reimburse the individual or organization that's owed the money. Examples include future wages to be paid to employees and utility bills. |
| **Bonds payable** | When companies issue bonds to raise money to finance large projects, they incur obligations to pay back the individuals and organizations that purchase them. |
| **Mortgages payable** | When companies purchase property, they often do so by taking out mortgages – long-term real estate loans, secured by the property itself. |

Liabilities are binding obligations that are payable to another person or entity. There are two types of liabilities: 1. current liabilities and 2. long-term liabilities.

# Owners' Equity

**Owners' Equity** is the money that remains when you take all your company's assets and subtract all your liabilities. Owners' equity represents the owners' direct investment in the firm or the owners' claims on the company's assets. Another way of expressing a company's owners' equity is its **net worth**. Net worth is simply a snapshot of your company's financial health for a particular period of time. Here are the two common types of owners' equity:

- **Paid-in capital**: The money that people invest in a company. When companies such as Facebook or Volkswagen offer to sell shares of stock, investors provide paid-in capital to the companies when they pay money to buy the stock.
- **Retained earnings**: A company's earnings that are held within the company. The money gets reinvested, not paid out to shareholders as dividends.

Although owners' equity generally is positive, it can go negative when a company takes on large amounts of debt – for example, to acquire another company.

Owner's equity, often called net assets, is the owners' claim to company assets after all of the liabilities have been paid off. Finally, there are two types of owner's equity: 1. paid-in capital and 2. retained earnings.

# The Equation

The basic accounting equation (Assets = Liabilities + Owners' Equity) is similar to any other equation: A change to one side of the equation causes a change in the other. Therefore, every financial transaction you make results in not one, but two entries to your accounting records – noted as **double-entry bookkeeping**.

**Rules of the Accounting Equation:**

- Both sides of the Basic Accounting Equation should be equal and balance.
- Every business transaction should change at least two accounts. It means that in every value received, another value is given up.

**Example: Susie's Sushi**
For example, let's take a look at Susie's Sushi restaurant: When Susie's Sushi buys a big yellowfin tuna to slice up for customers, it affects her accounting equation.

Let's assume that Susie's Sushi starts with assets (inventory) of $1,000, liabilities (accounts payable) of $500, and owners' equity of $500. Her equation would look like this:

**Assets = Liabilities + Owners' Equity**
$1,000 = $500 + $500

When Susie purchases that yellowfin tuna from the local fish market for $100, and the fish market agrees to bill her for it, she acquires an asset (inventory). She also takes on a liability of $100 — the money owed to the fish market (accounts payable). After this transaction, the accounting equation now looks like this:

**Assets = Liabilities + Owners' Equity**
$1,100 = $600 + $500

As you can see, Susie added $100 of inventory to her assets, but she simultaneously added a payable of $100 to her liabilities. The owners' equity doesn't change. As this example shows, every transaction on one side of the accounting equation results in a transaction on the other side of the accounting equation.

The basic accounting equation is: Assets = Liabilities + Owners' Equity

# 4. The Income Statement

The **Income Statement**, also referred to as Profit and Loss (P&L) Statement, is one of the three most important financial statements. The Income Statement shows managers and investors whether a company has **made or lost money** during a specific period of time.

## Profit and Loss

The income statement, also called the profit and loss statement (P&L), presents the results of a company's operations for a given period – a quarter, a year, etc. The income statement presents a summary of the revenues, gains, expenses, losses, and net income or net loss of an entity for the period.

This statement is similar to a moving picture of the entity's operations during the time period specified. In most cases, the income statement is the first financial statement prepared because the net income or loss must be calculated before other financial statements can be prepared.

Keep in mind that the income statement shows revenues, expenses, gains, and losses; it does not show cash receipts (money you receive) nor cash disbursements (money you payout).

The key item listed on the income statement is the net income or loss. A company's net income for an accounting period is measured as follows:

Let's break this down:

- **Revenues** are inflows or other enhancements of assets of an entity or settlement of its liabilities (or both) during a period, based on production and delivery of goods, provisions of services, and other activities that constitute the entity's major operations. Examples of revenues are sales revenue, interest revenue, and rent revenue.
- **Expenses** are outflows or other uses of assets during a period as a result of delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. Examples are cost of goods sold, salaries expense, and interest expense.
- **Gains** are increases in owners' equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and events affecting the entity during the accounting period, except those that result from revenues or investments by owners. Examples are a gain on the sale of a building and a gain on lawsuits.
- **Losses** are decreases in owners' equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and events affecting the entity during the accounting period except those that result from expenses or distributions to owners. Examples are losses on the sale of investments and losses on lawsuits.
- **Net Income** is the excess of all revenues and gains for a period over all expenses and losses of the period. Net loss is the excess of expenses and losses over revenues and gains for a period.

The income statement presents the results of a company's operations for a given time period.

# Single-Step Example

There are two income statement formats that are generally prepared: The single-step statement and the multi-step statement.

The **single-step income statement** uses only one subtraction to arrive at net income:

**Net Income = (Revenues + Gains) – (Expenses + Losses)**

An extremely condensed income statement in the single-step format would look like this:

**Sample Products Co.**
**Income Statement**
**For the Five Months Ended May 31, 2018**

| | |
|---|---|
| Revenues & Gains | $108,000 |
| Expenses & Losses | 90,000 |
| Net Income | $ 18,000 |

The **heading** of the income statement conveys critical information. The name of the company appears first, followed by the title “Income Statement.” The third line tells the reader the time interval reported on the profit and loss statement.

Since income statements can be prepared for any period of time, you must inform the reader of the precise period of time being covered (for example: Year Ended May 31 or Month Ended May 31.)

A sample income statement in the single-step format with more details would look like this:

**Sample Products Co.**
**Income Statement**
**For the Five Months Ended May 31, 2018**

| | |
|---|---|
| Revenues & Gains | |
| Sales revenues | $100,000 |
| Interest revenues | 5,000 |
| Gain on sales of assets | 3,000 |
| Total revenue & gains | 108,000 |
| | |
| Expenses & Losses | |
| Cost of goods sold | 75,000 |
| Commissions expense | 5,000 |
| Office supplies expense | 3,500 |
| Office equipment expense | 2,500 |
| Advertising expense | 2,000 |
| Interest expense | 500 |
| Loss from lawsuit | 1,500 |
| Total expenses & losses | 90,000 |
| | |
| Net Income | $ 18,000 |

# Multi-Step Example

An alternative to the single-step income statement is the **multiple-step income statement** because it uses multiple subtractions in computing the net income shown on the bottom line.

The multiple-step statement segregates the operating revenues and operating expenses from the nonoperating revenues, nonoperating expenses, gains, and losses. The multiple-step income statement also shows the **gross profit** (net sales minus the cost of goods sold).

Here is a sample income statement in the multiple-step format:

**Sample Products Co.**
**Income Statement**
**For the Five Months Ended May 31, 2018**

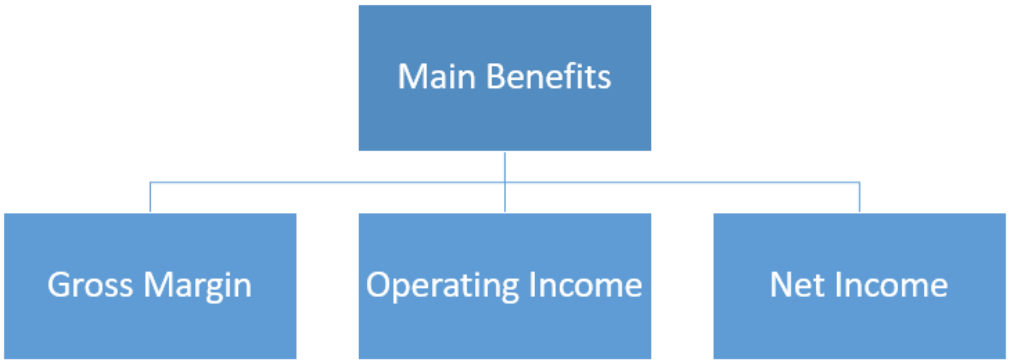
| | | |
|---|---|---|
| Sales | | $100,000 |
| Cost of goods sold | | 75,000 |
| Gross profit | | 25,000 |
| | | |
| Operating expenses | | |
| Selling expenses | | |
| Advertising expense | 2,000 | |
| Commissions expense | 5,000 | 7,000 |
| Administrative expenses | | |
| Office supplies expense | 3,500 | |
| Office equipment expense | 2,500 | 6,000 |
| Total operating expenses | | 13,000 |
| | | |
| Operating income | | 12,000 |
| | | |
| Non-Operating or other | | |
| Interest revenues | | 5,000 |
| Gain on sale of investments | | 3,000 |
| Interest expense | | (500) |
| Loss from lawsuit | | (1,500) |
| Total non-operating | | 6,000 |

Using the above multiple-step income statement as an example, we see that there are three steps needed to arrive at the bottom line Net Income:

- Cost of goods sold is subtracted from net sales to arrive at the **gross profit**:
  $100,000 – $75,000 = **$25,000**
- Operating expenses are subtracted from gross profit to arrive at **operating income:**
  $25,000 – $13,000 = **$12,000**
- The net amount of nonoperating revenues, gains, nonoperating expenses and losses is combined with the operating income to

arrive at the **net income (or net loss)**:
$12,000 + $6,000 = **$18,000**

There are **three main benefits** to using a multiple-step income statement instead of a single-step income statement:




- The multiple-step income statement clearly states the gross profit amount. Many readers of financial statements monitor a company's **gross margin** (gross profit as a percentage of net sales). Readers may compare a company's gross margin to its past gross margins and to the gross margins of the industry.
- The multiple-step income statement presents the subtotal **operating income**, which indicates the profit earned from the company's primary activities of buying and selling merchandise.
- The bottom line of a multiple-step income statement reports the net amount for all the items on the income statement. If the net amount is positive, it is labeled as **net income**. If the net amount is negative, it is labeled as **net loss**.

# 5. The Balance Sheet

A **Balance Sheet** shows what the business is **worth at a given point in time**. The purpose of the balance sheet is to provide an idea of a company's financial position. It does so by outlining the total assets that a company owns, the amounts that it owes to lenders (liabilities), as well as the amount of equity.

## Financial Position

The balance sheet, also called the **statement of financial position**, reports a company's financial position based on its assets, liabilities, and equity at a single moment in time.

Unlike the income statement, the balance sheet does not report activities over a vast time frame. The balance sheet is essentially a **picture** of a company's resources, debts, and ownership on a given day.

This is why the balance sheet is sometimes considered less reliable or less telling of a company's current financial performance. Annual income statements look at performance over the course of 12 months whereas the balance sheet only focuses on the financial position of one day.

The Balance Sheet reports a firm's financial position at a single moment in time.
The balance sheet is basically a report version of the accounting equation (also called the balance sheet equation) where assets always equal liabilities plus shareholder's equity.

In this way, the balance sheet shows whether the resources controlled by the business (**assets**) are financed by debt (**liabilities**) or shareholder investments (**equity**). Investors and creditors generally look at the statement of financial position for insight as to how efficiently a company can use its resources and how effectively it can finance them.

Accountants usually prepare **classified balance sheets**. “Classified” means that the balance sheet accounts are presented in distinct groupings, categories, or classifications. An outline of a balance sheet using the balance sheet classifications is shown here:

**Example Company**
**Balance Sheet**
**December 31, 2018**

| ASSETS | LIABILITIES & OWNER'S EQUITY |
|---|---|
| Current assets | Current Liabilities |
| Investments | Long-term liabilities |
| Property, plant, and equipment | Total liabilities |
| Intangible assets | |
| Other assets | Owner’s equity |
| Total assets | Total liabilities & owner's equity |

# Example

Most accounting balance sheets classify a company’s assets and liabilities into distinctive groupings such as Current Assets; Property, Plant, and Equipment; Current Liabilities; etc. These classifications make the balance sheet more useful.

Like all financial statements, the balance sheet has a heading that display’s the company name, the title of the statement and the time period of the report:

**Example Company**
**Balance Sheet**
**December 31, 2014**

| ASSETS | | LIABILITIES | |
|---|---|---|---|
| Current assets | | Current liabilities | |
| Cash | $ 2,100 | Notes payable | $ 5,000 |
| Petty cash | 100 | Accounts payable | 35,900 |
| Temporary investments | 10,000 | Wages payable | 8,500 |
| Accounts receivable - net | 40,500 | Interest payable | 2,900 |
| Inventory | 31,000 | Taxes payable | 6,100 |
| Supplies | 3,800 | Warranty liability | 1,100 |
| Prepaid insurance | 1,500 | Unearned revenues | 1,500 |
| Total current assets | 89,000 | Total current liabilities | 61,000 |
| Investments | 36,000 | Long-term liabilities | |
| | | Notes payable | 20,000 |
| Property, plant & equipment | | Bonds payable | 400,000 |
| Land | 5,500 | Total long-term liabilities | 420,000 |
| Land improvements | 6,500 | | |
| Buildings | 180,000 | | |
| Equipment | 201,000 | Total liabilities | 481,000 |
| Less: accum depreciation | (56,000) | | |
| Prop, plant & equip - net | 337,000 | | |
| Intangible assets | | STOCKHOLDERS' EQUITY | |
| Goodwill | 105,000 | Common stock | 110,000 |
| Trade names | 200,000 | Retained earnings | 229,000 |
| Total intangible assets | 305,000 | Less: Treasury stock | (50,000) |
| | | Total stockholders' equity | 289,000 |
| Other assets | 3,000 | | |
| Total assets | $ 770,000 | Total liabilities & stockholders' equity | $ 770,000 |

The notes to the sample balance sheet have been omitted.

One thing to note is that just like in the accounting equation, total assets equal total liabilities and equity. This is always the case. In this example, total assets are $770,000 and total liabilities plus stockholders' equity are $770,000 as well.

The balance sheet gives us an idea of a firm's financial position:

- The company has total assets of $770,000 – such as $2,100 in cash, $40,500 in accounts receivable and $337,000 in property, plant & equipment.
- The company has liabilities of $481,000 ($61,000 current liabilities plus $420,000 long-term debt). The company has equity of $289,000.
- The firm's total assets equal the firms's total liabilities and equity. This is not only true for this company but for all balance sheets.

Now that the balance sheet is prepared and the beginning and ending cash balances are calculated, the **statement of cash flows** (next chapter) can be prepared.

# 6. The Cash Flow Statement

The **Cash Flow Statement**, also called the Statement of Cash Flows, reports the **cash generated and used** in a specific time period. The term cash flow generally refers to a company's ability to collect and maintain adequate amounts of cash to pay its upcoming bills.

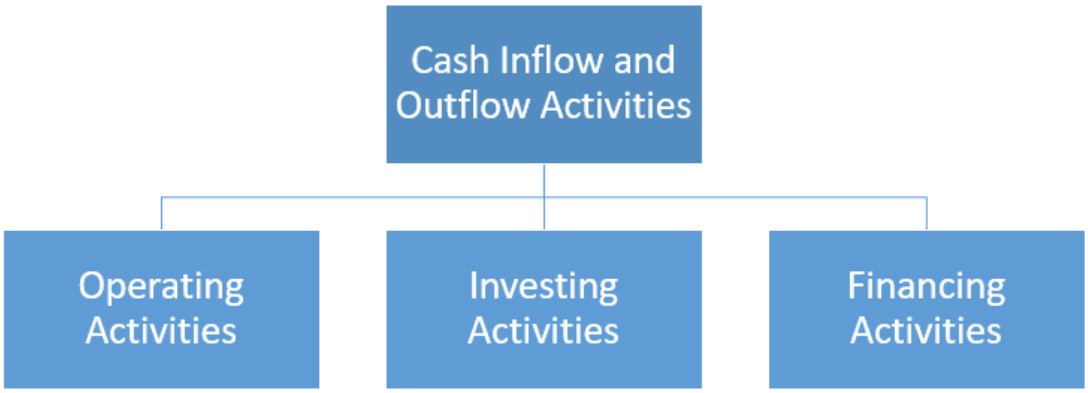
## Cash Flows

The cash flow statement, also called the **statement of cash flows**, reports the cash generated and used during the time interval specified in its heading. The cash flow statement shows investors and creditors what transactions affected the cash accounts and how effectively and efficiently a company can use its cash to finance its operations and expansions.

This is particularly important because investors want to know the company is financially sound while creditors want to know the company is liquid enough to pay its bills as they come due. In other words, does the company have good cash flow?

The cash flow statement reports the cash generated and used in a specific time period.

Cash inflows and outflows are classified into three activities:




- **Operating activities** refer to the main operations of the company such as the rendering of professional services, acquisition of supplies, selling of inventories, and others. In general, operating activities refer to those that involve current assets and current liabilities.
- **Investing activities** may be summed up as: “where the company puts its money for long-term purposes”, such as the acquisition of property, plant, and equipment; and investment in long-term securities. In general, investing activities include transactions that involve non-current assets.
- **Financing activities** refer to: “where the company gets its funds”, such as investment of the owner/s, and cash proceeds from a bank loan and other long-term payables. In general, financing activities include those that affect non-current liabilities and capital.

Because the income statement is prepared under the **accrual** basis of accounting, the revenues reported may not have been collected. Similarly, the expenses reported on the income statement might not have been paid. You could review the balance sheet changes to determine the facts, but the cash flow statement already has integrated all that information. As a result, smart business people and investors utilize this important financial statement.

# Example

On January 2, 2014 Matt invests $2,000 of his personal money into his sole proprietorship, Good Deal Co. On January 20, Good Deal buys 14 graphing calculators for $50 per calculator—this is about 50% less than the selling price Matt has observed at the retail stores. The total cost to

Good Deal for all 14 calculators is $700. Good Deal has no other transactions during January.

Matt prepares the Cash Flow Statement for his new business as of January 31, 2014. Like all financial statements, the statement of cash flows has a heading that display's the company name, the title of the statement and the time period of the report. It also lists the operating, investing and financing activities:

**Good Deal Co.**
**Statement of Cash Flows**
**For the Month Ended January 31, 2014**

| | |
|---|---|
| **Operating Activities** | |
| Net income | $ 0 |
| Increase in inventory | (700) |
| Cash provided (used) in operating activities | (700) |
| **Investing Activities** | 0 |
| **Financing Activities** | |
| Investment by owner | 2,000 |
| Net increase in cash | 1,300 |
| Cash at the beginning of the month | 0 |
| Cash at the end of the month | $1,300 |

The cash flow statement reports that Good Deal's **operating activities** resulted in a decrease in cash of $700. The decrease in cash occurred because the company increased its inventory by $700 during January. The **financing activities** section shows an increase in cash of $2,000 which corresponds to the increase in Matt Jones, Capital (Matt's investment in the business). The net change in the Cash account from the owner's investment and the cash outflow for inventory is a positive $1,300.

This net change of $1,300 is verified at the bottom of the cash flow statement. There was $0 cash on January 1, but on January 31, the Cash balance is $1,300.

# 7. Analyzing the Statements

The financial statements are interconnected: assets and liabilities on the **balance sheet** will increase or decrease based on the incomes and expenses from the **income statement** and the **cash flows** from the cash flow statement.


**Analyzing the Income Statement:**
Investors and creditors closely monitor a firm's net income because it indicates the firm's ability to sell goods and services for more than they cost to produce and deliver. Investors buy stock when they believe that future earnings will improve and lead to a higher stock price. Lenders also rely on future earnings to provide the resources to repay loans.

**Analyzing the Balance Sheet:**
Assessment of a company's **assets** is important to its creditors and its prospective investors because assets provide a basis for judging whether the company has sufficient resources available to operate. Investors are interested in a company's **liabilities** because of the

concerns of whether the company has sufficient sources of cash to pay its debts. If a business does not pay its creditors, the creditors may force the sale of assets sufficient to meet their claims. **Stockholders' equity** is important to banks because creditors' claims legally come before those of owners. If a firm goes out of business and its assets are sold, the proceeds of that sale must be used to pay back creditors such as the banks before the owners receive any money. Thus, creditors consider stockholders' equity a protective "cushion."

**Analyzing the Cash Flow Statement:**
Many analysts believe that the cash flow statement is particularly useful in predicting future cash flows that may be available for payment of debt to creditors and dividends to investors. Bankers often consider the Operating Activities section to be most important because it indicates the company's ability to generate cash from sales to meet its current cash needs. Any amount of leftover can be used to pay back the bank debt or expand the company. Stockholders will invest in a company only if they believe that it will eventually generate more cash from operations than it uses so that cash will become available to pay dividends and expand.

# 8. Conclusion

In this course, you learned the basics of Accounting. Accounting – also called the "language of business" – is the measurement, processing, and communication of financial information about economic entities – such as businesses and corporations.

From the large, multi-national corporation down to the corner beauty salon, every business transaction will have an effect on a company's financial position. The financial position of a company is measured by the following items:

- **Assets** (what it owns)
- **Liabilities** (what it owes to others)
- **Owner's Equity** (the difference between assets and liabilities)

The **Basic Accounting Equation** is an accounting principle and rule which states that the business resources (assets) are attributable to the amount owed to creditors (liabilities) and capital invested by the owners (equity). It is formulated as:

**Assets = Liabilities + Owner's Equity**

The most widely used financial statements are:

- **Income Statement** (an accounting of revenue, expenses, and profit for a given period)
- **Balance Sheet** (a statement that summarizes the assets and liabilities at a given date)
- **Statement of Cash Flow** (a report with all transactions that involved or influenced cash)

The financial statements are heavily interconnected as the assets and liabilities on the balance sheet will increase or decrease based on the incomes and expenses from the income statement and the cash flows from the cash flow statement.

# Basic Financial Concepts

## 1. Introduction

**Welcome to Basic Financial Concepts!**
This course emphasizes and develops a basic understanding of financial concepts, financial tools, and major decision areas related to the financial management of a business or organization.

Finance is a broad term that describes activities associated with banking, leverage or debt, credit, capital markets, money, and investments. Basically, finance represents money management and the process of acquiring needed funds. Finance also encompasses the oversight, creation, and study of money, investments, assets, and liabilities that make up financial systems.

We'll discuss concepts like Dollar Cost Averaging (DCA) and Diversification, which are especially useful for individual investors. We will also plunge into some of the more complex academic explanations – like the Efficient Market Hypothesis or the Capital Asset Pricing Model (CAPM). Many of the concepts in finance originate from micro and macroeconomic theories.

Since individuals, businesses, and government entities all need funding to operate, the finance field includes three main sub-categories: personal finance, corporate finance, and public finance.

- **Personal Finance** involves analyzing the current financial position of individuals to formulate strategies for future needs within financial constraints. Financial strategies depend largely on the person's earnings, living requirements, goals, and desires.
- **Corporate Finance** refers to financial activities related to running a corporation. For example, a large company may have to decide whether to raise additional funds or startups may receive capital from angel investors.
- **Public Finance** includes tax, spending, budgeting, and debt issuance policies that affect how a government pays for the services it provides to the public. The federal government helps prevent market failure by overseeing the allocation of resources and economic stability.

This course is directed toward the businessperson who must have financial knowledge but has not had advanced formal training in finance – perhaps a newly promoted middle manager or a marketing manager of a small company who must know some basic finance concepts. The entrepreneur or sole proprietor also needs this knowledge; he or she may have brilliant product ideas, but not the slightest idea about financing.

# 2. Risk-Return and TVM

The risk-return tradeoff states that higher risk is associated with greater probability of higher return and lower risk with a greater probability of smaller return. Time value of money (TVM) is the idea that money that is available at the present time is worth more than the same amount in the future.

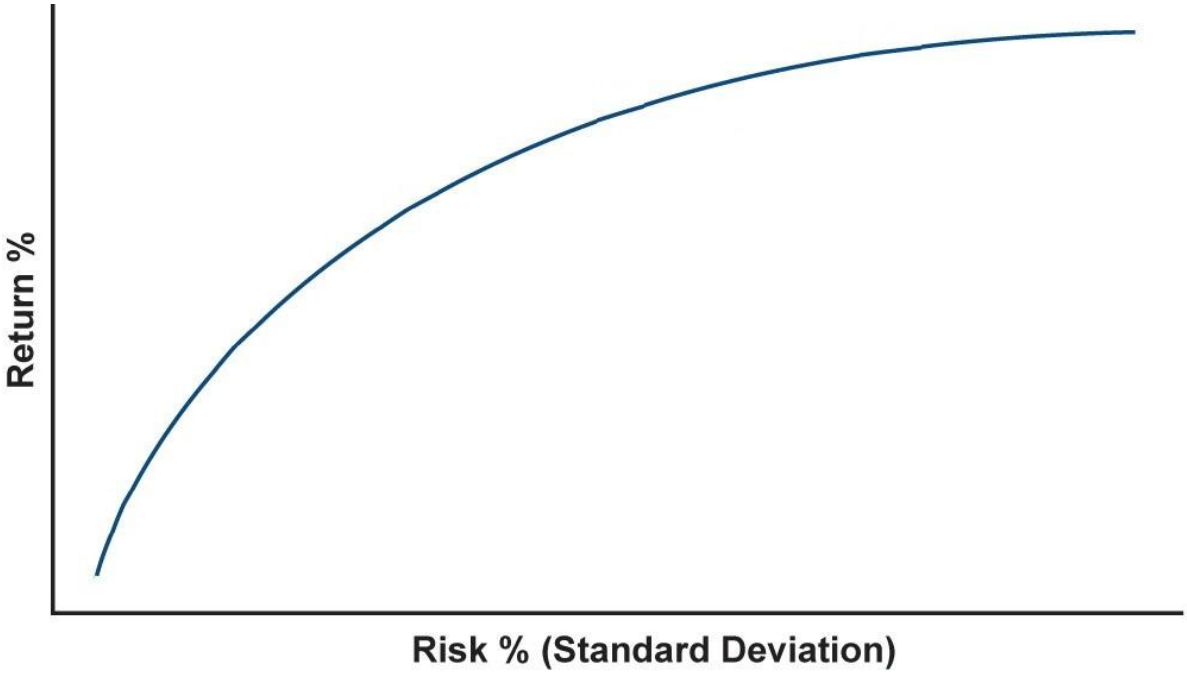
## Risk and Return

The Risk-Return Tradeoff could easily be called the "ability-to-sleep-at-night test." While some people can handle the equivalent of financial

skydiving without batting an eye, others are terrified to climb the financial ladder without a secure harness.

Depending upon factors like your age, income, and investment goals, you may be willing to take significant financial risks in your investments, or you may prefer to keep things much safer. Deciding what amount of risk you can take while remaining comfortable with your investments is very important.

In the investing world, the dictionary definition of risk is the chance that an investment's actual return will be different than expected. Technically, this is measured in statistics by standard deviation. Risk means you have the possibility of losing some, or even all, of your original investment.



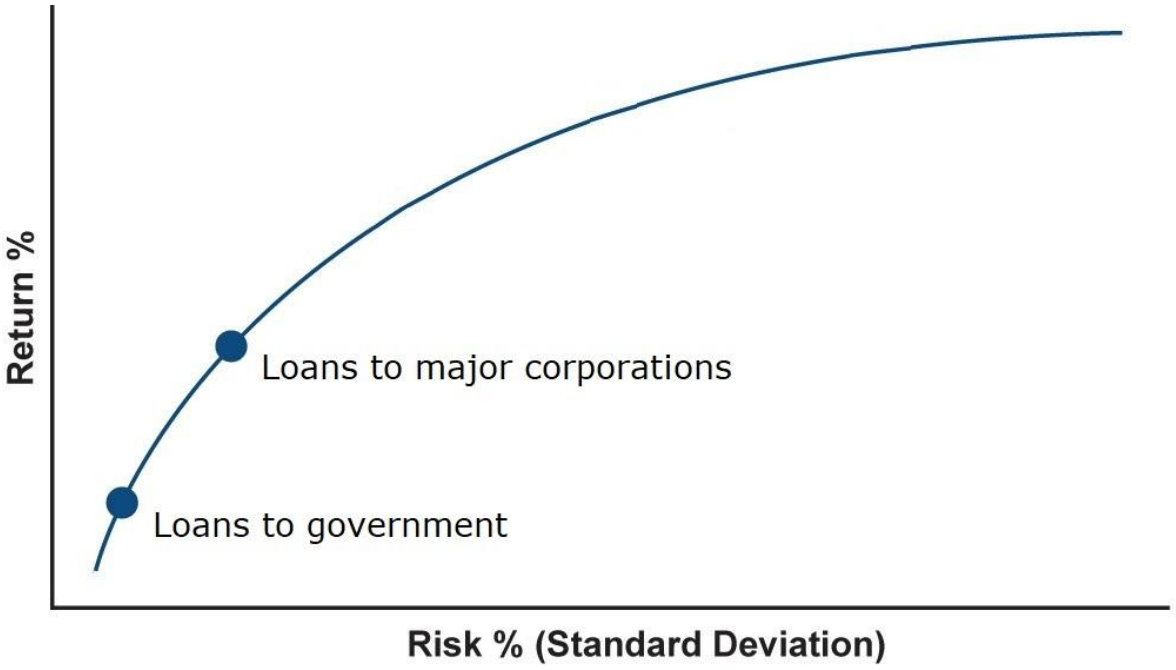

Low levels of uncertainty (low risk) are associated with low potential returns. High levels of uncertainty (high risk) are associated with high potential returns. The risk/return tradeoff is the balance between the desire for the lowest possible risk and the highest possible return. This is demonstrated graphically in the chart below. A higher standard deviation means a higher risk and higher possible return.

The risk-return tradeoff states that the potential return rises with an increase in risk. It is also called the "ability-to-sleep-at-night test."

# Example

It's crucial to keep in mind that higher risk does NOT equal greater return. The risk-return tradeoff only indicates that higher risk levels are associated with the possibility of higher returns, but nothing is guaranteed. At the same time, higher risk also means higher potential losses on an investment.

On the lower end of the scale, the risk-free rate of return is represented by the return on **government securities** because their chance of default is next to nothing. If the risk-free rate is currently 6%, this means, with virtually no risk, we can earn 6% per year on our money.



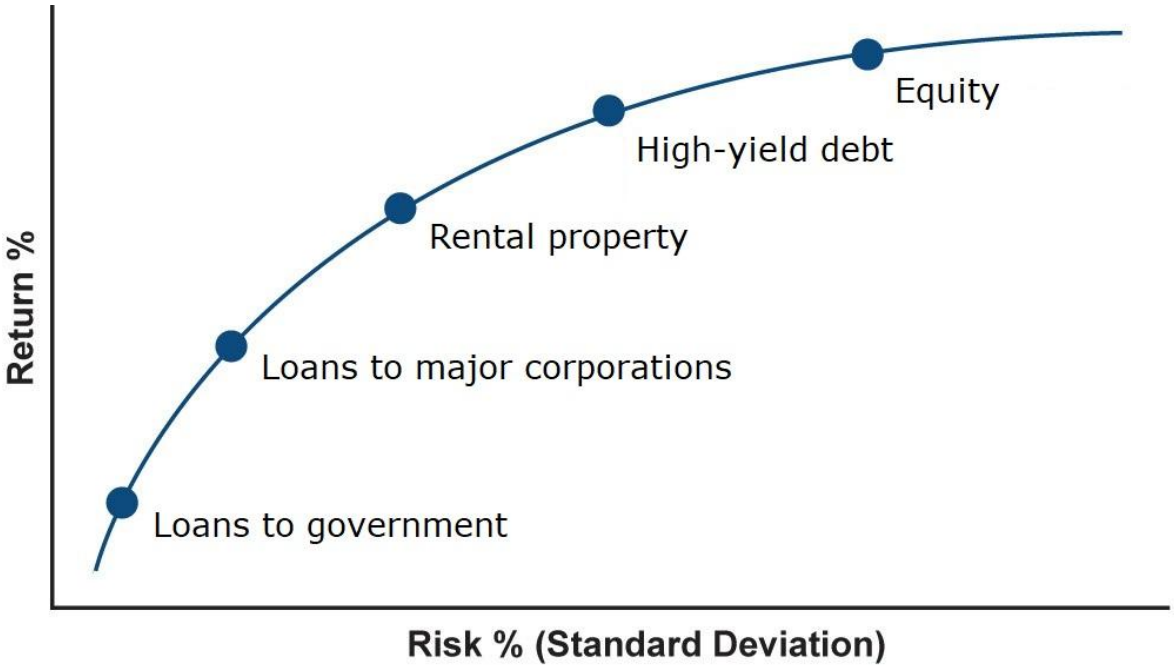

The common question arises: who wants to earn 6% when **investment-grade corporate bonds** average 12% per year over the long run? The answer to this is that a corporate bond carries more risk. The return on corporate bonds is not 12% every year, but rather -5% one year, 25% the next year, and so on. An investor still faces substantially greater risk and volatility to get an overall return that is higher than a predictable government security. We call this additional return the **risk premium**, which in this case is 6% (12% – 6%).

Determining what risk level is most appropriate for you isn't an easy question to answer. Risk tolerance differs from person to person. Your decision will depend on your goals, income, and personal situation.

# Progression

There are various **classes of possible investments**, each with their own positions on the overall risk-return spectrum. There is considerable overlap of the ranges for each investment class.

The general progression is: government debt – major corporations debt – property – high-yield debt – and equity. All this can be visualized by plotting expected return on the vertical axis against risk (represented by standard deviation upon that expected return) on the horizontal axis. This line starts at the risk-free rate and rises as risk rises.




| | |
|---|---|
| **Loans to government** | On the lowest end is short-dated loans to the government. The lowest of all is the risk-free rate of return. However, there are also longer-term loans to the government, such as 3-year bonds. The range width is larger and follows the influence of increasing risk premium required as the maturity of that debt grows longer. Nevertheless, the highest end of the range is still comparatively low compared to the ranges of other investment types discussed below. |
| **Loans to major corporations** | Following the lowest-risk investments are short-dated loans to major corporations with the highest credit ratings. The further away from perfect the credit rating, the higher up the risk-return spectrum that particular investment will be. Longer-term debt from those same well-rated corporations is higher up the range because the maturity has increased. |

| | |
|---|---|
| **Rental property** | A commercial property that the investor rents out is comparable in risk or return to a low-investment grade. Industrial property has higher risk and returns, followed by residential. |
| **High-yield debt** | After the returns upon all classes of investment-grade debt come the returns on speculative-grade high-yield debt (also known as "junk bonds"). These may come from mid and low rated corporations and less politically stable governments. |
| **Equity** | Equity returns are the profits earned by businesses after interest and tax. Even the equity returns on the highest rated corporations are notably risky. Small-cap stocks are generally riskier than large-cap; companies that primarily service governments tend to be less volatile than those in other industries. |

# Time Value of Money

The time value of money (TVM) is one of the most fundamental theories in finance. It states that a dollar today is worth more than a dollar in the future.

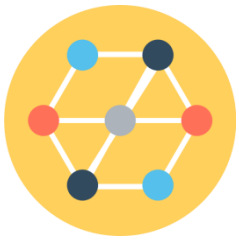
The time value of money draws from the idea that rational investors prefer to receive money today rather than the same amount of money in the future because of money's potential to grow in value over a given period of time. For example, money deposited into a savings account earns a certain interest rate and is therefore said to be compounding in value.

Further illustrating the rational investor's preference, assume you have the option to choose between receiving $10,000 now versus $10,000 in two years. It's reasonable to assume most people would choose the first option.

Despite the equal value at the time of disbursement, receiving the $10,000 today has more value and utility to the beneficiary than receiving it in the future due to the opportunity costs associated with the wait. Such opportunity costs could include the potential gain on interest were that money received today and held in a savings account for two years.

The time value of money (TVM) is the idea that money received in the present is more valuable than the same sum in the future because of its potential to be invested and earn interest.

# 3. Diversification, DCA and Assets



There are a variety of techniques that organizations will use during the identification process to establish solid strategies to manage risks. Diversification, Dollar Cost Averaging (DCA), and Asset Allocation are three of the most essential risk-management techniques.

## Diversification

Many individual investors can't tolerate the short-term fluctuations in the stock market. Diversifying your portfolio is the best way to smooth out the ride.

**Diversification** is a risk-management technique that mixes a wide variety of investments within a portfolio in order to minimize the impact that any one security will have on the overall performance of the portfolio. Diversification lowers the risk of your portfolio. Academics have complex formulas to demonstrate how this works, but we can explain it clearly with an example:

Suppose that you live on an island where the entire economy consists of only two companies: one sells umbrellas while the other sells sunscreen. If you invest your entire portfolio in the company that sells umbrellas, you'll have a strong performance during the rainy season, but poor performance when it's sunny outside. The reverse occurs with the sunscreen company, the alternative investment; your portfolio will be high performance when the sun is out, but it will tank when the clouds roll in.

Chances are you'd rather have constant, steady returns. The solution is to invest 50% in one company and 50% in the other. Because you have diversified your portfolio, you will get decent performance year-round instead of having either excellent or terrible performance depending on the season.

There are three main practices that can help you ensure the best diversification:


- **Spread your portfolio among multiple investment vehicles** such as cash, stocks, bonds, mutual funds and perhaps even some real estate.
- **Vary the risk in your securities:** You're not restricted to choosing only major company stocks. In fact, it would be wise to pick investments with varying risk levels; this will ensure that large losses are offset by other areas.
- **Vary your securities by industry:** This will minimize the impact of industry-specific risks.

Diversification is the strategy of investing in a variety of securities in order to lower the risk involved with putting money into few investments.

Diversification is a powerful component in helping you reach your long-range financial goals while minimizing your risk. At the same time, diversification is **not** a guarantee against a loss. No matter how much diversification you employ, investing involves taking on some risk.

# Dollar Cost Averaging (DCA)

If you ask any professional investor what the hardest investment task is, he or she will likely tell you that it is picking bottoms and tops in the market. Trying to time the market is a very tricky strategy. Buying at the

absolute low and selling at the peak is nearly impossible in practice. This is why so many professionals preach about **Dollar Cost Averaging (DCA)**.

Although the term might imply a complex concept, DCA is actually a fairly simple and extremely useful technique. Dollar cost averaging is the process of buying, regardless of the share price, a fixed dollar amount of a particular investment on a regular schedule. More shares are purchased when prices are low, and fewer shares are purchased when prices are high. The cost per share over time eventually averages out. This reduces the risk of investing a large amount in a single investment at the wrong time.


Let's analyze this with an example. Suppose you recently got a bonus for your hard work, and now you have $8,000 to invest. Instead of investing the lump sum into a mutual fund or stock, with DCA, you'd spread the investment out over several months. Investing $1,000 a month for the next eight months, "averages" the price over eight months. So one month you might buy high, and the next month you might buy more shares because the price is lower, and so on.

This plan is also applicable to the investor who doesn't have that big lump sum at the start but can invest small amounts regularly. This way you can contribute as little as $25-50 a month to an investment like an index fund. Keep in mind that dollar cost averaging doesn't prevent a

loss in a steadily declining market, but it is quite effective in taking advantage of growth over the long term.

There are a few things investors should understand before starting their own dollar cost averaging plan:

- Dollar cost averaging is a strategy that is better suited for investors with a lower risk tolerance and a long-term investment horizon.
- Next, the strategy is no guarantee of good returns on your investment. Dollar cost averaging into an investment that continues to fall each and every month is not a wise move.
- Finally, investing involves risk and your own due diligence, so you should only dollar cost average into an investment that you understand and are comfortable with.

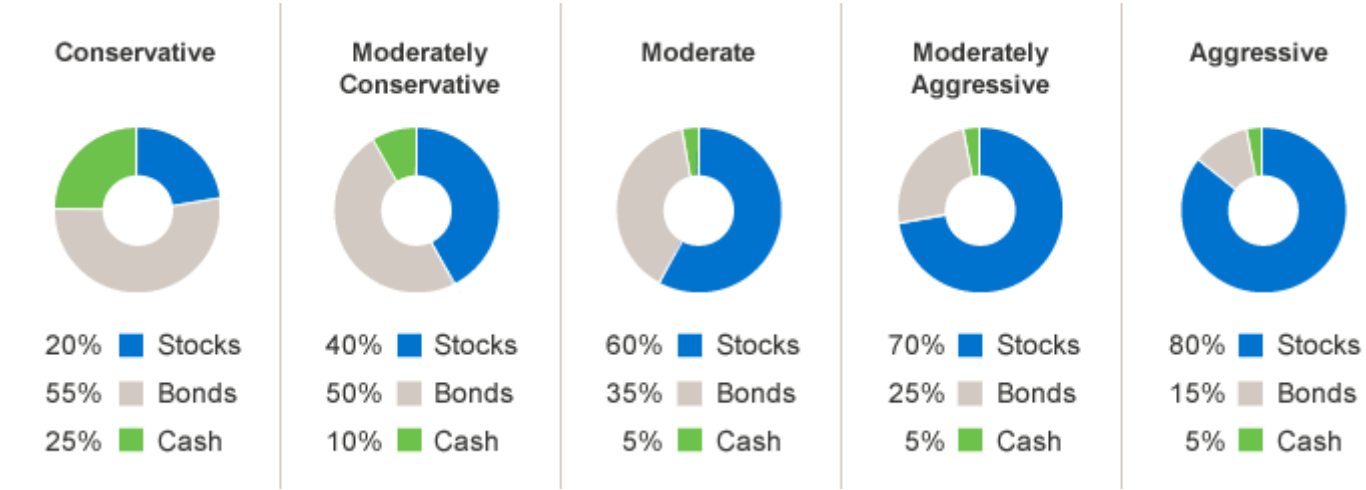
# Asset Allocation

It's no secret that throughout history common stock has outperformed most financial instruments. If an investor plans to have an investment for a long period of time, his or her portfolio should be comprised mostly of stocks. Investors who don't have this kind of time should diversify their portfolios by including investments other than stocks.

For this reason, the concept of **asset allocation** was developed. Asset allocation is an investment portfolio technique that aims to balance risk and create diversification by dividing assets among major categories such as bonds, stocks, real estate, and cash. Each asset class has different levels of return and risk, so each will behave differently over time. At the same time that one asset is increasing in value, another may be decreasing or not increasing as much.

The underlying principle of asset allocation is that the older a person gets, the less risk he or she should take on. After you retire, you may have to depend on your savings as your only source of income. It follows that you should invest more conservatively because asset preservation is crucial at this time in life.

Examples of different investor profiles by asset allocation:




Determining the proper mix of investments in your portfolio is extremely important. Deciding what percentage of your portfolio you should put into stocks, mutual funds, and low-risk instruments like bonds and treasuries isn't simple, particularly for those reaching retirement age.

Asset allocation is an investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance, and investment horizon.

# 4. Market Investing Theories

In this chapter, we will discuss three essential market investing theories: the Random Walk Theory developed by Maurice Kendall and Burton Malkiel, the Efficient Market Hypothesis formulated by Eugene Fama, and the Optimal Portfolio Concept originated by Harry Markowitz.

## Random Walk Theory

**Random Walk Theory** gained popularity in 1973 when Burton Malkiel wrote "A Random Walk Down Wall Street", a book that is now regarded as an investment classic. Random walk is a stock market theory that states that the past movement or direction of the price of a stock or

overall market cannot be used to predict its future movement. Originally examined by Maurice Kendall in 1953, the theory states that stock price fluctuations are independent of each other and have the same probability distribution, but that over a period of time, prices maintain an upward trend.

In short, random walk says that **stocks take a random and unpredictable path**. The chance of a stock's future price going up is the same as it going down. A follower of random walk believes it is impossible to outperform the market without assuming additional risk. In his book, Malkiel preaches that both technical analysis and fundamental analysis are largely a waste of time and are still unproven in outperforming the markets.

Malkiel constantly states that a **long-term buy-and-hold strategy** is the best and that individuals should not attempt to time the markets. Attempts based on technical, fundamental, or any other analysis are futile. He backs this up with statistics showing that most mutual funds fail to beat benchmark averages like the S&P 500.

Random Walk Theory is the idea that stocks take a random and unpredictable path.
While many still follow the preaching of Malkiel, others believe that the investing landscape is very different than it was when Malkiel wrote his book in the 1970s. Today, everyone has easy and fast access to relevant news and stock quotes. Investing is no longer a game for the privileged. Random walk has never been a popular concept with those on Wall Street, probably because it condemns the concepts on which it is based such as analysis and stock picking.

It's hard to say how much truth there is to this theory; there is evidence that supports both sides of the debate. However, it is an important theory every investor should know.

# Efficient Market Hypothesis

**Efficient Market Hypothesis** (EMH) is an idea partly developed in the 1960s by Eugene Fama. It states that it is impossible to beat the market because prices already incorporate and reflect all relevant information. This is also a highly controversial and often disputed theory. Supporters of this model believe it is pointless to search for undervalued stocks or

try to predict trends in the market through fundamental analysis or technical analysis.

Under the efficient market hypothesis, any time you buy and sell securities, you're engaging in a game of chance, not skill. If markets are efficient and current, it means that **prices always reflect all information**, so there's no way you'll ever be able to buy a stock at a bargain price.

The Efficient Market Hypothesis states that prices fully reflect all available information and it is impossible to beat the market on a risk-adjusted basis.
This theory has been met with a lot of opposition, especially from technical analysts. Their argument against the efficient market theory is that many investors base their expectations on past prices, past earnings, track records and other indicators. Because stock prices are largely based on investor expectation, many believe it only makes sense to believe that past prices influence future prices.

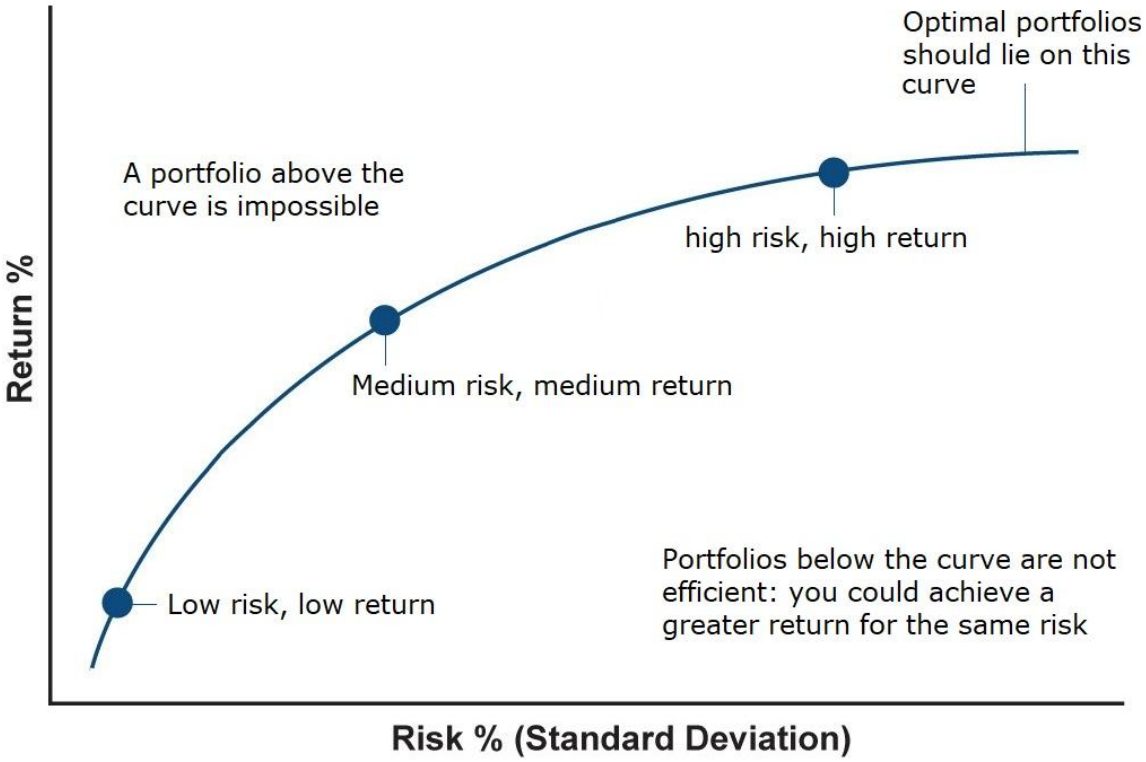
# Optimal Portfolio Concept

The **Optimal Portfolio** concept falls under the modern portfolio theory. The theory assumes that investors fanatically try to minimize risk while striving for the highest return possible. The theory states that investors will act rationally, always making decisions aimed at maximizing their return for their acceptable level of risk.

The optimal portfolio was used in 1952 by Harry Markowitz, and it shows us that it is possible for different portfolios to have varying levels of risk and return. Each investor must decide how much risk they can handle and then allocate (or diversify) their portfolio according to this decision.

The chart below illustrates how the optimal portfolio works. The optimal-risk portfolio is usually determined to be somewhere in the middle of the curve because as you go higher up the curve, you take on proportionately more risk for a lower incremental return. On the other end, low risk/low return portfolios are pointless because you can achieve

a similar return by investing in risk-free assets, like government securities.




You can choose how much volatility you are willing to bear in your portfolio by picking any other point that falls on the efficient frontier. This will give you the maximum return for the amount of risk you wish to accept. Optimizing your portfolio is not something you can calculate in your head. There are computer programs that are dedicated to determining optimal portfolios by estimating hundreds (and sometimes thousands) of different expected returns for each given amount of risk.

The Optimal Portfolio concept assumes that investors try to minimize risk while striving for the highest return possible.

# 5. Capital Asset Pricing Model (CAPM)

The Capital Asset Pricing Model (CAPM) describes the relationship between systematic risk and expected return for assets, particularly stocks. CAPM is widely used throughout finance for pricing risky securities and generating expected returns for assets given the risk of those assets and cost of capital.

# Definition

The Capital Asset Pricing Model (CAPM) was developed in 1952 by Harry Markowitz and fine-tuned over a decade later by other economists and investors, including William Sharpe. CAPM describes the **relationship between an investor's risk and the expected return**. It is designed to help model the pricing of higher-risk securities.

According to the CAPM theory, the expected return of a particular security or a portfolio is equal to the rate on a risk-free security plus a risk premium. If the security or portfolio does not either meet or exceed the required return, then the investment should not be entered into.

CAPM uses the following formula:


- **Expected return:** The expected return of a capital asset over time, given all of the other variables in the equation. "Expected return" is a long-term assumption about how an investment will play out over its entire life.
- **Risk-free rate:** The the risk-free rate is typically equal to the yield on a 10-year US government bond. The risk-free rate should correspond to the country where the investment is being made, and the maturity of the bond should match the time horizon of the investment. The professional convention, however, is to typically use the 10-year rate no matter what, because it's the most heavily quoted and most liquid bond.
- **Beta:** The beta is a measure of a stock's risk (volatility of returns) reflected by measuring the fluctuation of its price changes relative to the overall market. In other words, it is the stock's sensitivity to market risk. For instance, if a company's

beta is equal to 1.5 the security has 150% of the volatility of the market average. However, if the beta is equal to 1, the expected return on a security is equal to the average market return. A beta of -1 means security has a perfect negative correlation with the market.

- **Market return premium (market return – risk-free rate):** From the above components of CAPM, we can simplify the formula to reduce "expected return of the market minus the risk-free rate" to be simply the "market risk premium". The market risk premium represents the additional return over and above the risk-free rate, which is required to compensate investors for investing in a riskier asset class. Put another way, the more volatile a market or an asset class is, the higher the market risk premium will be.

# Example

In order to properly understand the CAPM equation, let's take a look an example:

We assume that the current **risk-free rate is 5%**, and the American stock market index S&P 500 is expected to bring in **returns of 12% over the next year**. You are interested in evaluating the return that Joe's Oyster Bar, Inc. (JOB) will have over the same time period (**expected return**). You have determined that the **stock's Beta value is 1.9**, and the overall stock market has a beta of 1.0. This means that JOB carries a higher level of risk than the overall stock market. Because of this extra risk, we should expect a higher potential return than the market's 12% anticipated return. We can calculate the expected return of JOB as follows:

**Expected Return = Risk-Free Rate + Beta * (Market Return – Risk-Free Rate)**

Expected Return = 5% + 1.9 * (12% – 5%)

Expected Return = 18.3%

CAPM tells us that Joe's Oyster Bar has a required rate of return of 18.3%. An investor who buys JOB stock should be getting at least 18.3% in return on his or her investment. If you have reason to believe that JOB will not be able to produce those returns for you over the specified time period, then it's best to invest your funds elsewhere.

One important add-on to the CAPM theory is that high-beta shares typically provide the highest returns. Over a longer period of time, though, high-beta shares tend to be the worst performers during bear markets (a period marked with falling stock prices). Thus, while you may receive high returns from high-beta shares in a given window of time, there is no guarantee that the CAPM return will be realized.

# Advantages and Limitations

CAPM is most often used to determine what the fair price of an investment should be. When you calculate the risky asset's rate of return using CAPM, that rate can then be used to discount the investment's future cash flows to their present value and thus arrive at the investment's fair value.

There are assumptions behind the CAPM formula that have been shown not to hold in reality:

- First, the model assumes that a riskier asset will yield a higher return. But this is not necessarily true. A risky asset could decline in value.
- Second, historical data determines beta. The model assumes this historical data an accurate predictor of future results. But the asset's future volatility may not necessarily reflect its past volatility.

Considering the critiques of the CAPM and the assumptions behind its use in portfolio construction, it might be difficult to see how it could be useful. However, the underlying concepts of CAPM can help investors understand the relationship between expected risk and reward as they make better decisions about adding securities to a portfolio.

Despite the aforementioned drawbacks, there are numerous advantages to the application of CAPM, the most important one being its easy-of-use. CAPM is a simplistic calculation that can be easily stress-tested to derive a range of possible outcomes to provide confidence around the required rates of return.

No model is perfect, but each should have a few characteristics that make it useful and applicable. CAPM, while criticized for its unrealistic assumptions, provides a more useful outcome than most other financial

models. It is easily calculated and stress-tested, and when used in conjunction with other aspects of an investment mosaic, it can provide unparalleled yield data that can support or eliminate a potential investment.

# 6. Conclusion

The world of investing and finance can be a chaotic and confusing place. We hope that this course has given you some basic knowledge about investing in financial markets and about different investment strategies suitable to your risk profile. Let's recap what we've learned in this course:

- **Risk-Return Tradeoff** is the balance between the desire for the lowest possible risk and the highest possible return. Higher risk equals greater possible return.
- **Diversification** lowers the risk of your portfolio.
- **Dollar cost averaging (DCA)** is a technique by which, regardless of the share price, a fixed dollar amount is invested on a regular schedule.
- **Asset allocation** divides assets among major categories in order to create diversification and balance the risk.

Also, we introduced three of the most important market investing theories and the widely used capital asset pricing model (CAPM):

- The **Random Walk Theory** says that stocks take a random and unpredictable path.
- The **Efficient Market Hypothesis (EMH)** says it is impossible to beat the market because prices already incorporate and reflect all relevant information.
- The **Optimal Portfolio Concept** attempts to show how rational investors will maximize their returns for the level of risk that is acceptable to them.

- The **Capital Asset Pricing Model (CAPM)** describes the relationship between risk and expected return and serves as a model for the pricing of risky securities.

# Investment Fundamentals

# 1. Introduction

**Welcome to Investment Fundamentals!**
This course aims to demystify the process of investing and to give you a basic introduction. To get ready to invest you will need to reflect upon a number of fundamental things about both yourself and the world of investments.

In short, investing can be defined as the act of committing money or capital to an endeavor with the expectation of obtaining an additional income or profit. In even simpler words: investing means **putting your money to work for you**.

There are many different ways you can go about making an investment. This includes putting money into stocks, bonds, mutual funds, or real estate (among many other things), or starting your own business. Each of these vehicles has positives and negatives, but the goal is always to put your money to work so it earns you an additional profit. Even though this is a simple idea, it's the most important concept for you to understand.

This course takes you through:

- Getting ready to invest, including goal setting and understanding the impact of cost and risk
- The importance of asset allocation and the different asset classes
- The different types of investment management
- Looking after your investments over time

From taking this course you will understand the fundamentals of investing and the key steps needed to begin to work with your financial adviser to develop your investment plan. The most important rule: The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

# 2. Prepare to Invest

If you don't have any experience investing on your own, getting started can be rather intimidating, confusing, and overwhelming. In this chapter, we will discuss some things all starting investors should keep in mind while getting ready to buy their first stock.

## Saving and Investing

Saving for the deposit on a new car or next year's holiday is different from investing to achieve a long-term goal, such as building up a retirement pot or paying school fees.


**Saving** generally involves putting money into a bank account or money market fund that is relatively **safe** and pays a fixed, although typically low, rate of interest. However, a savings plan may not earn you wealth enhancing returns over the long term and taking into account the impact of inflation the real purchasing power of your money will likely decline.

**Investing**, on the other hand, can help you to both create and preserve your wealth. By taking an appropriate level of **risk** you may have the opportunity to earn potentially higher long-term returns. The value of investments may fall or rise and investors may get back less than they invested. Quite simply, you invest to create and preserve wealth.

Remember: saving and investing are two different concepts.

Becoming a successful investor requires both planning and discipline:

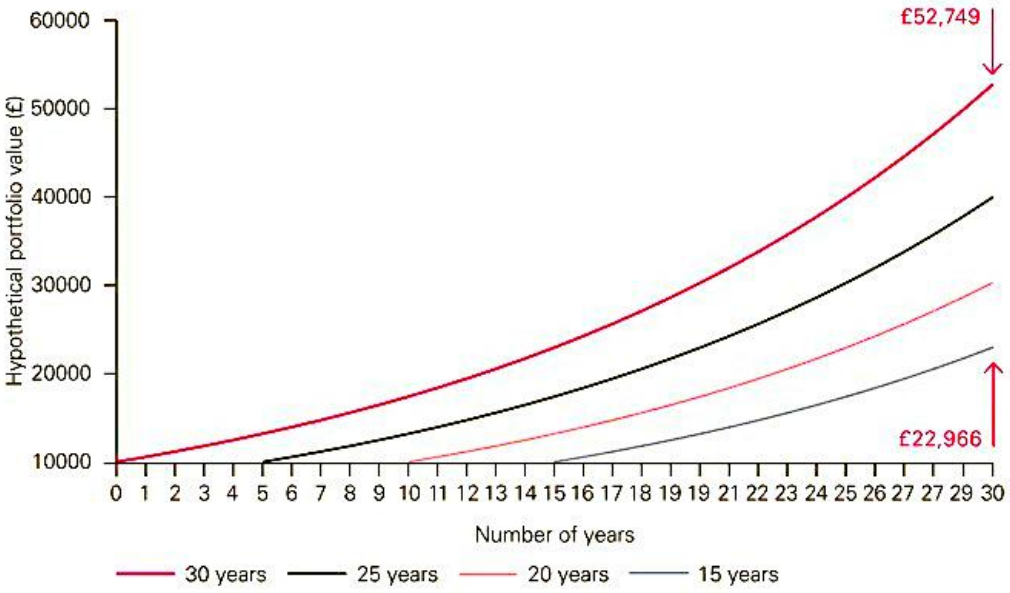
- **Planning** means thinking carefully about everything you need to consider when developing your investment plan. You have to define your goals, understand asset allocation, and look after your investments over time.
- **Discipline** means keeping market movements into perspective, recognizing the potential impact of risk and regularly rebalancing your portfolio. It is also important to live within your means and decide how much you will set aside for investing before you start to develop your plan.

# Compounding

People have different goals at different stages of their lives. For example, if you are retired, you may simply want to maximize the amount of income you receive. Whereas, your longer-term focus might be building financial security for you and your family. Whatever your goals and your time frame for investing, it is important to be realistic about what you can afford to invest and how best to manage your investments.

The old saying ‘time is money’ sums up precisely why it’s so important to **invest for the long term**. That’s because the effects of “compounding” the returns you receive from your investments over time can be significant. **Compounding** is the engine that powers long-term investment returns. It happens as you reinvest your returns, then reinvest the returns on those returns, and so on.

This chart illustrates the power of compounding over time:

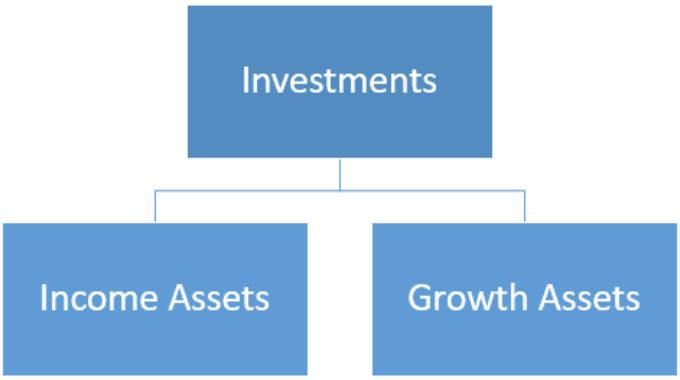



This hypothetical graph shows the growth of a £10,000 initial investment over different time periods. For simplicity, the graph assumes a 6% annual income. It demonstrates that the longer you hold your investment while reinvesting your income, the bigger the potential impact. For example, over thirty years, the initial investment would have grown to £52,749 if all income had been reinvested. In comparison, over a fifteen-year period, the initial investment would only have grown to £22,996. As this is a hypothetical example it does not reflect any particular investment.

It is important to remember that forecasts are not a reliable indicator of future performance and the value of investments and the income from them may rise as well as fall.

# Income or Growth

Investments can be divided into “income assets” and “growth assets”. One of the key investment decisions you need to make during the planning stage is whether you require income, growth or a bit of both from your investments.




**Income Assets:**
These assets primarily provide returns in the form of income and include cash investments, rental of property, or ownership of a business. Income assets tend to provide more stable, but lower returns. If your primary need is for income, you may benefit from holding a higher proportion of income assets.

**Growth Assets:**
Growth assets are designed to grow your investment and include investments such as shares. They tend to carry higher levels of risk, yet have the potential to deliver higher returns over longer investment time frames. In general, growth assets are expected to provide returns in the form of capital growth. For example, as a shareholder, you may receive income in the form of a dividend on the shares you own. However, the majority of the return usually comes from changes in the value of the company over time, as determined by its share price.

Having decided whether you require more income or more growth from your investments, you can go on to working with your financial adviser to develop your investment plan.

# Reducing Risk

A number of specific risks can affect your investments. As part of developing your investment plan, you should understand the potential risks. One of the ways to define risk is the likelihood that an investment's actual return will differ from expectations.

There are six different risk categories:


- **Country risk**: Political upheaval, financial troubles, or natural disasters can weaken a country's financial markets.
- **Currency risk**: The risk that changes in currency exchange rates cause the value of an investment to decline.
- **Inflation risk**: Inflation can erode the value or purchasing power of your investments.
- **Liquidity risk**: The chance that an investment may be difficult to buy or sell.
- **Market risk**: Market risk is the risk that investment returns will fluctuate across the market in which you are invested.
- **Short fall risk**: Short fall risk is a possibility that your portfolio will fail to meet your longer-term financial goals.

Spreading your money across a range of investments is one of the best ways to reduce risk and protect against sudden falls in any particular market, sector, or individual investment. With a **diversified portfolio** of investments, returns from better-performing investments can help offset those that underperform.

Diversification alone does not ensure you will make a profit, nor protect you fully against losses in a declining market. But it can reduce the risk

of experiencing a serious loss of wealth as the result of being over-committed to a single investment.

You can spread your potential risk by investing in a mix of investments. That way, when some investments are underperforming, other investments can carry the load and help to even out the ups and downs in your portfolio.

# 3. Asset Allocation

Asset allocation is the rigorous implementation of an investment strategy that attempts to balance risk versus reward by adjusting the percentage of each asset in an investment portfolio according to the investor's risk tolerance, goals and investment time frame.

## Equity


**Equities**, also sometimes called stocks or shares, represent ownership in a company. This ownership gives you the right to share in that company's future financial performance.

Of the major asset types equities, bonds, property, and cash, history has shown that equities have the highest potential to deliver strong returns over the long-term. That's why many people who invest for the long run make equities the biggest portion of their portfolios. But remember that equities can be volatile.

When a company is doing well, it may decide to pay out some of its profits by distributing dividends to shareholders. Or it might reinvest those profits in the business in the hope of increasing future sales –

which, in turn, may increase the value of your shares. But if the company runs into trouble, the value of your holding could drop or even be wiped out. It is important to remember that the value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Many companies decide to make payments – called dividends – to their shareholders on a regular basis. The level of dividend payments is determined by both the company's earnings and its management strategy.

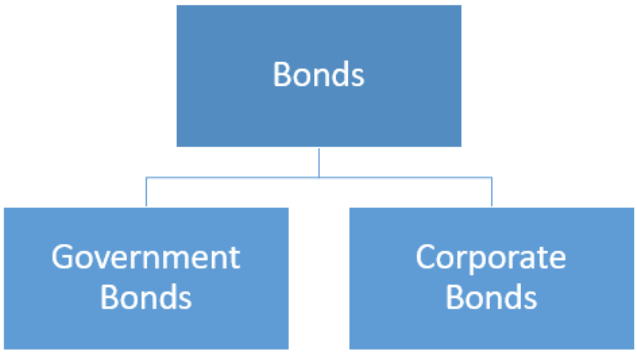
An equity investment is money invested in a company through the purchase of its shares. Equity investors purchase shares in the expectation that they will rise in value in the form of capital gains and/or generate capital dividends from the company.

# Bonds


A **bond** is a loan made to the bond's issuer, which could be a company, a government, or some other institution.

Bonds can be useful in a portfolio as they provide income, typically paid twice a year. Bonds are issued for a set period and when that period expires – in other words when the bond reaches its maturity – the issuer will repay the face value of the bond. You may include bonds in your portfolio to help offset some of the volatility of equities. As bonds typically offer regular payments of a fixed amount of interest, they are sometimes called **fixed interest investments**.

Bonds can be divided into two groups: government bonds and corporate bonds.




- **Government bonds**, also called gilts, are generally assumed to have a zero risk of default as they are backed by the government. The interest rate paid (or 'coupon') is therefore relatively low.
- Companies also issue bonds (called **corporate bonds**). These provide credit to help finance a variety of operations, as an alternative to issuing shares or borrowing from a bank. As you would expect, corporate bonds tend to be safer when issued by reputable companies and riskier when issued by weak companies. Typically, financially stronger companies issue bonds that pay less interest than those offered by financially weaker companies.

For example, a start-up biotechnology firm might issue a five-year bond which pays a high rate of interest because it is deemed to be more risky. It has to pay this rate of interest in order to persuade investors to take on the higher risk involved. Bonds like these are therefore called 'high yield bonds' and are sometimes called 'junk bonds'. However, a large stable FTSE 100 company making solid long-term profits might pay a substantially lower rate of interest because it is perceived as being relatively safe. These are often referred to as 'investment grade bonds'.

Credit rating agencies, such as Standard & Poor's or Moody's, rate bond issuers according to their credit-worthiness, in the same way that individuals are given a credit score by banks. These ratings can be a useful starting point for understanding the credit-worthiness of a bond.

# Property

For most people, their major investment in **property** will be owning their own home. As home ownership represents a significant proportion of an investors' wealth, many people will decide that this gives them a high enough proportion of property in their portfolio.

However, for investors who want to increase their exposure to property, it is possible to diversify into commercial property. This can be done through specialist property funds which are run by professional managers (in the same way as equity or bond funds).

These funds may invest within a single country or internationally, in a variety of different types of property, such as office space, retail outlets or industrial property. These funds earn returns from both rents on the property they own and potential gains in the value of that property.

Where and what you buy will affect your return on investment significantly. Here are some tips to help you identify a good investment property:

- Familiar markets: Consider buying an investment property in an area you are familiar with as it will take you less time to research. Check recent sale prices in the area to give you an idea of what you can expect to pay for local properties.
- Growth suburbs: Look for areas where high growth is expected, where there is potential for capital gains.
- Rental yield: Look for areas where rents are high compared to the property value.
- Low vacancy rates: Find out about the vacancy rates in the neighbourhood. A high vacancy rate may indicate a less desirable area, which could make it harder to rent the property out, or sell it in the future.
- Planning: Find out about proposed changes in the suburb that may affect future property prices. Things like new developments or zoning changes can affect the future value of a property.

# Cash Investments

A **cash investment** is a short-term obligation, usually fewer than 90 days, that provides a return in the form of interest payments. Cash investments generally offer a low return compared to other investments but are associated with very low levels of risk.

Cash investments include:

- **Savings Account:** Some people consider a savings account as an investment alternative for cash. Money held in the account is insured by the Federal Deposit Insurance Corporation (FDIC), however, the interest rate on these accounts is minimal. The average interest return on a savings account is only 0.09%. Investors that want the option to access their money any time but also require a slightly higher rate of return typically will put their cash in a high yield savings account, offered through local banks.
- **Money Market:** This is a very short-term security that usually has a maturity of fewer than six months. They are very liquid investments that pay variable interest rates. Money market accounts generally have a slightly higher interest rate return than a cash savings account. Examples of money market instruments include commercial paper and treasury bills.
- **Certificate of Deposit (CD):** A CD functions like a bond in that it makes periodic interest payments to investors and funds are held for a predetermined period of time. But unlike bonds that can be sold prior to the maturity date, funds in a CD are locked in if held with a bank. Withdrawing the money will incur a penalty.

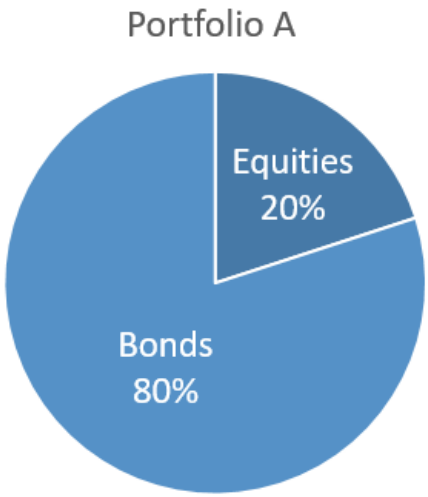
While cash investments tend to be the **least volatile** of the major asset classes, historically they tend to provide the lowest returns. That's why they are often used as places to keep emergency funds and to save for short-term objectives such as car and home purchases. Volatility is the extent to which asset prices or interest rates fluctuate over time. Volatility is often used to assess the potential risk associated with an investment.

Cash investments are usually undertaken by investors who need a temporary place to keep their cash while researching other investment products. Investors benefit from the low-risk yield and high liquidity of cash investments. Interest rates tend to be low but an investor has access to his or her money within a short period of time.

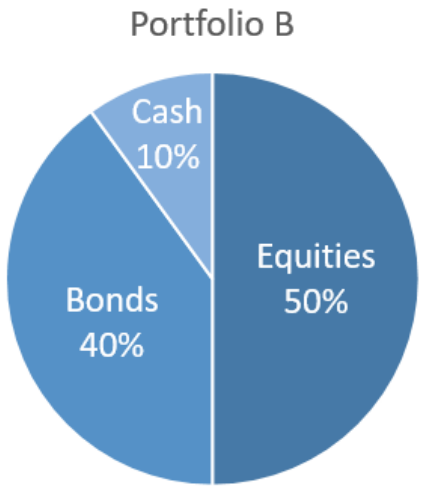
# Investor Types

Every investor will have different goals and their asset allocation will reflect this. The examples below highlight how different types of investors may choose to structure their investment mix.

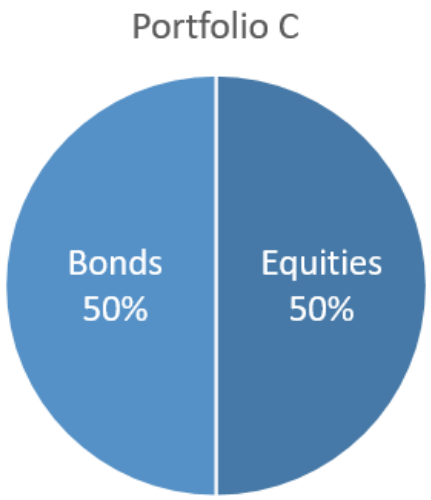
**Example 1: The wary investor**
An investor in her 30s is saving for retirement, and you might expect her to meet her goal by investing primarily in equity-based funds. But she's wary of the stock market and inexperienced with investing and sees that equities have suffered recent declines. She finds that she's most comfortable with a portfolio that includes 20% equities and 80% bonds.




**Example 2: The dual-income couple**
A dual-income married couple in their 40s wants to build up additional savings for retirement in about 20 years. A portfolio that consists of 70% equities and 30% bonds might be appropriate. However, the husband's job (which provides nearly half of their income) has become unstable, and they're anxious about their economic future. So they may settle on a more conservative asset allocation of 50% equities, 40% bonds, and 10% cash.




**Example 3: The recently retired couple**
A newly retired couple in their 60s first considered a portfolio of 30% equities and 70% bonds. However, they believe their retirement benefits are ample for their income needs, and they want to build a larger estate to benefit their grandchildren. So they decide on a more aggressive asset allocation – consisting of 50% equities and 50% bonds. Here, the additional risk is expected to generate higher long-term returns.




Investment markets move in cycles, reflecting the underlying strength of the economy, industry trends and investor sentiment. Asset classes have performed quite differently in the last decades, which shows the importance of diversifying an investment portfolio. The basic principle is simple: combining asset classes that tend not to rise or fall together can potentially reduce your overall risk.

# 4. Investment Management

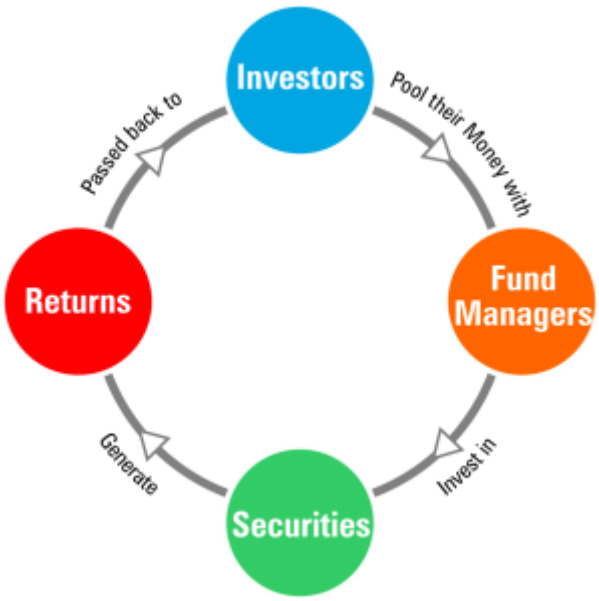
There are a number of ways you can invest your money in the asset classes we have discussed in the previous chapter. One of the most popular options is the use of pooled funds with the help of professional investment management companies.

# Pooled Funds

Mutual funds offer a way for a group of investors to effectively pool their money so they can invest in a wider variety of investment vehicles and take advantage of professional money management through the purchase of one mutual fund share.

When you buy a mutual fund share, you're investing in stocks, bonds and other securities that are held within the fund. For example, a German equity fund is likely to hold a wide number of stocks from a broad set of different German industry sectors.

The mutual fund then passes along the profits (and losses) of those investments to its shareholders. So if a mutual fund does well, you benefit. But, they're not risk-free.



**Advantages:**

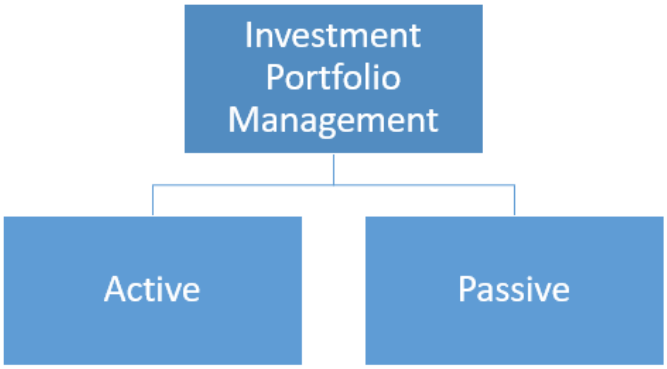
- **Diversification:** The holdings of a single pooled fund can range from a few securities to hundreds. This diversification can reduce the risk of loss due to problems in a particular company or industry.
- **Professional management:** Fund managers have access to extensive research, market information, and skilled traders.
- **Liquidity:** Shares in a pooled fund can be bought and sold on any business day, so investors have relatively easy access to their money.

**Disadvantages:**

- **Diversification penalty:** While diversification eliminates the risk from owning a single security whose value plummets, it also limits the potential for making a significant gain if a security's value increases dramatically. And, most importantly, diversification does not protect you from a loss caused by an overall decline in the financial markets.
- **Not bespoke:** Pooled funds are not bespoke investment portfolios. As a result, they may meet their investment objectives perfectly, but still not meet yours.
- **No guarantees:** As with many other investments, the value of a pooled fund will fluctuate, so it's possible for investors to lose money if they sell shares for less than they paid for them.

# Active and Passive Managers

In broad terms, investment funds are managed in one of two ways – active or passive:



**Active managers** aim to beat, rather than simply match, the return of a market index or benchmark. There are several techniques managers may use. Typically, this is done by taking a top-down or a bottom-up approach.

- **Top-down managers** start by looking at economic trends to help them predict which sectors will prosper in the future. After zeroing in on particular industries, they try to identify their most promising companies.
- **Bottom-up managers** look for outstanding companies in any industry. They assume that a great company will do well even if it's in an industry that's not currently thriving.

**Passive managers** aim to closely match the returns of a market index or benchmark. Passive management is a style of management associated with **exchange-traded funds (ETFs)** where a fund's portfolio mirrors a market index (like the Dow-Jones, NASDAQ, etc). They do this by either purchasing all the shares in the chosen index or a representative sample of securities which aims to replicate the performance of the index. Therefore, passive managers do **not** attempt to beat the market. This is why ETFs have significantly lower fees and commissions than actively managed mutual funds.

# Sustainable Investing

**Sustainable Investing**, also known as **Socially Responsible Investing (SRI)** or ethical investing, is any investment strategy which seeks to consider both financial return as well as social/environmental good.

In general, socially responsible investors encourage corporate practices that they believe promote environmental stewardship, consumer protection, human rights, and racial or gender diversity. Some SRIs avoid businesses perceived to have negative social effects such as alcohol, tobacco, fast food, gambling, pornography, weapons, fossil fuel production, or the military.

The areas of concern recognized by the SRI practitioners are sometimes also summarized under the heading of **ESG (Environmental, Social, and Governance) Investing**.

**What Considerations Go Into Sustainable Investing?**

| Environmental | Social | Governance |
|---|---|---|
| Carbon emissions | Diversity & workplace policies | Board structure |
| Energy efficiency | Labor standards | Board composition |
| Water scarcity | Supply chain management | Executive compensation |
| Waste management | Product safety and usefulness | Political contributions & lobbying |
| Pollution mitigation | Customer privacy | Bribery and corruption policies & oversight |
| | Community impact | Strategic sustainability oversight |

These are examples of ESG criteria but not a complete list.

For the investor, eco-friendly investing is a way to get peace of mind. If you're fully invested in sustainable companies, you don't have to worry that your wealth is working to benefit any companies that are actively destroying the environment or exploiting lax regulations in other countries. Eco-friendly investing also gives you the opportunity to foster innovation at companies that have green initiatives and rely on sustainable energy.

On the company level, there are clear returns for sustainability. For today's investors, "eco-friendly" and "sustainable" are more than just buzzwords: Many sustainable funds have been shown to match or even outperform the traditional market!

Just as there are multiple ways to manage a traditional portfolio, there are multiple ways to invest sustainably. You can either invest in sustainable funds and specific companies by yourself, or you can rely on an advisor.

Sustainable Investing, Socially Responsible Investing (SRI), and ESG-Investing are investment strategies that seek to consider financial return as well as social and environmental good.

# 5. Monitoring your Investments

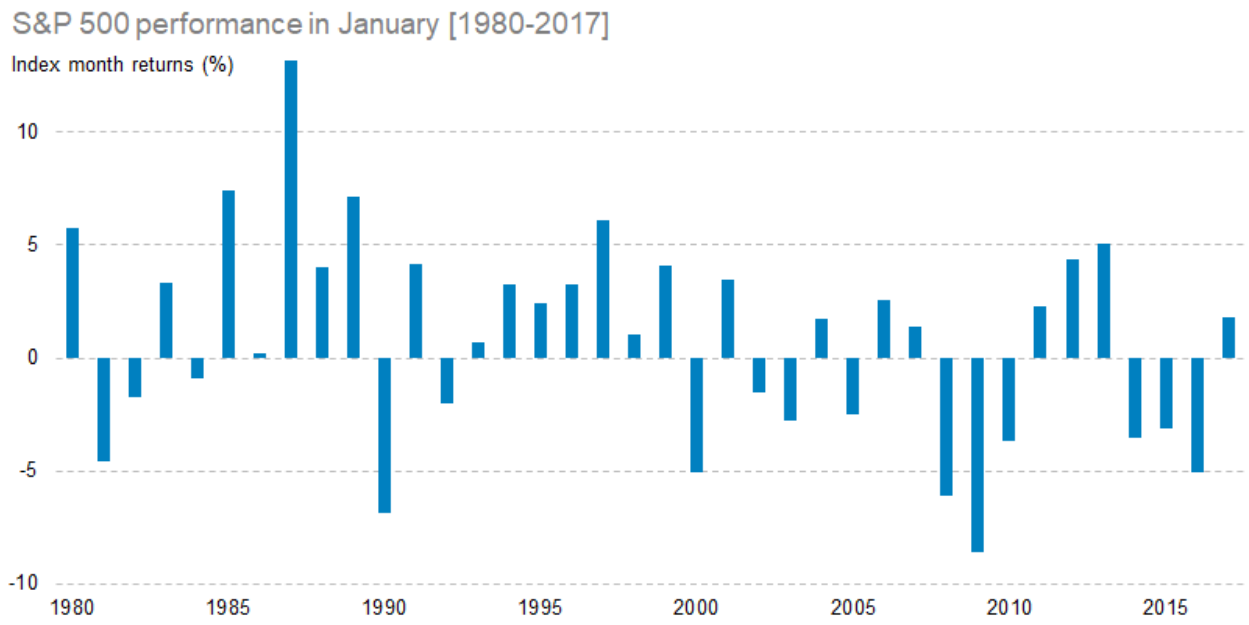
A number of factors will influence your portfolio and your investment choices over time. That's why it is important to understand the nature of markets. This background knowledge will enable you to react to market changes and to adjust your portfolio when necessary.

## Market Movements

The assets you invest in will **rise and fall over time** as markets are affected by economic, social and political events. But always remember that it's in the nature of markets to fluctuate, sometimes quite dramatically. It's often impossible to explain market movements until long after the dust has settled. In other words, it is important not to lose sight of your investment objective and speak to your financial adviser before deciding to change your investment approach based on market moods.

Timing the markets for the best time to invest – buying and selling tactically for profit – is far easier said than done. Trying to pick the top and the bottom of the market is not easy. It's hard to sell when everyone is buying. If you sell out at the bottom (which many investors do) you risk being out of the market when it rallies. Even professional fund managers find it difficult to consistently time the markets.

This chart shows just how erratic the stock market can be, and shows the performance of the S&P 500 Index (the index which tracks the share prices of the 500 largest US companies) in January from 1980 to 2017.




However, despite the market's ups and downs over the decades, the index averaged approximately 9.8% per year total return. This represents solid performance for investors focused on the long term.

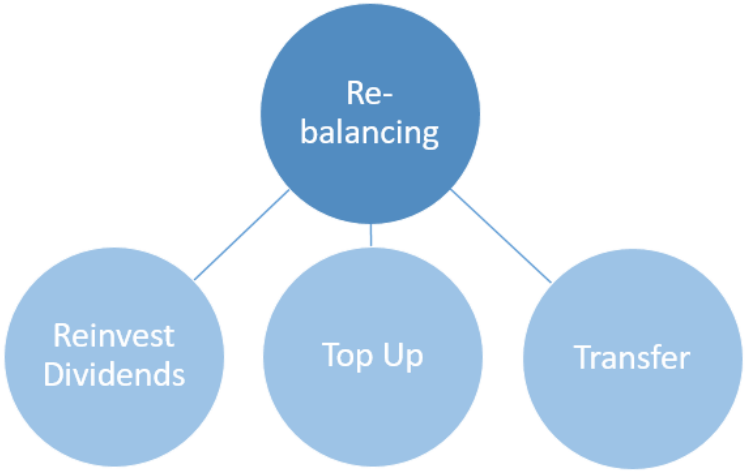
A popular strategy to benefit from the solid long-term performance of the stock market is spreading your investments over several months and years. This way, you avoid the risk of placing a large one-time investment at the wrong moment.

# Review and Rebalance

You should review your portfolio at least annually to make sure your asset allocation stays on track. You may decide to review your portfolio, for example, if your personal situation has changed, or market conditions have altered. If you do not review and adjust your portfolio in light of changing circumstances, you risk not achieving your investment goals.

During your review, you may decide to **rebalance** your portfolio – that is, change the proportion of assets you hold. This will involve selling some investments and buying others. When you rebalance, you need to think carefully about the costs and tax implications. In most cases, such as buying equities or bonds, you will have brokerage costs – and with some pooled funds you may be asked to pay an initial charge or an exit charge. You may also have a capital gains tax liability if a sale of assets means you go above your annual allowance.

If you need to make changes, you could consider **rebalancing in three ways**:




- **Reinvest dividends:** Direct dividends or capital gains from the asset sector that has exceeded its target into one that has fallen short.
- **Top up:** Add money to the asset sector that has fallen below its target percentage.
- **Transfer:** Move funds between asset classes. Shift money out of the asset sector that has exceeds its allocation target into the other investments.

# 6. Conclusion

In this course, you learned the basics of investing money. In simple words, investing means putting your money to work for you. You learned that each investor is different in his/her risk tolerance and that there is more than one strategy that can be used to invest successfully.

With an understanding of your investment goals, time frame, and risk, you can begin to create an asset allocation for your portfolio. Asset allocation simply means deciding how to spread your money across the different asset classes (including equities, bonds, property, and cash) and how much you want to hold in each. It also means selecting a mix of asset classes that reflects your objectives, time frame, and attitude to risk:

- **Equities**: Potential for capital growth, and may offer income through the payment of dividends. You can choose to invest in national and overseas companies.
- **Bonds**: Can provide a steady and reliable income stream with potential for capital growth and usually offers a higher interest rate, or yield, than cash. Includes government bonds (gilts), overseas government bonds, and company loans (corporate bonds).
- **Property**: Provides the benefits of diversification through access to properties in retail, office, industrial, tourism and infrastructure sectors. You can invest in both national and international property.
- **Cash Investments**: May be suitable for short-term needs, such as an impending down payment on a new home. Usually includes higher interest-paying securities, as well as bank and building society accounts or term deposits (a cash deposit at a financial institution that has a fixed term).

Remember that investing successfully is about knowing what you want, understanding your time frame for investing and your attitude to risk, and then making a plan to help you achieve your objectives. You should review your plan regularly and rebalance your investment portfolio when necessary.

Finally, always keep an eye on costs. The power of compounding means that you could end up with a much bigger pot of money over the longer term.

# Financial Performance

## 1. Introduction

**Welcome to Financial Performance!**
The ability to evaluate the financial position of a business is a valuable skill for any manager to have – whether you are choosing a supplier or considering a strategic partnership with a company.

Many organizations can appear successful despite deep structural problems with the way they are financed and managed. Just think for a moment about the consequences of working with a supplier or partner organization who goes bust, or who, despite appearing credible, never seems able to deliver on their promises because of hidden financial problems within their own organization.

Very few managers take the time and trouble to learn how to make a simple financial assessment of another organization, even though doing so is straightforward and the necessary information can usually be obtained online either free of charge or for only a few dollars.

This course explains the tools used to assess the financial performance of an organization. These are known as '**key financial ratios**' and they help you interpret financial information in a way that can aid you in making the right decisions when choosing who to work with or sell to. This information can also give you a valuable insight into how well an organization is managed at the highest level.

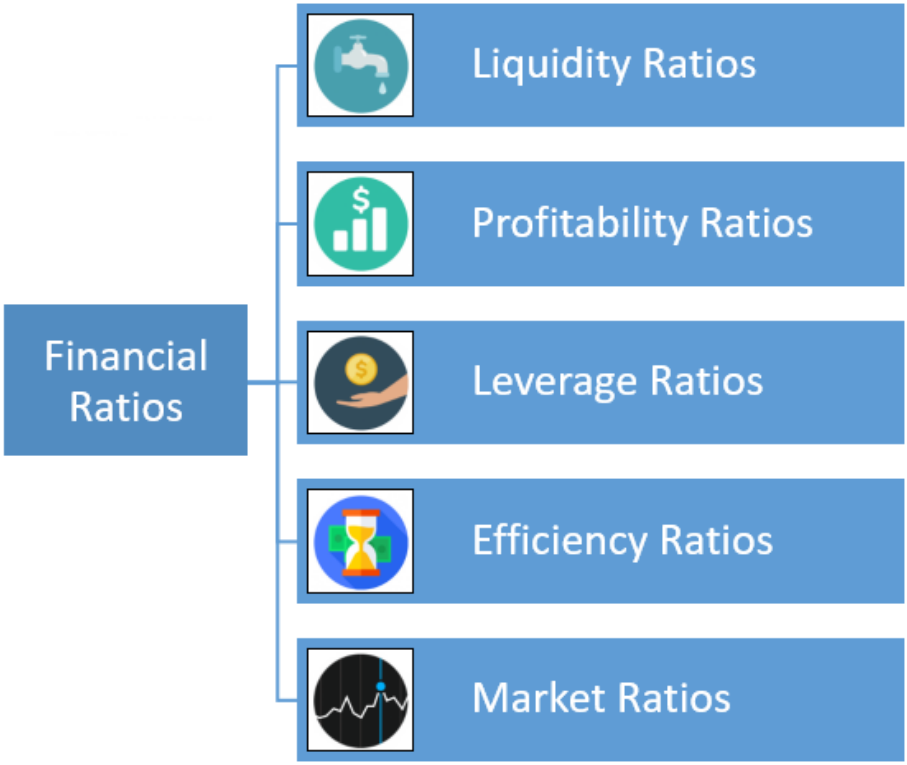
A key financial ratio is calculated by comparing certain values taken from an organization's **financial statements**, including the income statement,

balance sheet, and cash flow statement. Before you can fully understand financial ratios you must have a clear and accurate appreciation of how each of these statements is derived and what it can tell you. If you are not already familiar with these statements we recommend to run our "**Accounting Principles**" course first.

# 2. Types of Financial Ratios

**Ratio analysis** is a tool that was developed to perform quantitative analysis on numbers found on financial statements. Ratios help link different financial statements together and offer figures that are comparable between companies and across industries and sectors.

Ratio analysis is one of the most widely used fundamental analysis techniques. Generally speaking, these ratios can be grouped into five different categories. In the following chapters, we will discuss each ratio in detail:




- **Liquidity Ratios** measure a company's ability to pay off its short-term debt obligations
- **Profitability Ratios** show a company's ability to generate profits from its operations

- **Solvency Ratios** quantify the firm's ability to repay long-term debt
- **Efficiency Ratios** measure the effectiveness of the firm's use of resources
- **Market Ratios** estimate the attractiveness of a potential or existing investment

Financial ratios are not useful unless they are **benchmarked** against something else, for example past performance or another organization in the same business area. Whilst you can compare the ratios of organizations in different industries, this is usually of limited value because of differences in market conditions, capital requirements, and competition. However, comparing ratios for potential suppliers, partners, acquisitions, or competitors can provide you with useful data to help with decision making.

Key financial ratios allow for useful comparisons between:

- Organizations in the same industry sector
- Different time periods for the same organization
- An organization and its industry average

# 3. Liquidity

**Liquidity Ratios** evaluate a firm's ability to meet its short-term financial obligations. If it does not have enough short-term assets to cover short-term obligations, or if it does not generate enough cash flow to cover costs, it may face problems. Here are the two most common liquidity ratios:

## Current Ratio

The **Current Ratio** measures a firm's ability to pay off its short-term liabilities with its current assets. The current ratio is an important

measure of liquidity because short-term liabilities are due within the next year.

This means that a company has a limited amount of time in order to raise the funds to pay for these liabilities. Current assets like cash, cash equivalents, and marketable securities can easily be converted into cash in the short term. This means that companies with larger amounts of current assets will more easily be able to pay off current liabilities when they become due without having to sell off long-term, revenue-generating assets.

The current ratio is calculated by dividing current assets by current liabilities:

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

The current ratio helps investors and creditors understand the liquidity of a company and how easily that company will be able to pay off its current liabilities. This ratio expresses a firm's current debt in terms of current assets. So a current ratio of 4 would mean that the company has 4 times more current assets than current liabilities.

A higher current ratio is always more favorable than a lower current ratio because it shows the company can more easily make current debt payments.

**Example:**

Alberto's Pizzeria is applying for loans to build a large terrace. Alberto's bank asks for the balance sheet so they can analysis the pizzeria's current debt levels. According to Alberto's balance sheet, the pizzeria reported $100,000 of current liabilities and only $25,000 of current assets. Alberto's current ratio would be calculated like this:

$25,000 / $100,000 = 0.25

As you can see, the pizzeria only has enough current assets to pay off 25 percent of its current liabilities. This shows that Alberto's Pizzeria is highly leveraged and highly risky. Banks would prefer a current ratio of at

least 1 or 2, so that all the current liabilities would be covered by the current assets. Since the pizzeria's ratio is so low, it is unlikely that it will get approved for the loan.

# Quick Ratio

The **Quick Ratio** or Acid Test Ratio measures the ability of a company to pay its current liabilities when they come due with only quick assets. Quick assets are current assets that can be converted to cash within 90 days or in the short-term. Cash, cash equivalents, short-term investments or marketable securities, and current accounts receivable are considered **quick assets**.

The acid test of finance shows how well a company can quickly convert its assets into cash in order to pay off its current liabilities. It also shows the level of quick assets to current liabilities.

The quick ratio is calculated by dividing quick assets (cash, cash equivalents, short-term investments, and current receivables) by current liabilities:

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

Higher quick ratios are more favorable for companies because it shows there are more quick assets than current liabilities. A company with a quick ratio of 1 indicates that quick assets equal current assets. This also shows that the company could pay off its current liabilities without selling any long-term assets. An acid ratio of 2 shows that the company has twice as many quick assets than current liabilities.

Obviously, as the ratio increases so does the liquidity of the company. More assets will be easily converted into cash if need be. This is a good sign for investors, but an even better sign to creditors because creditors want to know they will be paid back on time.

**Example:**

Let's assume Jim's Clothing Store is applying for a loan to remodel the storefront. The bank asks Jim for a detailed balance sheet, so it can compute the quick ratio. Jim's balance sheet included cash of $10,000, accounts receivable of $5,000, stock investments of $1,000, and current liabilities of $15,000.

The bank can compute Jim's quick ratio like this:

($10,000 + $5,000 + $1,000) / $15,000 = 1.07

As you can see Jim's quick ratio is 1.07. This means that Jim can pay off all of his current liabilities with quick assets and still have some quick assets left over.

# 4. Profitability

**Profitability Ratios** are financial metrics that are used to assess a business's ability to generate profit. Profitability ratios focus on a company's return on investment in inventory and other assets. Here are four of the key ratios that investors consider when judging how profitable a company should be:

# Profit Margin

The **Profit Margin Ratio**, also called the Return on Sales Ratio, compares the earnings reported by a business to its sales. It is a key indicator of the financial health of an organization.

Creditors and investors use this ratio to measure how well a company can convert sales into net income. Investors want to make sure profits are high enough to distribute dividends while creditors want to make sure the company has enough profits to pay back its loans. An extremely low-

profit margin formula would indicate the expenses are too high and the management needs to budget and cut expenses.

The profit margin ratio formula can be calculated by dividing net income by net sales:

$$\text{Profit Margin Ratio} = \frac{\text{Net Income}}{\text{Net Sales}}$$

The profit margin ratio directly measures what percentage of sales is made up of net income. In other words, it measures how much profits are produced at a certain level of sales.

This ratio also indirectly measures how well a company manages its expenses relative to its net sales. That is why companies strive to achieve higher ratios. They can do this by either generating more revenues why keeping expenses constant or keep revenues constant and lower expenses. Since most of the time generating additional revenues is much more difficult than cutting expenses, managers generally tend to reduce spending budgets to improve their profit ratio.

**Example:**

Peter's Fishing Shop is an outdoor fishing store that selling lures and other fishing gear to the public. Last year Peter had the best year in sales he has ever had since she opened the business 10 years ago. Last year Peter's net sales were $1,000,000 and his net income was $100,000.

Here is Peter's Profit Margin Ratio:

$100,000 / $1,000,000 = 10%

As you can see, Peter only converted 10 percent of his sales into profits. Contrast that with this year's numbers of $800,000 of net sales and $200,000 of net income:

$200,000 / $800,000 = 25%

This year Peter may have made fewer sales, but he cut expenses and was able to convert more of these sales into profits with a ratio of 25 percent.

# Return on Assets (ROA)

The **Return on Assets Ratio (ROA)** compares the net earnings of a business to its total assets. In other words, the Return on Assets Ratio measures how well a company can manage its assets to produce profits during a period.

Since company assets' sole purpose is to generate revenues and produce profits, this ratio helps both management and investors see how well the company can convert its investments in assets into profits. In short, this ratio measures how profitable a company's assets are.

The return on assets ratio formula is calculated by dividing net income by average total assets:

$$\text{Return on Assets Ratio} = \frac{\text{Net Profit}}{\text{Total Assets}}$$

The return on assets ratio measures how effectively a company can earn a return on its investment in assets. In other words, ROA shows how efficiently a company can convert the money used to purchase assets into net income or profits.

A positive ROA ratio usually indicates an upward profit trend as well. ROA is most useful for comparing companies in the same industry as different industries use assets differently. For instance, construction companies use large, expensive equipment while software companies use computers and servers.

**Example:**

Charlie's Construction Company is a growing construction business that has a few contracts to build storefronts in downtown Chicago. Charlie's balance sheet shows total assets of $200,000. During the current year, Charlie's company had a net income of $2,000,000. Charlie's return on assets ratio looks like this:

$200,000 / $2,000,000 = 10%

As you can see, Charlie's ratio is 10 percent. In other words, every dollar that Charlie invested in assets during the year produced $10 of net income. Depending on the economy, this can be a healthy return rate no matter what the investment is.

Investors would have to compare Charlie's return with other construction companies in his industry to get a true understanding of how well Charlie is managing his assets.

# Return on Equity (ROE)

The **Return on Equity Ratio (ROE)** measures the ability of a firm to generate profits from its shareholders' investments in the company. In other words, the return on equity ratio shows how much profit each dollar of common stockholders' equity generates.

This is an important measurement for potential investors because they want to see how efficiently a company will use its money to generate net income. ROE is also an indicator of how well management is at using equity financing to fund operations and grow the company.

To calculate the return on equity, simply divide net income by shareholder's equity. The formula is:

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

ROE is a profitability ratio from the investor's point of view—not the company. In other words, this ratio calculates how much money is made based on the investors' investment in the company, not the company's investment in assets or something else.

That being said, investors want to see a high return on equity ratio because this indicates that the company is using its investors' funds

effectively. Higher ratios are almost always better than lower ratios but have to be compared to other companies' ratios in the industry. Since every industry has different levels of investors and income, ROE can't be used to compare companies outside of their industries very effectively.

Many investors also choose to calculate the return on equity at the beginning of a period and the end of a period to see the change in return. This helps track a company's progress and ability to maintain a positive earnings trend.

**Example:**

Toms Tool Company is a retail store that sells tools to construction companies across the country. Tom reported net income of $100,000. Tom also had $50,000 common shares outstanding during the year. Tom would calculate her return on common equity like this:

$100,000 / $50,000 = 2

As you can see, Tom's ROE is 2. This means that every dollar of common shareholder's equity earned about $2 this year. In other words, shareholders saw a 200 percent return on their investment. Tom's ratio is most likely considered high for his industry. An average of 5 to 10 years of ROE ratios will give investors a better picture of the growth of this company.

# Return on Investment (ROI)

Return on investment (ROI) calculates the profits of an investment as a percentage of the original cost. In other words, it measures how much money was made on the investment as a percentage of the purchase price. It shows investors how efficiently each dollar invested in a project is at producing a profit.

The ROI calculation is one of the most common investment ratios because it's simple and extremely versatile. Managers can use it to compare performance rates on capital equipment purchases while investors can calculate what stock purchases performed better.

The return on investment formula is calculated by subtracting the cost from the total income and dividing it by the total cost:

$$\text{Return on Investment} = \frac{(\text{Investment Revenue - Investment Cost})}{\text{Investment Cost}}$$

Generally, any positive ROI is considered a good return. This means that the total cost of the investment was recouped in addition to some profits left over. A negative return on investment means that the revenues weren't even enough to cover the total costs. That being said, higher return rates are always better than lower return rates.

**Example:**

Let's look at Richard's Brokerage House for example. Richard is a stockbroker who specializes in penny stocks. Richard made a somewhat risky investment in a liquid metals stock last year when he purchased 8,000 shares at $1 per share. Today, a year later, the fair market value per share is $3.50. Richard sells the share and uses an ROI calculator to measure his performance.

($28,000 – $8,000) / $8,000 = 2.5

As you can see, Richard's return on investment is 2.5. This means that Richard made $2.50 for every dollar that he invested in the liquid metals company. This investment was extremely efficient because it increased by 250%.

# 5. Leverage

**Leverage Ratios**, also called Solvency Ratios or Debt Ratios, measure a company's ability to sustain operations indefinitely by comparing debt levels with equity, assets, and earnings. Leverage ratios focus more on the long-term sustainability of a company. The two most important solvency ratios are:

# Debt Ratio

The **Debt Ratio** measures the proportion of assets paid for with debt. One can use the ratio to reach conclusions about the solvency of a business. A high ratio implies that the bulk of company financing is coming from debt; this is a risky financial structure since the borrower is at risk of not being able to pay for the associated interest expense or paying back the principal. A low debt ratio reflects a conservative financing strategy of using only equity to pay for assets.

The debt ratio is calculated as total liabilities divided by total assets. The formula is:

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Lenders and creditors use the debt ratio to estimate the amount of lending risk they will incur by extending credit to an organization. They are more likely to lend when the debt ratio is closer to 0% than when the ratio is closer to 100% (or more).

**Example:**

Jim's Guitar Shop is thinking about building an addition onto the back of its existing building for more storage. Jim consults with his banker about applying for a new loan. The bank asks for Jim's balance to examine his overall debt levels. The banker discovers that Jim has total assets of $100,000 and total liabilities of $25,000. Jim's debt ratio would be calculated like this:

$25,000 / $100,000 = 0.25

As you can see, Jim only has a debt ratio of 0.25. In other words, Jim has 4 times as many assets as he has liabilities. This is a relatively low ratio and implies that Jim will be able to pay back his loan. Jim shouldn't have a problem getting approved for his loan.

# Debt to Equity Ratio

The **Debt to Equity Ratio** compares a company's total liabilities to total equity. It shows the percentage of company financing that comes from creditors and investors. A higher debt to equity ratio indicates that more creditor financing (bank loans) is used than investor financing (shareholders).

The debt to equity ratio is calculated by dividing total liabilities by total equity:

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Each industry has a different debt to equity ratio benchmarks, as some industries tend to use more debt financing than others. A debt ratio of 0.5 means that there are half as many liabilities than there is equity. In other words, the assets of the company are funded 2-to-1 by investors to creditors. A debt to equity ratio of 1 would mean that investors and creditors have an equal stake in the business assets.

A lower debt to equity ratio usually implies a more financially stable business. Companies with a higher debt to equity ratio are considered riskier to creditors and investors than companies with a lower ratio. Unlike equity financing, a debt must be repaid to the lender. Since debt financing also requires debt servicing or regular interest payments, debt can be a far more expensive form of financing than equity financing. Companies leveraging large amounts of debt might not be able to make the payments.

**Example:**

Assume a company has $300,000 of bank lines of credit. The shareholders of the company have invested $1.2 million. Here is how you calculate the debt to equity ratio:

$300,000 / $1,200,000 = 0.25

Creditors view a higher debt to equity ratio as risky because it shows that the investors haven't funded the operations as much as creditors have. This could mean that investors don't want to fund business operations because the company isn't performing well.

# 6. Efficiency

**Efficiency Ratios**, also called Activity Ratios, measure how well companies use their assets to generate income. Efficiency ratios often look at the time it takes companies to collect cash from clients or the time it takes companies to convert inventory into cash. Here are the two most common efficiency ratios:

## Asset Turnover Ratio

The **Asset Turnover Ratio** compares the sales of a business to the book value of its assets. In other words, this ratio shows how efficiently a company can use its assets to generate sales. A high turnover level indicates that an entity uses a minimal amount of working capital and fixed assets in its daily operations.

The asset turnover ratio gives investors and creditors an idea of how a company is managed and uses its assets to produce products and sales.

To calculate the asset turnover ratio, divide sales by total average assets:

$$\text{Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Total Average Assets}}$$

This ratio measures how efficiently a firm uses its assets to generate sales, so a higher ratio is always more favorable. Higher turnover ratios mean the company is using its assets more efficiently. Lower ratios mean that the company isn’t using its assets efficiently and most likely have management or production problems.

For instance, a ratio of 1 means that the net sales of a company equal the average total assets for the year. In other words, the company is generating 1 dollar of sales for every dollar invested in assets.

Like with most ratios, the asset turnover ratio is based on industry standards. Some industries use assets more efficiently than others. To get a true sense of how well a company's assets are being used, it must be compared to other companies in its industry.

**Example:**

Sally's Tech Company is a tech start-up company that manufactures a new tablet computer. Sally is currently looking for new investors and has a meeting with an angel investor. The investor wants to know how well Sally uses her assets to produce sales, so he asks for her financial statements. The financial statements reports sales of $20,000 and total average assets of $80,000.

The total asset turnover ratio is calculated like this:

$$\$20,000 / \$80,000 = 0.25$$

As you can see, Sally's ratio is only 0.25. This means that for every dollar in assets, Sally only generates 25 cents. In other words, Sally's start-up in not very efficient with its use of assets.

# Inventory Turnover Ratio

The **Inventory Turnover Ratio** shows how effectively inventory is managed by comparing the cost of goods sold with the average inventory for a period. This measures how many times the average inventory is "turned" or sold during a period. In other words, it measures how many times a company sold its total average inventory dollar amount during the year. A company with $1,000 of average inventory and sales of $10,000 effectively sold its 10 times over.

To calculate inventory turnover, divide the ending inventory figure into the annualized cost of sales:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Inventory}}$$

When there is a low rate of inventory turnover, this implies that a business may have a flawed purchasing system that bought too many goods, or that stocks were increased in anticipation of sales that did not occur. In both cases, there is a high risk of inventory aging, in which case it becomes obsolete and has little residual value.

When there is a high rate of inventory turnover, this implies that the purchasing function is tightly managed. However, it may mean that a business does not have the cash reserves to maintain normal inventory levels, and so is turning away prospective sales. The latter scenario is most likely when the amount of debt is unusually high and there are few cash reserves.

**Example:**

Donny's Furniture Company sells industrial furniture for office buildings. During the current year, Donny reported cost of goods sold on its income statement of $1,000,000. Donny's inventory was $4,000,000. Donny's turnover is calculated like this:

$1,000,000 / $4,000,000 = 0.25

As you can see, Donny's turnover is 0.25. This means that Donny only sold a quarter of its inventory during the year. It also implies that it would take Donny approximately 4 years to sell his entire inventory or complete one turn. In other words, Donny does not have very good inventory control.

# 7. Market

**Market Ratios** are used to analyze stock price trends and help figure out a stock's current and future market value. In other words, market ratios show what investors should expect to receive from their investment. Here are the most important market ratios that investors tend to analyze:

# Earnings per Share (EPS)

The **Earnings per Share Ratio** (EPS Ratio) measures the amount of a company's net income that is theoretically available for payment to the holders of its common stock. A company with a high earnings per share ratio is capable of generating a significant dividend for investors, or it may plow the funds back into its business for more growth; in either case, a high ratio indicates a potentially worthwhile investment, depending on the market price of the stock.

To calculate the ratio, subtract any dividend payments due to the holders of preferred stock from net income, and divide by the average number of common shares outstanding during the measurement period. The calculation is:

$$\text{Earnings per Share} = \frac{(\text{Net Income} - \text{Preferred Dividends})}{\text{Number of Common Shares Outstanding}}$$

It is very worthwhile to track a company's earnings per share ratio on a trend line. If the trend is positive, then the company is either generating an increasing amount of earnings or buying back its stock. Conversely, a declining trend can signal to investors that a company is in trouble, which can lead to a decline in the stock price.

**Example:**

ABC Company has a net income of $1,000,000 and also must pay out $200,000 in preferred dividends. It has both bought back and sold its own stock during the measurement period; the weighted average number of common shares outstanding during the period was 400,000 shares. ABC's earnings per share ratio is:

($1,000,000 – $200,000) / 400,000 = $2.00 per share

As you can see, the EPS for the year is $2. This means that if ABC Company distributed every dollar of income to its shareholders, each share would receive 2 dollars.

# Price to Earnings Ratio

The **Price to Earnings Ratio (P/E Ratio)** calculates the market value of a stock relative to its earnings by comparing the market price per share by the earnings per share. In other words, the price-earnings ratio shows what the market is willing to pay for a stock based on its current earnings.

The P/E Ratio helps investors analyze how much they should pay for a stock based on its current earnings. Companies with higher future earnings are usually expected to issue higher dividends or have appreciating stock in the future.

The price-earnings ratio formula is calculated by dividing the market value price per share by the earnings per share:

$$\text{Price to Earnings Ratio} = \frac{\text{Current Market Price per Share}}{\text{Earnings per Share}}$$

A company with a high P/E ratio usually indicated positive future performance and investors are willing to pay more for this company's shares. A company with a lower ratio, on the other hand, is usually an indication of poor current and future performance.

**Example:**

The Island Corporation stock is currently trading at $50 a share and its earnings per share for the year is 5 dollars. Island's P/E ratio would be calculated like this:

$50 / $5 = 10

As you can see, the Island's ratio is 10. This means that investors are willing to pay 10 dollars for every dollar of earnings.

# Dividend Yield

The **Dividend Yield Ratio** shows the number of dividends that a company pays to its investors in comparison to the market price of its stock. Thus, the dividend yield ratio is the return on investment to an investor if the investor were to have bought the stock at the market price on the measurement date.

To calculate the ratio, divide the annual dividends paid per share of stock by the market price of the stock at the end of the measurement period. The basic calculation is:

$$\text{Dividend Yield Ratio} = \frac{\text{Cash Dividends per Share}}{\text{Market Value per Share}}$$

Investors use the dividend yield formula to compute the cash flow they are getting from their investment in stocks. In other words, investors want to know how much dividends they are getting for every dollar that the stock is worth.

A company with a high dividend yield pays its investors a large dividend compared to the fair market value of the stock. This means the investors are getting highly compensated for their investments compared with lower dividend-yielding stocks.

**Example:**

Stacy's Bakery is an upscale bakery that sells cupcakes and baked goods in Beverly Hills. Stacy's is listed on a smaller stock exchange and the current market price per share is $15. As of last year, Stacy paid $15,000 in dividends with 1,000 shares outstanding. Stacy's yield is computed like this:

$15 / $15 = 1

As you can see, Stacy's yield is one dollar. This means that Stacy's investors receive 1 dollar in dividends for every dollar they have invested in the company. In other words, the investors are getting a 100 percent return on their investment every year Stacy maintains this dividend level.

# 8. Conclusion

The more you know about how an organization is performing financially, the easier it will be for you to make informed management decisions about it. Financial ratios can be a great tool in your analysis toolbox as a manager or investor to evaluate the strength, profitability, and quality of a business.

Key financial ratios can help you to find out:

- Is an organization solvent?
- Is it profitable?
- How well is it managed?

Making a simple financial assessment of another organization is straightforward and the necessary information is readily available. This means that you can compare the performance of the organization with its previous track record and with the performance of other similar organizations. You can also make comparisons to see how profitable the business is, how efficiently it is performing, and whether it is able to pay its bills on time.

This ability to evaluate the financial position of another organization is a valuable skill for any manager to have, whether you are choosing a supplier, considering a strategic partnership, or deciding how much credit to extend to a customer.

Remember, the ability to communicate in the language of finance becomes more of an asset the higher you progress up through the levels of management, even if accounting and finance is not your specialty.

**Human Resource Management**

# 1. Introduction

**Welcome to Human Resource Management!**
Recruiting, selecting, hiring, and retaining competent employees as well as implementing the right internal structures and processes have always been essential for every organization.

In this course, we will dive into the exciting fields of human resource management and organizational behavior.

**Human Resource Management (HRM)** includes all management decisions that affect people within an organization. Today, in a business world shaped by globalization and technological revolutions, this task may be more important than ever before: businesses, human resource departments, and managers have to react to those changes and must offer flexible strategies. It is important to understand that all management decisions have impacts on human resource management and therefore HRM should be linked to all organizational processes.

**Organizational behavior (OB)** is the study of how individuals and groups perform together within an organization. OB focuses on the best way to manage individuals, groups, and organizations. Organizational behavior includes management theories and practices of motivation, and the fundamentals of organizational structure and design. Knowledge about organizational behavior can provide managers with a better understanding of how their company can make its processes more effective and efficient, thus allowing the firm or organization to successfully adapt to changing circumstances.

From the smallest nonprofit to the largest multinational firm, all organizations have to manage human resources and organizational behavior.

# 2. Human Resource Planning

Managers and organizations have to develop a plan for how human resources will be needed to meet short- and long-term goals. If, for example, a company decides to open a new store, the human resource component is an essential part of the strategic planning.

# Staffing Plan

**Human resources planning** starts by conducting an analysis of staffing needs. This could mean either assessing the current staffing requirements or projecting future requirements. In either situation there are several questions that need to be answered:

- What is the organization's vision and what are the short-term and long-term goals?
- Can any major changes in the market impact the organization's future?
- What changes in staffing, if any, are needed to support the overall vision?

A **staffing plan** involves evaluating the human capacity needed to meet the needs of the organization and estimating the number of people needed for each unit. This process does require a lot of experience and understanding of the specific business.

If the managers are new to the company, a good benchmark would be comparing the number of employees needed in similar organizations or gathering some sort of useful statistics. Here are some signs that the current staffing needs are not well planned:

- Regular breakdowns in the process flow (like missed deadlines, increased returns, decreased customer loyalty, and regular administration mistakes)
- Frequent employee absenteeism and turnover caused by employees being over-stressed or having poor morale

- Regularly occurring overtime caused by employees being overworked. Overworking employees can lead to burnouts and increased costs in the long run.

Staff planning is a systematic process to ensure that an organization has the right number of people with the right skills to fulfill its business needs.

# Job Descriptions

Once a staffing plan is developed, **job descriptions** can be created. This process involves analyzing each job in the organization in order to generate job specifications, and then these are aggregated at a firm-wide level. Some thought should be put into them due to the nature of employees using job descriptions to define their actions.

The **job analysis** involves collecting information to form a complete understanding of what is necessary to perform the job. A job description lists the activities that the employee performs, as well as the skills and qualities that are needed to successfully meet the job objectives. Think of this stage of human resources planning as if you were a newly appointed sports coach. Firstly, you would identify the positions you would need to complete the roster, secondly, the qualities you would like for each player, specific to each position.

Once the job analysis and job descriptions are determined, this information can then be aggregated to form a human resource inventory to track what skills and capabilities need to be filled in to complete the human resources requirements. When completed correctly, job descriptions can be a very important tool and can be used in many different functions, including:

- Giving employees a gauge of how they will be evaluated within the organization.
- Helping determine the compensation level for individual positions.
- Establishing hiring criteria for specific positions, and giving candidates responsibility expectations.

A typical outline of a job description includes:

**1. Job Title**

Specific title that would be included in an organizational chart

**2. Overall Description**

A brief description of the responsibilities

**3. Reporting To**

List of person(s) to whom this position reports

**4. Duties**

A list of regular duties this position would be expected to perform

**5. Requirements:**

A list of mandatory or preferred requirements for the position

**6. Criteria:**

Specific skills, experience, and knowledge

A job description is an internal document that clearly states the essential job requirements, duties, responsibilities, and skills required to perform a specific role. A more detailed job description might even cover how success is measured in the role so it can be used during performance evaluations.

# 3. Recruitment and Selection

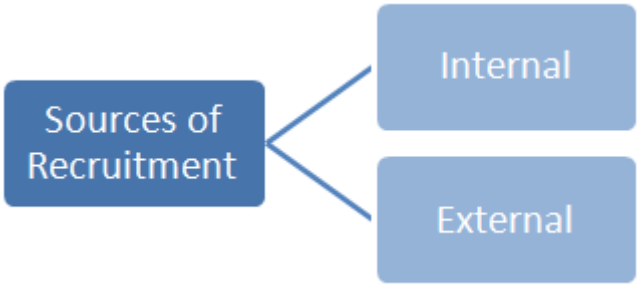
Once the planning part of the process is completed, the organization will set forth to implement this plan through the next set of human resource concepts and tactics: recruitment, selection, appraisal, rewards, as well as employee training and development.

# Recruitment

**Recruitment** is the process by which companies attract candidates to fill present and future positions, and the appropriate method varies from company to company. In most cases, the human resources department in the company will work together with managers in departments throughout the company to determine a recruitment method and approach.

Many recruitment methods are available, including Internet and print advertisements, employee referrals, and outsourced agencies ("headhunter" executive placement firms, job placement agencies, etc.) that perform recruitment services for the company, either on a fixed-fee arrangement, much like a consulting relationship, or on a performance-based basis where the fee is a percentage of the employee's salary. In some cases, the employee will pay the fees associated with such outsourced services, but more often the company will pay these fees. Other recruitment tactics include job fairs and college recruiting and might involve a combination of several methods.

There are **two ways** to fill a vacant position: by internal or external recruitment.




Hiring from within the organization (**internally**) allows the manager to choose from a known pool of talent and can minimize misperceptions among candidates about the actual requirements of the position. In addition, hiring from within can be cost-effective and provide motivation for existing employees.

Generally, it is advisable to look outside the company (**externally**) when specific skills are required for the position and existing employees may not be reasonably expected to train for or learn these skills. The decision to look outside the company tends to be more appropriate when there is

a specific need to fill, such as technical requirements. Hiring from outside also helps to avoid the ripple effect of frequent internal staffing changes and the employee “musical chairs” syndrome that does not give staff time to mature into their respective jobs.

Finally, recruiting outside the company can be an effective way to import experience and creativity or new ways of doing things. This infusion of outsider perspectives and approaches can infuse the company with a fresh look at its processes and systems.

# Selection

The recruitment process will result in a pool of candidates from which the organization has to select the right employee. This usually involves a combination of different **selection methods**.

Interviews and reference checks are the most commonly used, but other methods are available depending on the specific demands of the position. For example, background checks are appropriate when a position requires that the employee has significant customer interaction or if the prospective employee has a fiduciary responsibility with the company.

Other selection methods include:

- **Skill performance tests/work samples** – for example, a graphic artist may bring in a portfolio of past projects, or a data entry candidate may be given a simulated work assignment.
- **Personality tests** – used especially in customer contact recruitment and selection (e.g., salespersons and customer service candidates).

- **Physical abilities tests** – used in many job requirements where the physical condition is an essential element in job productivity or success (e.g., a product installation or delivery job).
- **Drug tests** – an increasingly used tool to ensure the selection of candidates who do not involve themselves in chemical or substance dependency.

Face-to-face interviews can be extremely revealing but must be well prepared. The goal of an interview should be to learn whether the candidate has the competencies and technical skills that are most critical to the job, and questions should be prepared for each area.

The interviewer's questions should focus on behaviors, not opinions, and may involve asking applicants to provide examples from their past experiences. Interviews provide an opportunity to read body language and the applicants' ability to "think on their feet," often replicating the realities of life on the job. Additionally, to ensure good fit with the culture of the company, an initial interview is often followed up by several more representing the other employees with whom the potential hire may work, as well as company representatives at different levels and areas within the company. An important step in the interview process is to check on a prospective employee's past performances by making inquiries to former employers and references.

Four rules for more effective reference checks are:

- Ask the applicant to inform prior employers that you intend to contact them. Former managers are much more likely to provide useful information if they are aware beforehand that they will be contacted.
- Open the call by describing the corporate culture of the organization. This provides some context for the previous employer's comments on the previous employee.
- Reassure the previous employers that the information they provide will not determine the final hiring decision, but that your goal is to learn more about the prospective hire.
- Save formal questions such as dates of employment and title until the end of the call.

# Outsourcing

In the past decade, the use of "**employee leasing**" and temporary, or project-based, **outsourcing** of human resource needs has become more prevalent. In this scenario, the company contracts with another company that provides the employees for a specific need or project.

The contracted worker is an employee of the provider company, with the provider company responsible for payroll, employee taxes, benefits, and other employee-related expenses. The company hiring these contract employees is thus free of the associated bookkeeping and administrative costs of maintaining these employees on its payroll – it makes a single payment to the company from which it is leasing the employees, rather than paying the workers individually.

The upsides and downsides of outsourcing include:

| Pros | Cons |
|---|---|
| • Reduced operating costs<br>• Reduced work training costs<br>• Main sight on the business goals | • Employees feel intimidated<br>• Security problems<br>• Loss of management and control |

These leasing or outsourcing arrangements are attractive to new or emerging companies or mature companies that may be experiencing an unusual spike in demand, or some other kind of nonrecurring event, presenting a solution for a company that needs to modify its workforce capacity with some upside or downside flexibility.

Outsourcing is an agreement in which one company contracts-out a part of their existing internal activity to another company.

# 4. Training and Development

It is one thing to be able to recruit and hire good employees, but to help them attain their full potential and to support them to become better is just as or even more important. That's why training and developing employees is so vital for any organization today.

# Orientation

Training should begin on day one of employment, with every employee given an **orientation**. Getting employees off to the right start is a very easy way to build a company that embraces learning and development. Most small companies do not have formal orientation programs but rely on individuals finding their way when they first get hired. This seems to work fine in smaller organizations when there are more informal means of communication, but as organizations grow, most have found that formal orientation programs are necessary to get employees up to speed and productive in a timely fashion.

Formal orientation programs can range from an hour to several days, and the level of orientation usually depends on the level of the positions. Whereas entry-level or unskilled labor will need very little orientation, experienced professionals will need quite a bit more to get up to speed with the organization. Each organization needs to define its own orientation needs and programs. Assigning mentors is often done in place of an orientation program to give new employees a helping hand during the first few weeks on the job.

At a minimum for small or large organizations, orientation programs should include:

- Detailed company history and overview of the current structure and products.
- Overview of employment policies and handbook (if applicable).
- Basics of compensation, benefits, and all other legal issues that arise.
- Health and safety issues.

- Information about business systems such as phone, e-mail, voice mail, and office equipment.
- Employee rewards and incentives.

Onboarding new hires at an organization should be a strategic process. How employers handle the first few days and weeks of a new employee's experience is crucial to ensuring high retention.

# Skill Training

What are the main benefits of employee development and training? In general, training…

- increases the value and capacity of the human assets of the company,
- provides an alternative to recruiting, by having qualified personnel to fill vacant positions,
- creates potential future leaders of the company, and
- helps reducing employee turnover by keeping individuals motivated and interested in their positions with the possibility of advancement.

**Skill training** is exactly what it says – training employees on new skill sets. This could take many forms, including training on new software, customer service techniques, or even team-building exercises. Skill training has **two main goals**:

- to maintain employees' current skill level with ever-advancing technology and business practices, and
- to give employees the necessary skills to advance through the organization.

Every organization is going to have a unique set of skills required of its employees. Of course, many general skills transfer from organization to organization very easily, but the scope of skills is usually unique for every organization. Prior to implementing training, organizations need to follow a few **basic steps**:

- Conduct complete skill assessments, involve all levels of employees, develop core skill competencies for each position, and assess current gaps in the skill set.
- Choose the training source. Whether you choose outside consultants, assign internal trainers, or devise online training, the source has to be effective for the given skill set.
- Align training with the broad goals and objectives of the organization. This will help employees see the importance and be more likely to jump on board with the training.
- Conduct training during work hours (this will help keep a positive attitude toward the training) and in suitable facilities.
- Plan for feedback and assessment of all training programs.

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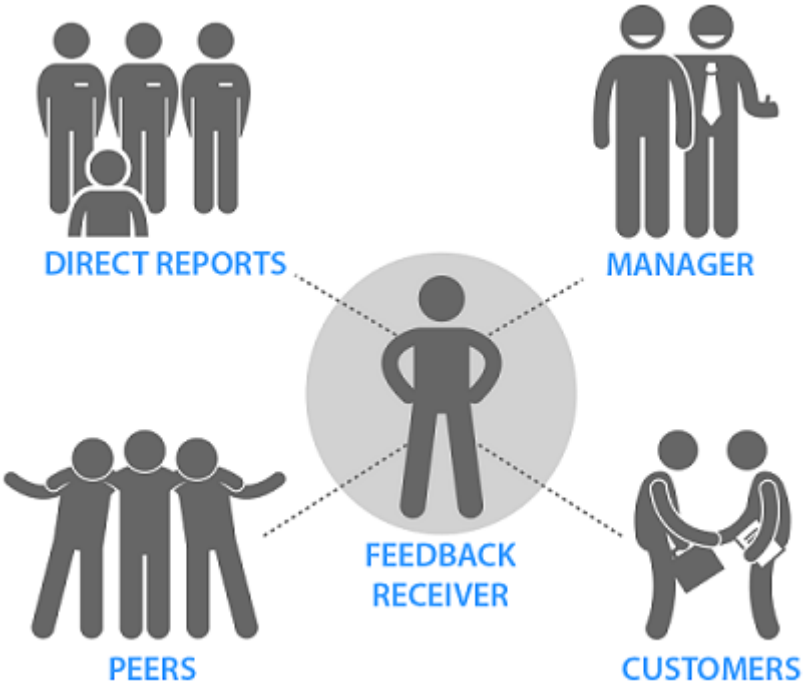
# 5. 360-Degree Assessment


The **360-degree assessment** (also known as 360-degree feedback) is a method of systematically collecting opinions about an individual's performance from a wide range of coworkers. This could include peers, direct reports, the boss, the boss's peers, or people outside the organization.

# Purpose

The 360-degree assessment is a commonly used tool in organizations as a way of giving and receiving feedback at all levels within the organization. Simply put, a 360-degree assessment is a system used to gather **input on individual employees' performance**, not only from

managers and supervisors but from coworkers and from direct reports as well. Some companies also involve customers in a 360-degree assessment, especially in the case of customer-contact personnel.




More traditional feedback tools, in which only the direct manager provides feedback, can very easily lead to a one-sided and incomplete employee review. The 360-degree assessment is much more likely to provide an accurate review and assessment of an employee's performance.

Almost all large companies today use a form of the 360-degree assessment for their employees; sometimes it takes on a different name, such as full-circle or multi-source assessment. Here's how it works.

Typically all employees are given the opportunity to rate and give comments on all employees they work with on a regular basis, including managers, peers, and subordinates. Each assessment includes several different categories for employee assessment – for example, leadership, performance management, communication, teamwork, integrity, quality, problem-solving, vision, trust, adaptability, and reliability. Each organization develops the assessment criteria based on what it feels is important.

Once the assessment is complete, employees have the opportunity to view how their coworkers assessed their performance, and managers get to see how they are generally viewed by their subordinates.

Dell, the U.S.-based computer manufacturer, has used 360-degree assessment, and the results have led to substantial management policy changes, including forcing upper management to be more in touch with the daily operations and allowing for routine opportunities for management to interact with subordinates.
Implementing the 360-degree assessment can sometimes be very difficult and can cause more harm than good if management is not careful. Giving feedback has to be done with caution given the sensitive nature of the data and the possible defensiveness of the employees who receive it. Some employees will not be comfortable giving frank feedback to their peers.

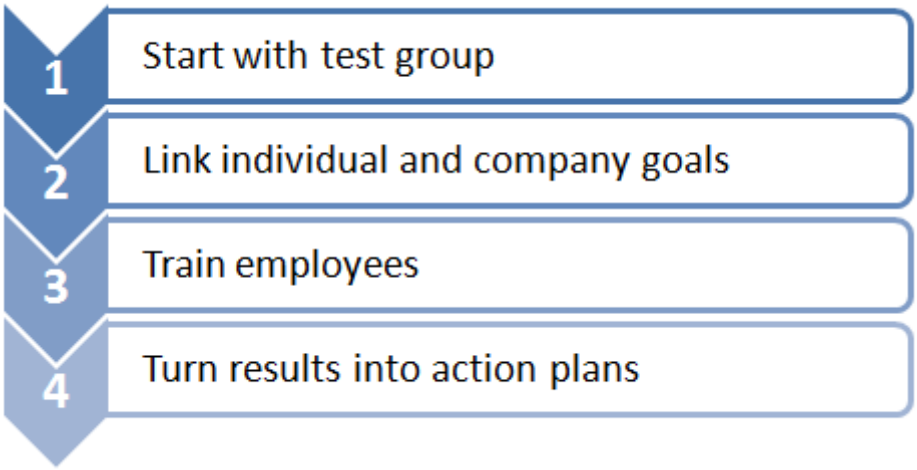
An organization needs to have a very high level of trust among the employees for this assessment to work effectively. If the level of trust is not established prior to the 360-degree evaluation, human tendencies such as protectiveness, revenge, and development of hierarchies take precedence and will skew the results, creating even more distrust within the ranks. If this trust level cannot be established, the 360-degree evaluation should be postponed to a later date.

The 360-degree assessment is a feedback process where not just your superior but your peers and direct reports and sometimes even customers evaluate you.

# Implementation

If a 360-degree evaluation has not been used previously in the organization, it is wise to introduce it as an internal program for personal improvement, not for management decisions. This will take the pressure off employees and allow for a more relaxed atmosphere during the process.

Many large companies have the 360-degree assessment in place for more than a year before they are able to see any benefits from the program and use it to make decisions. Employees need to feel comfortable with the system before they will actually use it as a learning tool. This can be achieved by following this 4-step-plan:




**1: Start out with a test group**
When first implementing the 360-degree evaluation, start out with one department or a small group of employees. The time and resources needed for a company-wide implementation could end up being substantial. Starting with a test group will provide insight on issues and problems that likely will arise and will limit the cost if the 360-degree evaluation does not work within the organization.

**2: Link the 360-degree evaluation's goals with the overall company goals**
The 360-degree evaluation needs full cooperation from all employees along with a significant business reason for the implementation. If the program is linked to the overall goals, individual employees will have an easier time accepting and providing value.

**3: Train employees**
The 360-degree evaluation may include hiring an outside firm to handle the process, or if it is handled internally, there need to be assigned roles and responsibilities. The employees who are responsible need to be trained on all aspects of the evaluation; they must ensure that complete trust is held throughout the process.

**4: Turn the results into an action plan**
Once the evaluation is complete, request ideas for an action plan from all employees. Hold meetings if necessary or provide other means for feedback opportunities. Ongoing goals and objectives need to be set for the future in order for everyone involved to feel that the program is effective and useful.

Questions that should be asked prior to implementing a 360-degree evaluation program include:

- How ready is the organization for the 360-degree evaluation?
- Who is going to be involved?
- Is this a mandatory or voluntary project?
- What criteria will be evaluated?
- How will the information be collected, compiled, and distributed?
- Who is going to be responsible for each activity, including planning, assessing, compiling the information, distributing the results, developing the action plan, and following through?

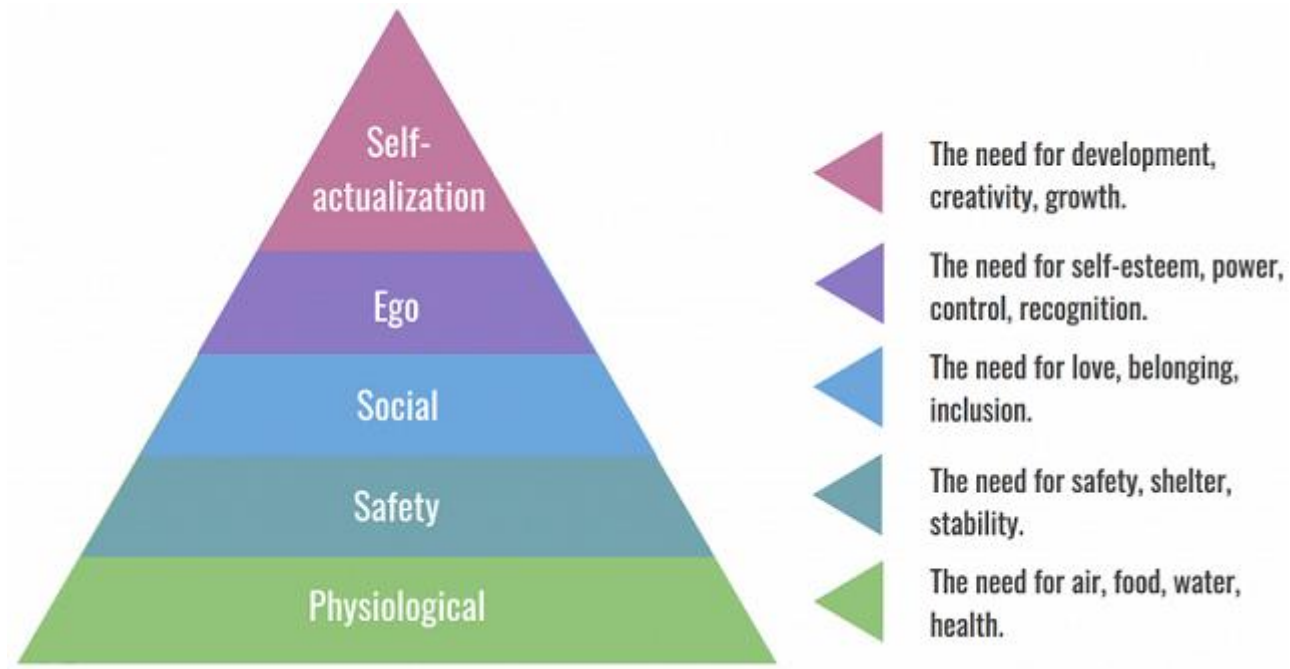
The 360-degree evaluation, if used correctly can be a valuable organizational tool that will provide a path for personal and organizational development. It can help direct and mold the corporate culture, set goals, and create camaraderie among employees.

# 6. Motivation and Satisfaction

**Motivation** is an important driver in any organization. It often determines how much effort employees will put into accomplishing their tasks and it is strongly tied to job satisfaction. **Job satisfaction** expresses how individuals feel about the tasks they are supposed to accomplish.

# Maslow: Hierarchy of Needs

In 1943, the American psychologist Abraham Maslow developed a theory about human motivation called the **hierarchy of needs**. This theory is still very popular and describes human needs in five general categories. According to Maslow, once an individual has met the needs in one category, he or she is motivated to seek needs in the next higher level. Maslow's hierarchy of needs consists of the following categories:




- **Physiological needs:** These are the first and lowest level of needs. They relate to the most basic needs for survival and include the need for food and shelter.
- **Safety needs:** The second level of needs involves an individual's need for security, protection, and safety in the physical and inter-personal events of daily life.
- **Social needs:** The third level of needs is associated with social behavior. It is based on an individual's desire to be accepted as part of a group and includes a desire for love and affection.
- **Ego/Esteem needs:** The fourth level of needs relates to an individual's need for respect, recognition, and prestige and involves a personal sense of competence.
- **Self-actualization:** This is the fifth and highest level of needs. Needs of this level are associated with an individual's desire to reach his full potential by growing and using his abilities to the fullest and most creative extent.

As individuals move higher in the corporate hierarchy, they may see higher-order needs as being more important than those of lower orders. Needs may also vary based on career stage, organizational structure, and geographic location.

The hierarchy of needs could also lack effective application in different cultural contexts. Certain cultures may value social needs over psychological and safety needs. In addition, the theory necessitates that

a manager is able to identify and understand an employee's needs. This is not always easy and can lead to inaccurate assumptions. Taken in the proper context, however, recognizing the importance of needs is a useful method for conceptualizing factors of employee motivation and thus being able to direct an organization's behavior.

According to Maslow's hierarchy of needs, people are motivated to fulfill basic needs before moving on to other, more advanced needs.

# Herzberg: Two-Factor Theory

In the 1950s, Frederick Herzberg studied the characteristics of a job in order to determine which factors served to increase or decrease workers' satisfaction. His study identified two factors related to job satisfaction: "hygiene" factors and "motivational" factors.


**Hygiene factors:**
These factors must be maintained at adequate levels. They are related more to the environment in which an employee is working rather than the nature of the work itself. Important hygiene factors include organizational policies, working conditions, relationships with peers and subordinates, status, job security, and salary. Adequate levels of these factors are necessary to prevent dissatisfaction; improving these factors beyond

adequate levels, however, does not necessarily lead to an increase in job satisfaction.

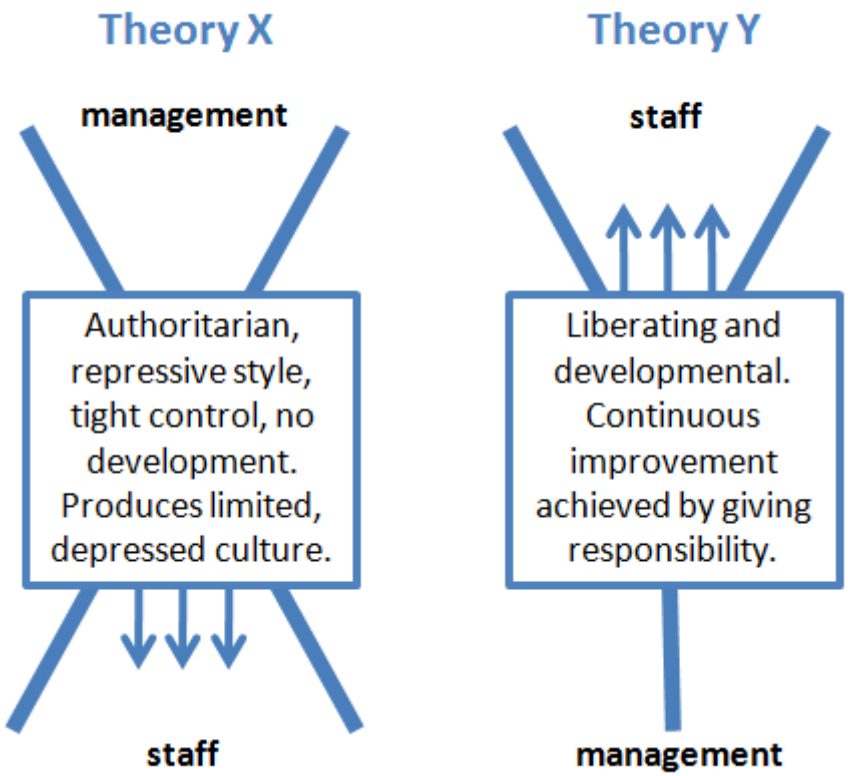
**Motivational factors:**
These set of factors are associated with having a direct effect on increasing job satisfaction. These factors include achievement, recognition, responsibility, growth, the work itself, and the opportunity for advancement.

Like Maslow's hierarchy of needs, Herzberg's factors must be tempered by sensitivity to individual and cultural differences and require that managers identify what employees consider to be "adequate levels." Managers sometimes simplify both of these theories and inappropriately assume that they know what their employees need.

Herzberg's two-factor theory states that there are certain factors in the workplace that cause job satisfaction, while a separate set of factors cause dissatisfaction.

# McGregor: Theory X and Theory Y

Douglas McGregor's theories focus less on employee needs and more on the nature of managerial behavior. These theories are based on the assumption that a supervisor's perceptions of her employees will strongly influence the way in which she attempts to motivate her employees. McGregor created two theories based on his studies, called Theory X and Theory Y.




In the case of **Theory X**, a supervisor assumes that her employees are averse to work and will do everything they can to avoid it. Acting on this assumption, the supervisor will exert tight control over employees, monitor their work closely, and hesitantly delegate authority.

In this case of **Theory Y**, a supervisor assumes that, contrary to Theory X, workers are willing to work and would be willing to accept increased responsibilities. In light of these assumptions, the supervisor will provide employees with more freedom and creativity in the workplace and will be more willing to delegate authority

Managers will seek to motivate their employees based on their perceptions of the employees' interests. This theory brings to light the variation in practice that can exist depending on the assumptions that managers make about their employees.

McGregor developed two motivation theories and they refer to two styles of management – authoritarian (Theory X) and participative (Theory Y).

# Conclusions from Theories

The three theories discussed can provide valuable insight into an organization's behavior. The following three conclusions can be drawn from them:

**Needs:**
Employees have needs. In order to motivate employees, supervisors should attempt to understand the breadth of their employees' needs. This is not always an easy task and requires open and frequent communication between managers and employees. By structuring a job so that it meets these needs a supervisor can increase an employee's motivation.

**Compensation:**
Compensation is an important part of motivation, with a goal to compensate employees according to the contribution each employee makes to the firm. Employees will be dissatisfied if they feel that they are getting less than they deserve. In order to decrease the likelihood of perceived inequities, a manager needs to be proactive and informative regarding reward structures.

**Rewards:**
Employees need to know that the goal they are working toward is achievable and that when they accomplish this goal that they will be rewarded in an appropriate and timely manner.

# 7. Compensation and Rewards

The discussion of motivational theories has shown the importance of assessing employee needs and rewards. Some of these actions include implementing an adequate compensation program, allowing for flexible work schedules, and establishing employee involvement programs.

# Compensation Programs

Before determining how compensation should be set, it is necessary to align the compensation program with several elements of the business:


- **Business goals:** A compensation plan should be developed in light of a firm's business goals. Employees should be compensated to the degree that their efforts help the business accomplish its goals.
- **Employee goals:** A compensation plan should be clear in stating individual employee goals. In order to effectively motivate employees, they need to know what goals they will be expected to achieve.
- **Achievable goals:** The goals that individual employees are expected to accomplish must be realistic and achievable. If employees feel that the goals associated with their positions are unreachable, they will not be motivated to work. If a supervisor can set reasonable goals and make the employee aware that numerous achievable bonuses will be given if these goals are met, the employee will be motivated.
- **Employee input:** Employees will be more satisfied with their jobs if they are consulted about the compensation plan before it is put into effect.

An adequate compensation program, taking these issues into account, will affect employee motivation; a compensation plan should give the highest relative raises to the individuals who achieve the highest levels of performance. This type of system is referred to as a merit-based pay system and bases pay on performance. It can be effectively implemented in conjunction with an incentive plan that rewards employees for achieving specific performance goals. These plans stand in contrast to a system that provides across-the-board pay raises, which will not motivate workers to put extra effort into achieving set goals.

**Job Security**

Employees who feel they are in danger of losing their jobs may not show high work productivity. Worker satisfaction can, and productivity may be increased by providing job security. One way firms can increase job security is by providing cross-training in other functions. This will give

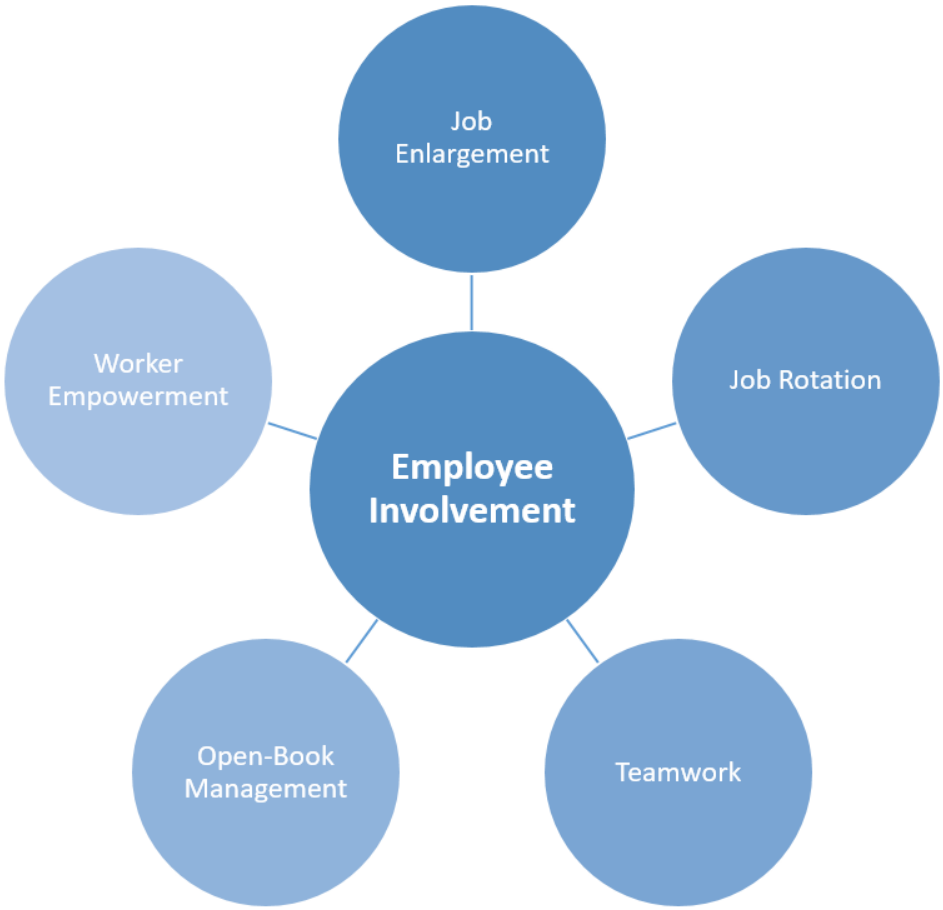
employees the versatility to accomplish new tasks if their current positions change or are no longer available.

**Flexible Work Schedules**
In today's time-pressed world, many employees view time away from work as an important factor in shaping their at-work motivation and on-job productivity. There are several methods for allowing flexible work schedules that meet the needs of employees seeking greater home/work flexibility.

A common approach towards more flexible work schedules is the so-called compressed workweek. This approach enables employees to work the same number of hours over the course of fewer days. Instead of working five eight-hour days, an employee might work four ten-hour days instead. Other examples of flexible work schedules include job-sharing where two or more people share a certain work schedule.

# Employee Involvement

Employee involvement programs seek to motivate employees by increasing their responsibilities or getting them more involved in decision-making processes. There are several types of employee involvement programs; the more basic programs include job enlargement, job rotation, and teamwork. More ambitious programs include open-book management and worker empowerment.




- **Job Enlargement:** Job enlargement is a direct way to increase job responsibility. It involves expanding a position and giving an employee a greater variety of tasks.
- **Job Rotation:** A job rotation program periodically reassigns employees to new positions. In addition to increasing employees' involvement in the firm and adjusting their responsibilities, job rotation can also improve employees' skill sets, thereby increasing their job security. In addition, it can also relieve the boredom in the workplace associated with doing the same job over a long period of time.
- **Teamwork:** This program attempts to increase motivation by putting individuals with different positions onto a team and setting them the task of achieving a specific goal. Teamwork serves to increase an employee's responsibilities and involvement in the firm. The best types of teams are self-directed. This provides the team with the authority to make decisions regarding planning, accomplishing, and evaluating the task they are working on.

- **Open-Book Management:** Open-book management is a challenging, but direct way of increasing employee involvement and responsibility. It involves allowing employees to see how their job performance affects key performance indicators important to the firm. In order to institute this program, a firm needs to make key indicators available to employees and educate them on how to interpret key performance measures. Employees also need to be empowered to make decisions related to their positions and training and be given the opportunity to see how these decisions affect the rest of the firm. Open-book management also necessitates an adequate compensation program whereby compensation is tied to performance.
- **Worker Empowerment:** Worker empowerment attempts to increase employee job responsibility as well as employee involvement. It does this by giving employees more authority and involving them in the decision-making process. Employees who are empowered can often make better and more informed decisions than can a manager who is not directly involved in the process. Participative management is similar to worker empowerment. Although it does not provide employees with direct decision-making power, it encourages managers to consult closely with workers before making decisions. Another type of participatory management is management by objective. This approach allows employees to set their own goals and provides them with the freedom to decide how they can best achieve these goals.

But how do managers (after gaining an understanding of the theories of motivation and applying different approaches to increase job satisfaction) know that their efforts have been successful? In practice, a manager must draw conclusions on a daily basis from social observations and interactions in the workplace.

Sometimes, however, it is a good idea to conduct a more formal survey. This can be accomplished through either interviews, surveys, or focus groups that often involve only a specific group of employees.

Two useful surveys are the Minnesota Satisfaction Questionnaire and the Job Descriptive Index. Both of these surveys address areas of employee satisfaction in regard to different aspects of an organization and provide managers with useful information. They cover work, working

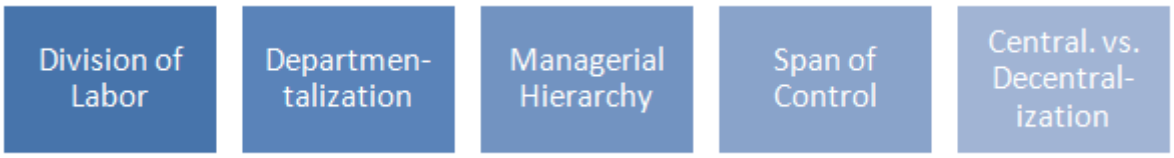
conditions, rewards, opportunities for advancement, and the quality of relationships with managers and coworkers.

# 8. Organizational Structure

Whether you start your own business or you want to improve an existing business, it is important to think about the firm's organizational structure: Who is responsible for accomplishing various tasks within the firm? How are employees grouped? Who manages them and how are they managed?

## Five Structural Factors

In essence, the primary goal of an organizational structure is to coordinate and allocate a firm's resources so that the firm can carry out its plans and achieve its goals and objectives. The fundamentals of organizational structure revolve around five factors:




**1. Division of Labor**
The division of labor involves two steps: dividing work into separate tasks and assigning these tasks to workers. What are the different tasks carried out by your firm? Who is responsible for accomplishing these tasks?

**2. Departmentalization**
Departmentalization is the process of grouping similar types of jobs together so that they can be accomplished more efficiently and

effectively. There are five different ways in which to departmentalize business activities. Different types of departmentalization can exist to varying degrees within a business. What types of departmentalization exist within your firm? Could your firm be departmentalized differently?

- Function: An example of functional departmentalization would be a firm that has a marketing and finance department. It involves grouping tasks based on the function that the organizational unit accomplishes within a firm.
- Product: A consumer electronics firm that has separate departments for cameras and MP3 players is using product-based departmentalization. In this case, departments are based on the goods or services that an organizational unit sells or provides.
- Process: A manufacturing firm that includes separate departments for assembly and shipping is an example of a firm with process-based departmentalization. In this case, departmentalization revolves around the production process used by the organizational unit.
- Customer: A bank with separate departments for its business customers and individual customers is using customer-based departmentalization. Its departmentalization is based on the type of customer served.
- Geographic: An example of a firm using geographic departmentalization is an automobile manufacturing company that has different departments for each country in which it sells cars. In this case, departmentalization is based on the geographic segmentation of organizational units.

**3. Managerial Hierarchy**

Managerial hierarchy relates to the way in which management is layered. It usually includes three levels – upper or top management, middle management, and supervisory roles. The higher levels of management generally have fewer employees, but more power.

**4. Span of Control**

Span of control is closely related to managerial hierarchy. At each level of management within a firm, an individual is responsible for a different number of employees. Span of control relates to the number of employees that a manager directly supervises. Span of control is determined by a number of factors, including the type of activity, the location of the workers, a manager's ability to delegate tasks, the amount

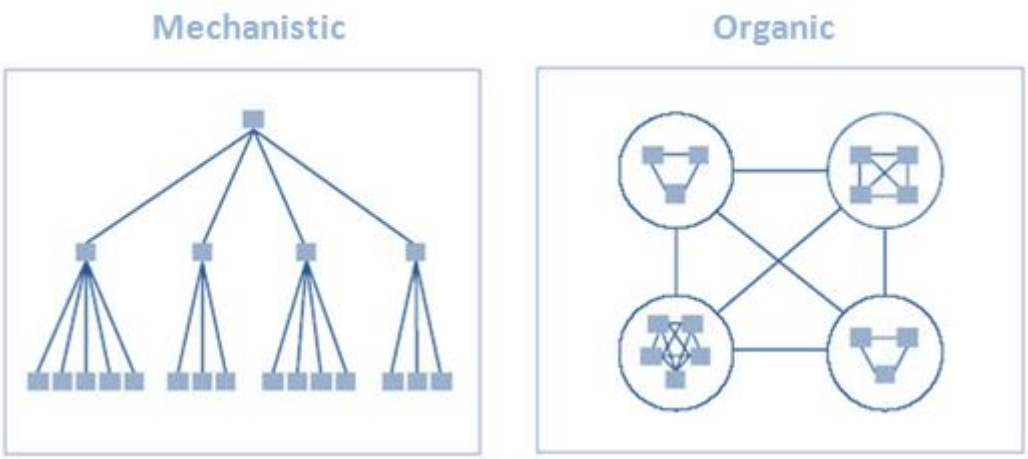
and nature of communication between the manager and the individuals being supervised, and the skill level and motivation of the individuals being supervised.

**5. Centralization vs. Decentralization**
Centralization is the degree to which formal authority is centralized within a unit or level of an organization. Decentralization is the process of actively shifting authority lower in a firm's hierarchical structure. This effectively gives more decision-making power and responsibility to those in supervisory roles. Centralization and decentralization have their benefits and costs. While centralization provides top-level managers with a better overview of operations and allows for tighter fiscal control, it can result in slower decision making and limit innovation and motivation. Decentralization, by contrast, can speed up decision making and increase motivation and innovation, but this is done at the expense of a top manager's view of the firm and financial control.

The fundamentals of organizational structure revolve around five factors: 1. the division of labor, 2. departmentalization, 3. the nature of the managerial hierarchy, 4. the managerial span of control, and 5. the amount of centralization or decentralization in the organization.

# Mechanistic vs. Organic Structures

The five structural factors just discussed give rise to numerous organizational possibilities. Mechanistic and organic structures are two possibilities at opposite ends of the organizational spectrum. They give shape to the concept of the factors of organizational structure.



A **mechanistic organization** is characterized by the following structural factors:

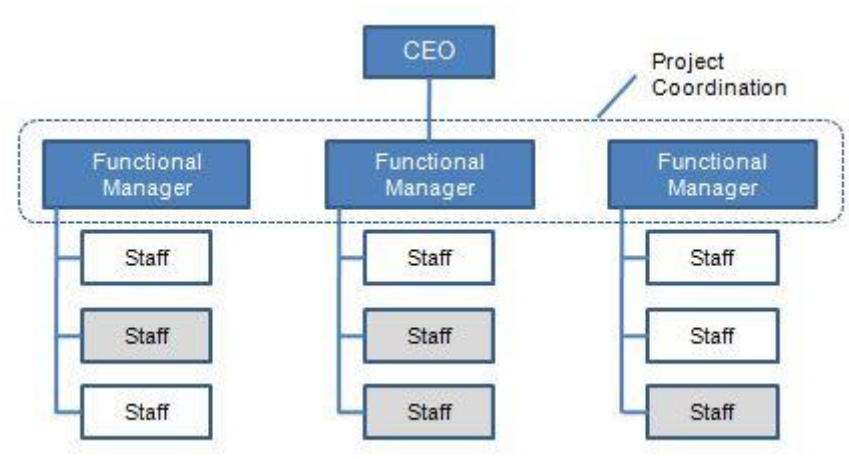
- Degree of work specialization is high.
- Departmentalization is rigid.
- Managerial hierarchy has many layers.
- Span of control is narrow.
- Decision making is centralized.
- Chain of command is long.
- Organizational structure is very tall.

An **organic organization** is characterized by the following factors:

- Degree of work specialization is low.
- Departmentalization is loose.
- Managerial hierarchy has few layers.
- Span of control is wide.
- Decision making is decentralized.
- Chain of command is short.
- Organizational structure is flat.

# Functional vs. Divisional Structures

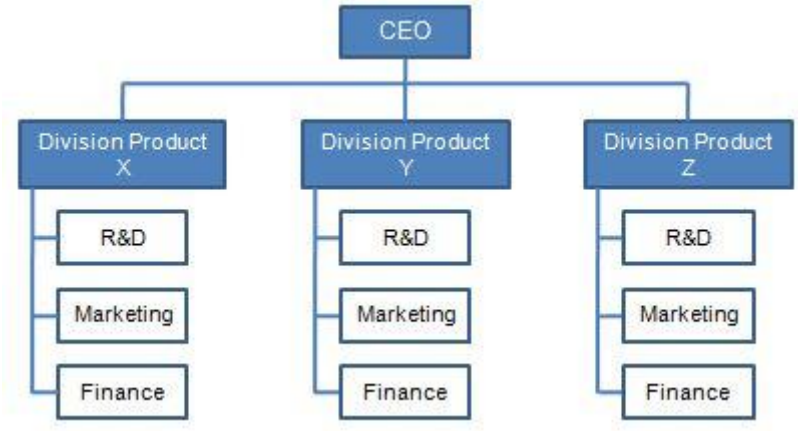
### 1. Functional Structure




The organization is divided into segments based on the functions when managing. This allows the organization to enhance the efficiencies of these functional groups. Functional structures appear to be successful in large organizations that produce high volumes of products at low costs. The low cost can be achieved by such companies due to the efficiencies

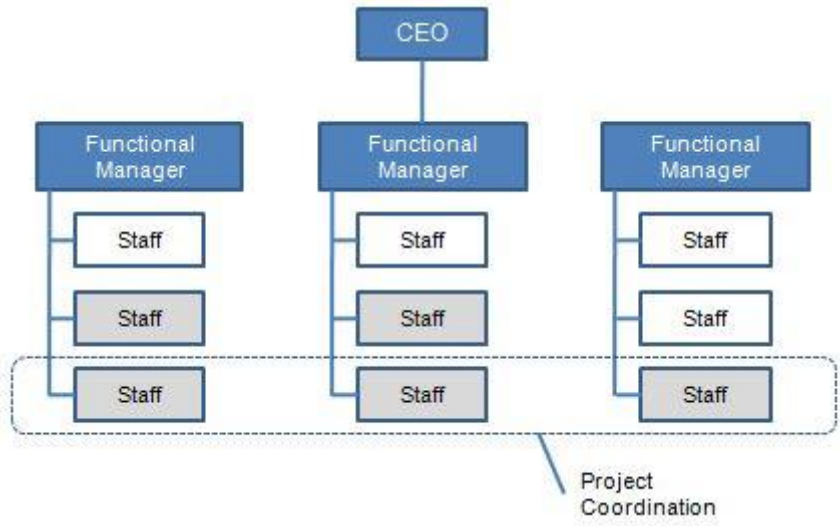
within functional groups. However, there can be a disadvantage from an organizational perspective if the communication between the functional groups is not effective.

## 2. Divisional Structure




These types of organizations divide the functional areas of the organization to divisions. Each division is equipped with its own resources in order to function independently. There can be many bases to define divisions. Divisions can be defined based on the geographical basis, products/services basis, or any other measurement. As an example, take a company such as General Electrics. It can have microwave division, turbine division, etc., and these divisions have their own marketing teams, finance teams, etc. In that sense, each division can be considered as a micro-company with the main organization.

## 3. Matrix Structure

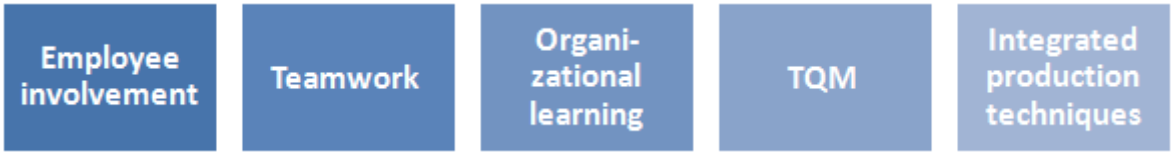



When it comes to a matrix structure, the organization places its employees based on the function and the product. The matrix structure gives the best of both worlds of functional and divisional structures. In this type of organization, the company uses teams to complete tasks. The teams are formed based on the functions they belong to (ex: software engineers) and product they are involved in (ex: Project A). This way, there are many teams in this organization such as software engineers of project A, software engineers of project B, QA engineers of project A, etc.

Every organization needs a structure in order to operate systematically. The organizational structures can be used by any organization if the structure fits into the nature and the maturity of the organization. In most cases, organizations evolve through structures when they progress through and enhance their processes and manpower. One company may start as a pre-bureaucratic company and may evolve up to a matrix organization.

# High-Performance Organizations

The goal of the **high-performance organization** is to effectively and efficiently utilize intellectual capital. High-performance organizations focus on employee involvement, teamwork, organizational learning, total quality management (TQM), and integrated production techniques.




- **Employee involvement** is accomplished through worker empowerment or participative management.
- **Teamwork** is accomplished though self-directed groups.
- **Organizational learning** involves gathering, communicating, and storing organizational information in order to anticipate changes and challenges and make more informed decisions about the future.
- **TQM** focuses on high quality, continuous improvement, and customer satisfaction.
- **Integrated production techniques** implement flexibility in manufacturing and services and involve job design and information systems to more effectively and efficiently utilize the resources, knowledge, and techniques that a business uses to create goods or services. It stresses the use of just-in-time production and service systems and relies heavily on computers to assist, control, and integrate different organizational functions. Implementing integrated production techniques requires speeding up communication and decision making within the organizational structure.

The process of transforming an organization into a high-performance organization begins by actively seeking to understand an organization's worksite problems and opportunities and its purpose, mission, strategy, and vision. These elements must be tied together into a new mission statement and vision for the firm that is aligned with the organization's core values.

In order to be successful, this process requires the active involvement of individuals from various levels and groups within the organization. The broad level of participation will also ensure a greater level of acceptance in the organization. Once these initial steps have been taken, the factors of employee involvement, teamwork, organizational learning, total quality management, and integrated production techniques can result in organizational, individual, and community benefits. The organization will be more effective in achieving its goals, job satisfaction, and employee motivation will increase, and the organization will be better able to contribute to the community as a whole.

Although there are numerous benefits associated with high-performance organizations, establishing and maintaining them is a difficult task. One of the most daunting elements is successfully integrating employee involvement, teamwork, organizational learning, total quality management, and integrated production techniques. These are not separate functions; teamwork must contain elements of employee involvement, organizational learning, and total quality management. This can be especially challenging for managers who, in addition to their regular functions, are asked to implement these changes.

Managers can experience many kinds of resistance. Employees may feel that the changes could put them out of a job. They may be resistant to participating in group decision making or in team-based activities. Managers may also experience obstacles related to cultural differences regarding hierarchy and participation. In light of these challenges, some firms succeed in implementing only some of the elements associated with high-performance organizations.

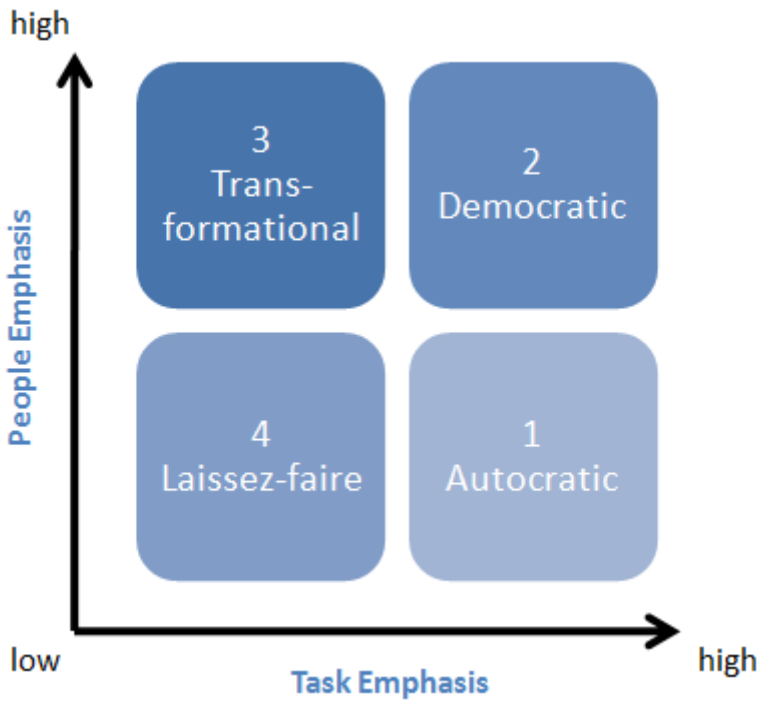
Successfully creating a high-performance organization requires a high degree of cooperation and a strong level of commitment and acceptance from all employees. It is a challenging and difficult process, but it offers significant rewards throughout the organization.

# 9. Organizational Culture

An organizational culture, also called corporate culture, is the system of beliefs, goals, and values that an organization possesses. Strong cultures create high levels of employee motivation and loyalty. Corporate culture also provides control and structure to the company.

# Leadership Styles and Culture

Individual managers have their own styles of managing, and within organizations, there is often a predominant style of leadership which is deeply rooted in the corporate culture. The four predominant leadership styles – autocratic, democratic, laissez-faire, and transformational – have many variations. We can compare the effectiveness of each of these styles as it affects employee performance.

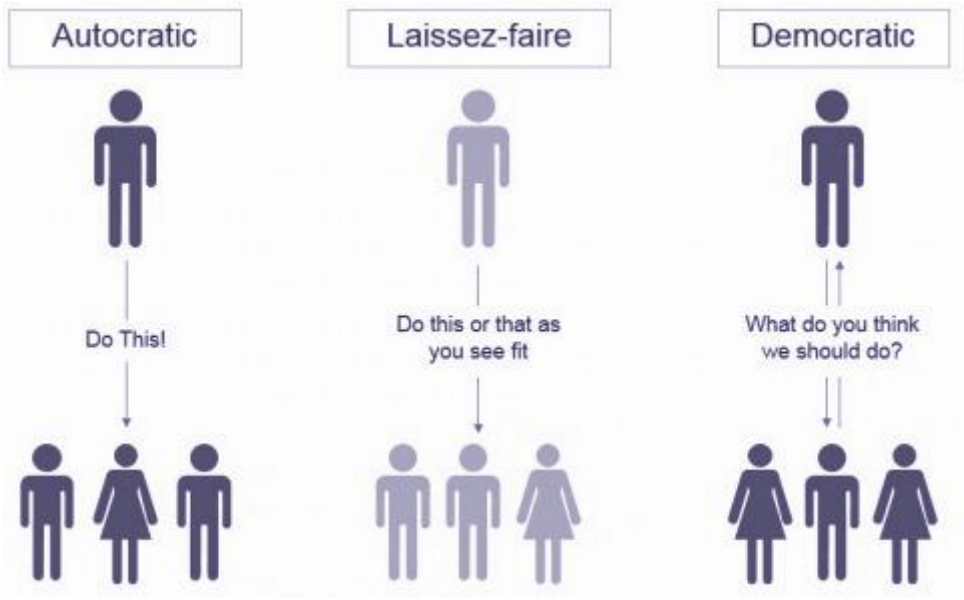



**1: Autocratic Leadership**
This style of leadership is directive and controlling. The leader will make all decisions without consulting employees. The autocratic style of leadership limits employee freedom of expression and participation in the decision-making process. It will not serve to create trust between managers and subordinates. Further, creative minds cannot flourish under autocratic leadership. Autocratic leadership may best be used when companies are managing less experienced employees. But managers should not use the autocratic leadership style in operations where employees expect to voice their opinions.

**2: Laissez-Faire Leadership**
This style of leadership makes employees responsible for most of the decisions that are made. This form requires extensive communication. Laissez-faire leadership may best be used when employees are educated, knowledgeable, and self-motivated. Employees must have the drive and ambition to achieve goals on their own for this style to be most

effective. Laissez-faire leadership is not a good idea in situations where employees feel insecure.

**3: Democratic Leadership**
This style of leadership is centered on employee participation and involves decision making by consensus. The leader will involve employees in the decision-making process and they will be encouraged to give input and delegate assignments. Democratic leadership often leads to empowerment of employees because it gives them a sense of responsibility for the decisions made by management. Democratic leadership may best be used when working with highly skilled employees. It is most useful for implementing organizational changes and when the leader requires input from knowledgeable employees. One of the down-sides of democratic leadership is that it may lead to endless meetings.




**4: Transformational Leadership**
Leaders who have a clear vision and are able to articulate it effectively to others often characterize this style of leadership. Transformational leaders look beyond themselves in order to work for the greater good of everyone. This type of leader will bring others into the decision-making process and will allow those around them opportunity to learn and grow as individuals. They seek out different perspectives when trying to solve a problem and are able to instill pride into those who work under them. Transformational leaders spend time coaching their employees and learning from them as well.

As with many categories that describe business concepts, an organization and its leadership may apply any or all of these leadership styles. For instance, a company may utilize an autocratic leadership style with the lower levels but employ a democratic leadership style with its professional staff in the upper levels.
The most effective leadership style is using a combination of styles. Leaders should know when it is best to be autocratic and when to be democratic.

# Successful Culture

Culture creates a sense of order, continuity, and commitment that permeates every aspect of the organization, from how employees interact to customer perceptions.

Culture is often difficult for an organization to articulate, but its impact is far-reaching and influences management, process, products, employee attraction and retention, productivity, reputation, and ultimately the bottom line. We will now look at seven important characteristics of successful corporate cultures:

**Caring:**
This involves employees taking responsibility for their actions, caring about both the customer and the good of the company. It creates high-quality customer service and a positive atmosphere in which to work.

**Challenge:**
If the CEO of a company states that employees should “think outside the box,” but then squashes ideas because of their perceived chance of failure, a contradictory environment is created. In this type of situation, a challenge to conventional thinking and performing causes employees to fear losing their jobs; creative employees will leave and a culture of yes-men will be created.

**Risk:**
A successful company will be able to manage risk and even turn it into a strategic and profitable advantage. It involves paying attention to reputation and earnings. Employees must anticipate the consequences of their decisions and actions. This type of risk management can add significant shareholder value.

**Ethics:**
Often ethics can be the glue that holds the culture of an organization together. An effective leader should create a written ethical code for the organization. This code of ethics should not only be enforced but continuously reinforced. The employee’s ethics should serve as a standard by which performance is evaluated.

**Focus:**
A leader has done his or her job well if the managers have a sense of continuity if they know where the company or organization is heading. If managers feel that the direction of the organization is decided on by which way the wind is blowing that day, goals will not be met. It is important for employees to know where they are going and what they should be achieving, and it is the job of the leader to define this for them. The leader should always know where he or she is going at all times. However, this does not mean that a leader should not be willing to change. In fact, a leader should be an agent for change, because stagnation does not often lead to success. It is important that while being accepting to change a leader is able to align employees with goals.

**Trust:**
Mutual trust is an important hallmark of effective leadership. Management should trust the leader and the leader should trust management. It is important to note that micromanaging can kill a trusting culture. When employees come to trust one another, it creates a team environment, where everyone is working for the common goals of the organization.

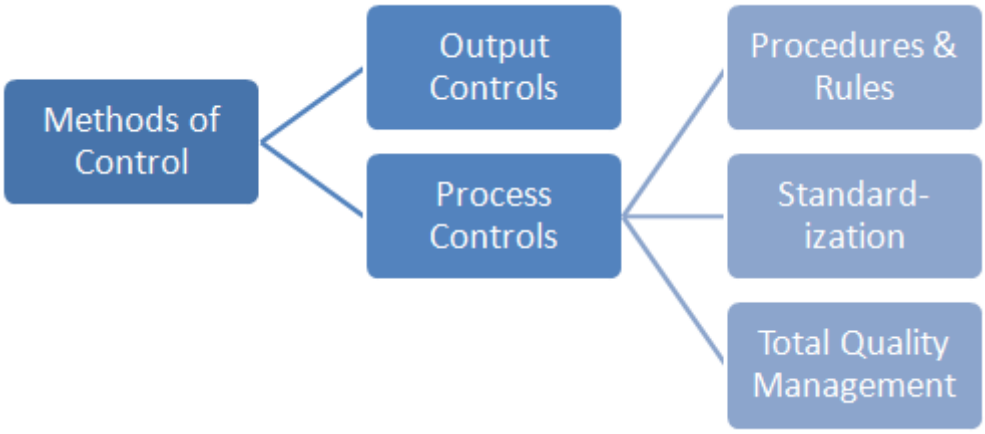
**Merit:**
Organizations often meet their goals by rewarding employee performance based on merit. Merit systems create fairness and help to further foster a team environment.

Characteristics of successful corporate cultures include:
caring, challenge, risk, ethics, focus, trust, and merit.

# 10. Methods of Control

Managers achieve organizational goals by managing intellectual capital in order to get the most out of organizational resources. An important part of this process is monitoring performance and outcomes. Two common ways that affect organizational behavior are **output controls** and **process controls**.

Controls relate to setting standards, obtaining measurements of results related to these standards, and taking corrective actions when these standards are not met. Managers must be judicious in their use of controls so as not to overburden the organization.




**Output Controls**
Output controls are about setting desired outcomes and allowing managers to decide how these outcomes can best be achieved. Output controls promote management creativity and flexibility. This type of control serves to separate methods from outcomes and subsequently decentralizes power by shifting it down the hierarchical structure.

**Process Controls**
Once effective methods have been determined for solving organizational problems, managers sometimes institutionalize them in order to prevent the problem from recurring. These types of controls are called process controls and are a way of regulating how specific tasks are conducted. Three types of process controls are (1) policies, procedures, and rules; (2) formalization and standardization; and (3) total quality management controls.

- **Policies, Procedures, and Rules:** These are often used in the absence of direct management control. Policies are general recommendations for conducting activities, while procedures are a more focused set of guidelines. Rules are the strictest set of limits and establish things that should and should not be done.

- **Formalization and Standardization:** Formalization involves creating a written set of policies, procedures, and rules that simplifies procedures in order to guide decision making and behavior. Standardization is the degree to which the actions necessary to accomplish a task are limited. It attempts to make sure that when certain tasks are carried out they are carried out in a similar fashion.

- **Total Quality Management Controls:** The previous methods of process control are based on organizational experience. TQM management controls differ in that they are based on an ongoing statistical analysis of a firm's operations. TQM involves all levels of management and has proved to be the most effective when it is instituted in an organization that has clearly defined outcomes and is done in conjunction with employee empowerment or participatory management programs.

# 11. Case Study: Google

- Google is an American multinational technology company that specializes in Internet-related services and products, which include online advertising technologies, search engine, cloud computing, software, and hardware.
- Today, Google (as part of Alphabet Inc.) is one of the biggest and most valuable technology companies in the world. Human capital and its management have become more important than ever in the 21st century. However, very few are 'good as Google' at managing people. Google has proved that it relies on innovation in every aspect of its business, even HRM.
- Google has established an employee-centered culture. Apart from Google's technological capabilities, innovative and efficient HR is the reason that it has acquired as much success and fame. Several things are different about Google's HR approach. The most outstanding thing about the tech giant is its mix of salaries and perks meant to keep its employees motivated and satisfied.
- In Google's early days, founders Larry Page and Sergey Brin focused only on two things: creating a better way to find information on the internet, and making Google a great place to work. The starting point for engagement is making employees feel valued. Here are six HR principles of how Google shows its employees that they're valued:
- **1. Inspire People**
  Google's approach to employee motivation is its "20 Percent" Rule: Employees spend up to 20% of their time at work every week

on projects that inspire them. With their 20% time, Google employees created Gmail, Google News, AdSense, and many other highly profitable products. A perk like 20% time inspires employees because it allows them to focus on things they're passionate about. That inspiration prevents burnout and increases engagement.

- **2. Support Flexibility**
  Another way to increase motivation is increasing flexibility in work schedules. Some of Google's more exotic benefits – like bowling alleys, massages, gaming rooms, and pools – aren't necessarily designed for after-work use. Googlers enjoy those amenities any time they want – even in the middle of the workday. While most Googlers work some version of a fixed week schedule, they can vary it up whenever they need to. According to Prasad Setty, VP of People Operations at Google, one of the company's core tenants is "if you give people freedom, they will amaze you."
- **3. Promote Diversity**
  In 2015, Google created "Diversity Core" – a program that allows employees to allocate their time to diversity projects and initiatives. Employees who participate in Diversity Core work on projects that raise the visibility of women in technology jobs and encourage more Hispanics to apply to work at Google, among many others. Google locations in the U.S. started to employ more female employees, more Asians, and more Hispanics over the last years.
- **4. Listen, Respond, and Adapt**
  Google collects feedback from its employees. Employees use a tool called Google Moderator—another outcome of 20% time—to ask questions and vote on others' questions they want to be answered. Every Friday, the company holds an all-hands meeting where company leaders respond to the most popular questions of the week. Also, leaders use a charting tool called Google-O-Meter to measure the popularity of different employee suggestions. There are plenty of ways for HR teams to solicit employee feedback: engagement surveys, pulse surveys, anonymous forms, or even just a basic pen-and-paper suggestion box.
- **5. Encourage Development**
  Google has created a work environment that fosters continuous learning. The company has special training programs related to presentation skills, content development, management, and leadership. Free classes in foreign language and culture are also provided to Google employees. Learning and development receive

special attention at Google whose learning and development team has continued to expand. This team works on leadership programs for developing future leaders for Google. 120 hours of training and development every year is mandatory for all Google employees. This is triple the industry average.

- **6. Create a Culture of Empathy**
  Google learned during the company's quest to determine the composition of the perfect team (Project Aristotle), that the perfect team had nothing to do with any qualities of the people on that team. The statisticians couldn't find patterns. The company observed high- and low-performing teams to look for consistencies in how the teams interacted and ran meetings. They discovered that members of the highest-performing teams felt safe speaking up and sharing their ideas. Great teams trust and respect each other, providing all members with not only a voice but also the confidence to share that voice with others.
- **Learning from Google**
  If you're part of an HR team at a small or medium-sized business that's looking for ways to boost engagement, discover new ideas and exciting opportunities by learning more about the employee engagement practices at Google: there are plenty of ways to support flexibility at your company. Allow employees to work from home when needed, adopt flex schedules, or increase the amount of personal time employees get each year.
- When experimenting, Google recommends that you "treat HR interventions like a medical researcher treats a drug trial: have a treatment group and an equivalent control group, hypotheses, a data collection period, an analysis comparing groups, and quantifiable outcomes." It is very important to test the changes first and measure the outcomes. It's a lot of work, but the engagement benefits will make the hard work well worth it in the end.
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- Recruiting, selecting, hiring, and retaining competent employees as well as implementing the right internal structures and processes

have always been essential for every organization. In this course, you were able to dive into the exciting fields of human resource management and organizational behavior.

# Marketing and Communications

## 1. Introduction

**Welcome to Marketing & Communications!**
From a societal point of view, marketing is the link between a society's requirements and its economic patterns of response. Marketing satisfies these needs through exchange processes and building long-term relationships.

Marketing can be looked at as an organizational function and as a set of processes for creating, delivering and communicating value to customers, and managing customer relationships in ways that benefit the organization and its shareholders. Marketing is the science of choosing target markets through market analysis and market segmentation, as well as understanding consumer buying behavior and providing superior customer value.

The set of engagements necessary for successful marketing management include:

- capturing marketing insights
- connecting with customers
- building strong brands
- shaping the market offerings
- delivering and communicating value
- creating long-term growth
- developing marketing strategies and plans

Noted Harvard Professor of Business Theodore Levitt states that the purpose of all business is to "find and keep customers". The only way

you can achieve this objective is to create a competitive advantage. That is, you must convince potential buyers that what you have to offer them comes closest to meeting their particular need.

Every organization has a set of functional areas (e.g. purchasing, manufacturing, finance, human resources, marketing, etc.) in which tasks that are necessary for the success of the organization are performed. These functional areas must be managed if they are to achieve maximum performance. Marketing differs from the other functional areas in that its primary concern is with exchanges that take place in markets outside the organization (e.g. customers, competitors, public relations, transport, etc).

Marketing is the creation, communication, and delivery of value as well as the management of customer relationships for a lifetime.

# 2. The Customer

In this chapter, we will focus on one of the most important essentials of marketing: the basic need, demand, want and value of customers. We will then discuss how customers make decisions and how exchanges take place between companies and their clients.

## Customer Needs

Although many variations of the definition of marketing exist, they all include the same primary determinant: Success is achieved by meeting the customer's needs. All the time, effort, and money put into marketing aim to meet the needs of the customer.

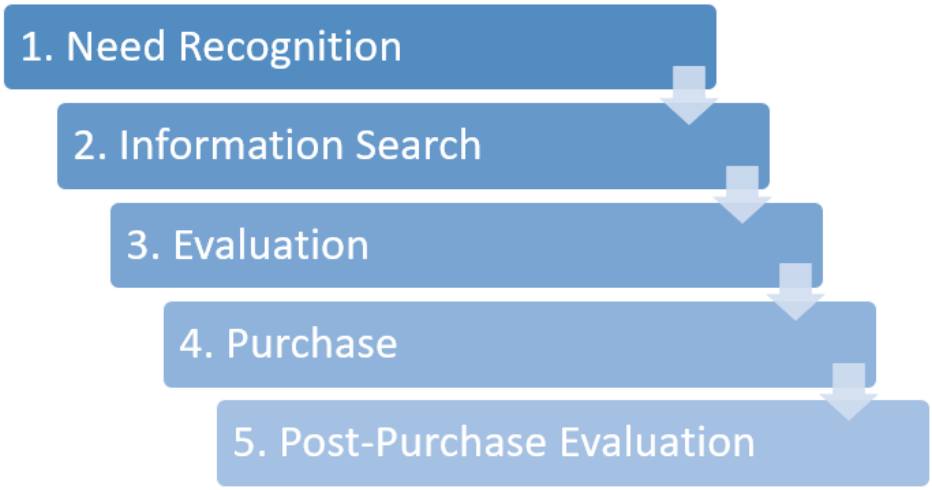
- The most **basic needs** are those inherent to all human beings. For example, people have physiologic needs, for food, water, and sleep, in addition to safety, social, and personal needs.
- As individuals grow in their environment, and into their own personality, these needs become **wants**. For example, when someone is hungry, perhaps the person does not want a piece of bread with water, but a pizza with juice, because he has seen a commercial that advertised pizza and juice.
- The next question is, whether a person can actually afford to purchase the item. If yes, this then creates a demand for the product. A want combined with the ability to pay creates **demand**.
- When multiple purchase options are available, a multitude of factors play into the consumer's decision, such as price, personal tastes, and preferences. Ultimately though, a consumer most likely chooses the option that provides the most **value**. Value is typically viewed as the subjective relationship between the perceived benefits and perceived costs of a product or service.

In the quest to meet customer needs, wants, and demand, while providing maximum value, companies employ a wide array of activities to make their marketing more effective. Through their own interactions with their customer base, as well as the feedback through now mostly online media, companies can gauge the pulse of their customers on a day-to-day, real-time basis.

Truly successful marketing organizations use this market intelligence, and their own operational efficiency, to adapt to any situation, while continually focusing their energy and strategy on meeting the customer's needs.

# Customer Decision Process

The Consumer or Buyer Decision-Making Process is the method used by marketers to identify and track the decision-making process of a customer journey from start to finish. It is broken down into five individual stages:




**1. Need Recognition**
The customer decision process begins with **need identification**. Whether we act to resolve a particular problem depends upon two factors: the magnitude of the discrepancy between what we have and what we need, and the importance of the problem. This involves the concept of consumer motivation, which is the internal drive consumers experience to fulfill conscious and unconscious wants and needs. Once the problem is recognized, it must be defined in such a way that the consumer can actually initiate the action that will bring about a relevant solution.

**2. Information Search**
The next step is **information search and processing**. After a need is recognized, the prospective consumer may seek information from family, friends, personal observation, consumer reports, salespeople, or mass media. The promotional component of the marketer's offering is aimed at providing information to assist the consumer in their problem-solving process. If the buyer can retrieve relevant information about a product, brand, or store, he or she will apply it to solve a problem or meet a need.

**3. Evaluation**
The criteria used in the **evaluation of alternatives** vary from consumer to consumer. One consumer may consider price the most important factor while another may put more weight upon quality or convenience. The search for alternatives is influenced by such factors as time and money costs, how much information the consumer already has, the amount of the perceived risk if a wrong selection is made, and the consumer's disposition toward particular choices.

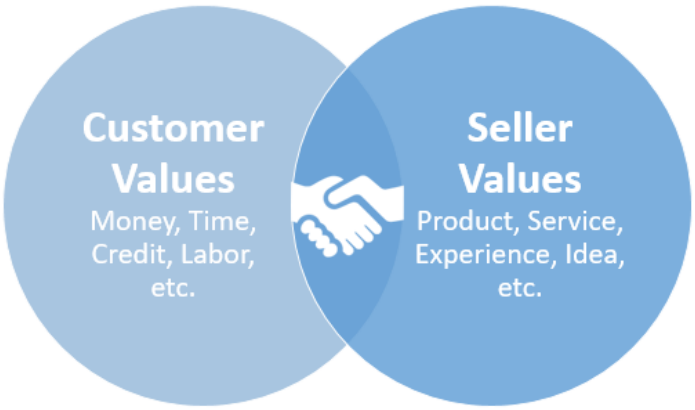
**4. Purchase**
During the **purchase phase** of the decision-making process, the consumer may form an intention to buy the most preferred brand because he has evaluated all the alternatives and identified the value that it will bring him. Anything marketers can do to simplify purchasing will attract buyers. Providing basic product, price, and location information through labels, advertising, personal selling, and public relations is an obvious starting point. Product sampling, coupons, and rebates may also provide an extra incentive to buy.

**5. Post-Purchase Evaluation**
A consumer's feelings and evaluations after the sale come into play during the **post-purchase phase**. These feelings can influence customer retention and influence what the customer tells others about the product or brand. The marketer may take specific steps to reduce post-purchase dissonance. Advertising that stresses the many positive attributes or confirms the popularity of the product can be helpful.

The Customer Decision Process includes 5 stages: need recognition, information search, evaluation, purchase and post-purchase evaluation.

# The Exchange Process

The exchange process is the act of obtaining a desired object from someone by offering something of value in return. The exchange between the person in need (i.e., someone who offers money, time, labor or some other personal resource) and the organization selling the product, service, experience, or idea results in a transaction.



The top goal of any marketing organization is to facilitate and help increase sales transaction by convincing potential consumers and existing customers to buy their company's product or service.

With the emergence of the internet, the nature of the marketing exchange has changed drastically. Today's consumers have access to far more and far better information. They also have many more choices. Businesses must provide personalized, relevant and high-quality content that competes with a fast, ever-changing competitive landscape.

The exchange process allows the parties to assess the relative trade-offs they must make to satisfy their respective needs and wants. For the marketer, analysis of these trade-offs is guided by company policies and objectives. For example, a company may engage in exchanges only when the profit margin is 10% or greater.

Customers also have personal policies and objectives that guide their responses in an exchange. Unfortunately, customers seldom write down their personal policies and objectives. Even more likely, they often do not understand what prompts them to behave in a particular manner. This is the mystery or the "black box" of customers behavior that makes the exchange process so unpredictable and difficult for marketers to understand.

When potential customers are not satisfied, the exchange falters and the goals of the marketer cannot be met. As long as customers have free choice and competitive offerings from which to choose, they are ultimately in control of the marketplace.

The potential customers, in commercial situations, "vote" (with their dollars) for the market offering that they feel best meets their needs. An understanding of how they arrive at a decision allows the marketer to build an offering that will attract buyers. Two of the key questions that a marketer needs to answer relative to buyer behavior are:

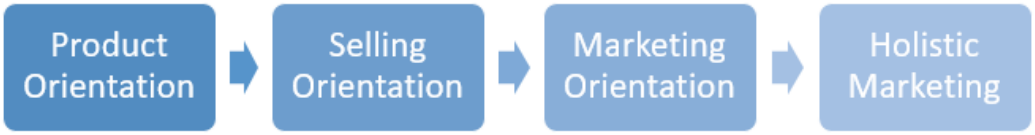
- How do potential customers go about making purchase decisions?
- What factors influence their decision process and in what way?

The answers to these two questions form the basis for target market selection, and, ultimately, the design of a market offering and strategy that we will discuss later in this course.

Selling may be viewed as a process in which two individuals exchange items of value. In the most simple situation, the customer receives a product and the seller receives money. In reality, it is likely that buyer and seller exchange attributes with both physical and psychological values.

# Evolution of Customer-Centered Marketing

The evolution from production-oriented organizations to marketing-oriented organizations was driven by a shift toward a marketplace that catered to meeting customer wants and needs rather than strictly delivering product features and functionality.




**Product Orientation**
The product orientation of marketing focuses solely on the product a company intends to sell. This orientation was popular during the 1950s. A firm employing a product orientation is chiefly concerned with the quality of its product. A firm such as this would assume that as long as its product was of a high standard, people would buy and consume the product. This approach stresses the research and development of products in order to maintain the attention of potential customers.

**Selling Orientation**
As opposed to product orientation, a firm using a sales orientation focuses primarily on the selling and promotion of a particular product. The successful management of the relationship between the company and its customers defines the act of sales. It creates value for customers. Emphasis is not placed on determining new consumer desires, as such. Consequently, this entails simply selling an already existing product and using promotion techniques to attain the highest sales possible. Approaching marketing with a selling orientation was popular for companies in the 1960s.

**Marketing Orientation**
Marketing orientation is a business model that focuses on delivering products designed according to customer desires, needs, and

requirements, in addition to product functionality and production efficiency (i.e., product orientation). Beginning in the 1970s, Harvard Professor Theodore Levitt and other academics argued that the sales orientation model was ill-equipped to deliver products tailored to customer wants and needs. Instead of manufacturing products for the sole purpose of generating profit, they argued for businesses to shift their strategy toward developing products based on customers' desires, insights, and opinions.

**Holistic Marketing**
The holistic marketing concept looks at marketing as a complex activity and acknowledges that everything matters in marketing. The four components that characterize holistic marketing are relationship marketing, internal marketing, integrated marketing, and socially responsive marketing.

- **Relationship marketing** emphasizes customer retention and satisfaction rather than a dominant focus on sales transactions.
- **Internal marketing** is a process that occurs within a company or organization whereby the functional process aligns, motivates, and empowers employees at all management levels to deliver a satisfying customer experience.
- **Integrated marketing** is an approach to brand communications where the different modes work together to create a seamless experience for the customer and are presented with a similar tone and style that reinforces the brand's core message.
- **Socially responsible marketing** is a marketing philosophy that states a company should take into consideration what is in the best interest of society in the present and long term.

# 3. Marketing Mix (4P)

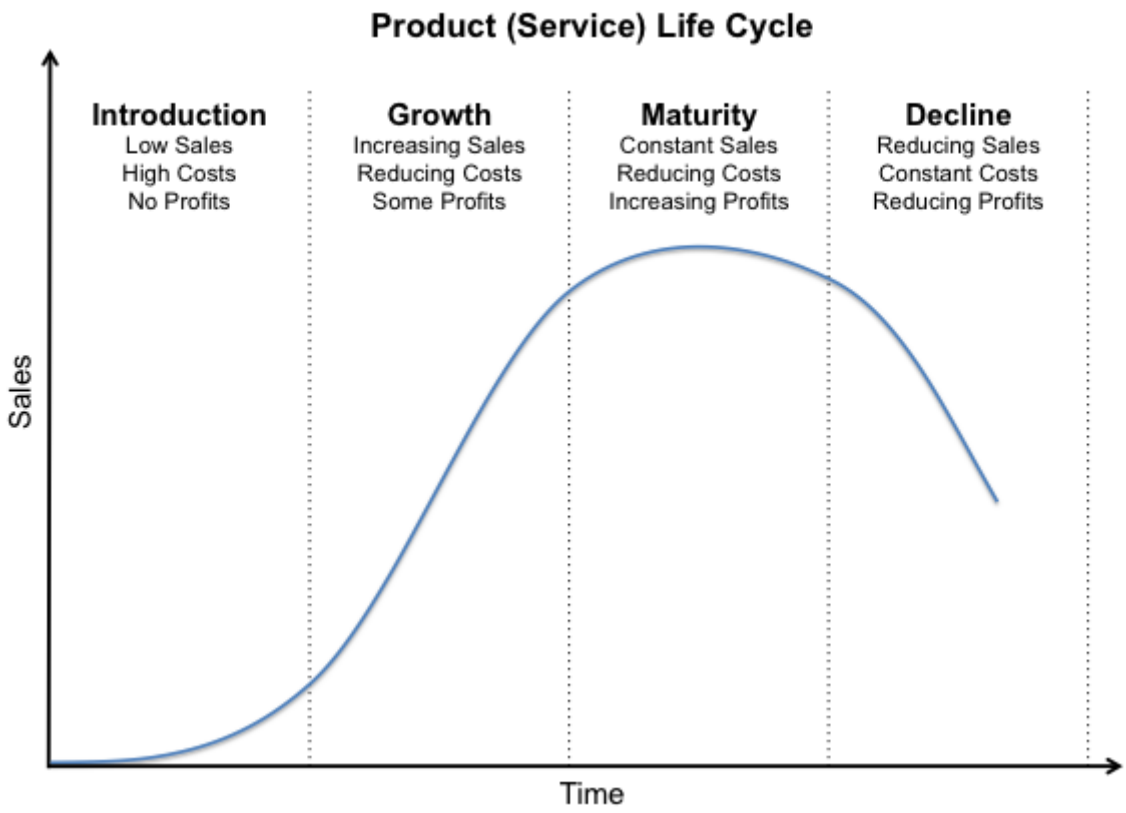

The **Marketing Mix** is a tool invented by the American professor Neil Borden, to describe the different types of choices organizations have, when bringing a product or service to market.

The basic principles of Borden's model were refined over the years until professor and author E. Jerome McCarthy reduced them to four elements, called the "**Four Ps**" of marketing.

# Product


As a company evolves, it must continually assess the customers' needs, to know whether it is providing the right product. In this course (as in the world of marketing) "products" can be both tangible goods or intangible services. In assessing which customers it wants to serve, a company gains direction in terms of the products or services it will offer.

The "**product life cycle**" is a frequently used model for analyzing a product. It identifies the stages of a product, by observing sales volumes over time. Traditionally, the product life cycle charts the following four stages:




**1. Introduction Stage**
This stage of the cycle could be the most expensive for a company launching a new product. The size of the market is still small, although it will be increasing. However, the cost of development, production, and marketing can be very high, especially if it's a competitive sector.

**2. Growth Stage**
The growth stage is typically characterized, by strong growth in sales and profits, and the company starts to benefit. This makes it possible for businesses to invest more money in the promotional activity, to maximize the potential of this stage.

**3. Maturity Stage**
During the maturity stage, the product is established, and the manufacturer's aim is now to maintain the market share they have built

up. This is probably the most competitive time, for most products and businesses need to invest wisely in any marketing they undertake.

**4. Decline Stage**
Eventually, the market for a product will start to shrink, and this is what's known as the decline stage. The cause of this shrinkage could be, the market becoming saturated (i.e. all the customers who might buy the product, have purchased it already), or the consumers switching to a different type of product.

The stages of a product life cycle are: 1. introduction, 2. growth, 3. maturity, 4. decline
It is important to assess the life cycle of the products you sell. If, for example, most of your revenues come from products in the mature or decline phases of their life cycles, you'll be hard-pressed to grow your sales in the teeth of stable or declining demand. At the other extreme, if you're too reliant on new products, the lack of an established cash cow to pay for those products' marketing and R&D could sink you. Keeping a good mix of new, refreshed, and established products can help stabilize your revenues, and give you predictable growth.

# Price


Now more than ever, consumers are price-conscious in almost all their purchases. For companies trying to market their goods or services, understanding customers' needs and wants as they relate to the price

variable, is essential to survival. A great product priced too high will struggle; while a product priced too low, might be devalued in the marketplace, and hamper the company's profit and growth potential. Thus, it is important for companies to find the right price point that meets both the customer's, and the company's needs.

Marketers generally choose from one of the following four pricing strategies, or create some successive combination of these strategies:

**1. Penetration Pricing:**
Marketers often use penetration pricing to introduce a new product. In a penetration strategy, marketers set the price of an item as low as possible, to generate the greatest possible volume of sales for that product. The company uses penetration pricing, to motivate consumers to make their purchase decision based on price.

**2. Perceived Value Pricing:**
Perceived value is a pricing strategy, where marketers set the price to how valuable the customer believes the item to be, and therefore how much the customer is willing to pay for it. The gap between the cost to produce and the perceived value is irrelevant to this strategy. For this reason, it is most often used for luxury goods, like prestige fragrances.

**3. Skimming Pricing:**
In a skimming strategy, marketers set the price of the new product as high as the market will allow. Once the population segment that is not price-sensitive has been saturated, or the product has reached almost all those consumers who were ever going to buy it, marketers progress to incorporate a different pricing strategy.

**4. Target Return Pricing:**
Some companies measure the success or failure of a product based on the relationship of how much revenue, or in some cases profit, a product generates in relation to how much it costs to make the product. This measure is called return on investment, or ROI.

The strategy a firm uses to price a product or service, can and does vary from firm to firm, and from product to product within a firm. Clearly, marketing professionals weigh a host of factors before choosing one strategy. Aside from the features and quality of the product itself, price is the single most powerful variable in determining the success or demise of a product.

Today, beyond promotions and discounts, companies use dynamic pricing strategies on the internet, to capture even greater profits. Dynamic pricing is a “real-time” change in price, based on customer preferences and past purchasing habits. However, having different prices for the same product can backfire, if consumers become aware of it.

# Place


From a marketing perspective, place, also often labeled as “distribution”, refers to any activity designed to create value and utility by making the product(s) available. In any manufacturing industry, products must be made, packaged, and distributed to the point of sale.

If a product is a mass consumer product, it needs to be available as far and wide as possible. On the other hand, if the product is a premium consumer product, it will be available only in select stores. Similarly, if the product is a business product, you need a team which interacts with businesses and makes the product available to them.

A company could make the best product, but if it cannot get that product into the hands of the customers, then the company’s potential success is at risk.

Important questions are:

- Where do buyers look for your product or service?
- If they look in a store, what kind of store? A specialist boutique or in a supermarket, or both? Or online?
- How can you access the right distribution channels?
- Do you need to use a sales force? Or attend trade fairs? Or make online submissions?

# Promotion


Finally, promotion is the marketing mix variable most commonly recognized by the consumer, given its visual nature, such as in television advertising. Promotion, however, is not just a short television commercial or a massive billboard. It functions as a company's communication arm, transmitting to consumers the other Ps – product, price, and place.

In today's world of digital and mobile technology, promotion takes many new forms while still including traditional media. Companies use a variety of outlets to promote their products (and/or services). The most common promotional methods used, include the following:


- **Advertising:**
  Advertising consists of the promotion of a given product, service, or message through mass media channels, such as newspapers, billboards, magazines, radio, internet, and television, and is used to both inform a given target market and persuade them, aiming at an increase in the use or sale of the company's products or services.
- **Sales promotions:**
  Sales promotions are found everywhere in society, such as 50% off, 0% financing, and the ever-popular "buy one, get one free." Sales promotions are used to persuade consumers, to buy the product or service at that specific moment in time, or while the sales promotion lasts.
- **Personal selling:**
  Personal selling involves a one-on-one interaction between an individual salesperson and a prospective client. Generally speaking, a company's sales force is meant for personal selling. For years, companies have employed sales personnel to develop solid relationships with the customers they serve.
- **Direct marketing:**
  Direct marketing is a much more focused and targeted promotion, than advertising. In the current market, direct marketing has greatly expanded its reach, because of the internet and mobile technology. These always-expanding channels, enable message customization and personalized marketing messages to be directed at a specific person, place, and time.
- **Public relations (PR):**
  As its name implies, PR involves relating with the public, or those considered to be company stakeholders. PR efforts, such as press releases, sponsorship, and corporate literature, are used to generate positive attitudes and feelings, or goodwill, toward the company and its products and services.

# Example: Starbucks Marketing Mix


Let's take a look at a short and simple example: the Marketing Mix of American coffee chain company Starbucks.

**Product:** Starbucks specializes in coffee and related beverages. The company sells coffee and espresso beverages, cold blended beverages, as well as a selection of premium teas. In addition, the firm also sells coffee-related accessories and equipment.

**Price:** Starbucks expects to maintain or lower the price of some of its most popular beverages, including certain espresso beverages; and, in most markets, its popular $1.50 tall brewed coffee. Furthermore, it anticipates raising prices of the labor-intensive, and larger-sized beverages.

**Place:** Starbucks coffees and teas were available in approximately 39,000 grocery and warehouse club stores, 33,000 of which were in the US, and 5,500 in international markets. In many cities, it is impossible to walk several blocks, and not run into a Starbucks store. Proximity and accessibility are some of the company's greatest assets.

**Promotion:** The company has gone to great lengths to create a "community atmosphere" among premium coffee lovers. The Starbucks reward program allows members to earn a free drink after a certain number of purchases at participating Starbucks stores. In general, Starbucks stresses quality above price, and other features it could emphasize.

# 4. New Models: 7P, 4C, SIVA

While the marketing mix was predominately associated with the traditional 4P's of marketing, new models such as the **7Ps model**, the **4Cs theory**, as well as the **SIVA model** try to build upon the 4P's model while increasing its explanatory power.

# The Extended 7P's

In the late 70's it was widely acknowledged by marketers, that the marketing mix should be updated. This led to the creation of the Extended 7Ps Marketing Mix in 1981 by Booms & Bitner, which added three new elements to the 4 Ps model. The three new factors focus not on physical products, but services. That's why the 7Ps model is also called "service marketing mix.


The three new factors are:

- **People:**
  All companies are reliant on the people who run them, from front line Sales staff to the Managing Director. Having the right people

is essential because they are as much a part of your business offering as the products/services you are offering.

- **Processes:**
  The delivery of your service is usually done with the customer present, therefore, how the service is delivered, is once again part of what the consumer is paying for.
- **Physical Evidence:**
  Almost all services include some physical elements, even if the product is intangible. For example, a travel agency would give their customers some form of printed material. Even if the material is not physically printed (in the case of PDFs), they are still receiving a kind of “physical evidence”.

Though existing since the 1980s, the 7 Ps are still widely taught, due to their fundamental logic, being sound in the marketing environment, and marketers’ abilities to adapt the marketing mix to include changes, such as in communications (social media), updates in selling locations, or customers’ expectations.

# Example: Starbucks Marketing Mix II


Let’s go back to our Starbucks example.

What is the company’s marketing mix concerning People, Process and Physical Evidence?

**People:**
Starbucks has a massive workforce. In addition, it plans to recruit around 240,000 more people worldwide. It is an equal opportunity employer who is committed to building a diverse workforce. Starbucks is also known for

its investment in employee training and development. It is a customer-centric company, where customers are the focal point.

**Process:**

- For costumers: Starbucks is often a very busy place, and employees need to serve customers as efficiently as possible. The interaction with the customers begins with a greeting by a Starbucks employee. Customers will then place their food/drink order and make the payment. This is then followed by the order being served, and a farewell being given.
- For business partners: The Starbuck Company's International special activities, includes retail stores with licensing operations in more than 55 countries. Like other big chains such as McDonald's, Burger King or Subway, Starbucks operates primarily through joint ventures and licensing arrangements, with consumer products business partners. This enables Starbucks to expand fast while keeping financial risks of store closures to a minimum.

**Physical Evidence:**
The famous Starbucks Logo (which is green and features a partially nude siren) has stayed largely unchanged since its origin. However, it has been altered to adjust to international sensibilities. Their logo is well-known and can be seen all over major cities. Their presence and recognizability are very important assets of the company.

# The 4C Model

The 4Cs marketing model was developed by Robert F. Lauterborn in 1990. This relatively new approach to marketing shifts the focus from producer and product to the consumers and their needs. Instead of the focus on mass marketing of the traditional 4P marketing model, the 4C marketing model is aimed at niche marketing.

The idea behind it is that the more familiar a company is with the consumer, the better it can align its strategies and the greater its conversion rates will be. Because it is the customers who form a company's marketing mix, the 4C marketing model makes them the main focus.

| The 4 Ps | The 4 Cs |
|---|---|
| Product | Customer solution |
| Price | Customer cost |
| Place | Convenience |
| Promotion | Communication |

- **Consumer Solutions:**
  A company should only sell a product, that addresses consumer demand. So, marketers and business researchers should carefully study the consumers' wants and needs.
- **Customer Cost:**
  According to Lauterborn, price is not the only cost incurred when purchasing a product. Cost of conscience and opportunity cost is also part of the cost of product ownership.
- **Convenience:**
  The product should be readily available to consumers. Marketers should strategically place the products, for example in several visible distribution points.
- **Communication:**
  According to Lauterborn, "promotion" is manipulative while communication is "cooperative". Marketers should aim to create an open, two-way dialogue, with potential clients, based on their needs and wants.

Whether you are using the 4Ps, the 7Ps, or the 4Cs, your marketing mix plan plays a vital role. It's important to devise a plan that balances profit, client satisfaction, brand recognition, and product availability. It is also extremely important to consider the overall "how" aspect, which will ultimately determine your success or failure.

# SIVA Model

SIVA is a formal approach to customer-focused marketing. It stands for **Solution, Information, Value, and Access**. This system is basically the four Ps renamed and reworded to provide a customer focus. The SIVA Model provides a demand and customer-centric alternative to the well-known four Ps supply-side model of marketing management.

| Instead of... | Focus on... | |
|---|---|---|
| Product | Solution | Design offering by needs to solve customer's problems, not by technology, functionality or features |
| Promotion | Information | Provide relevant information and maintain educational dialogue with the marketplace, rather than one-way push communications |
| Price | Value | Articulate benefits related to price, rather than focusing on cost-plus or competitor prices |
| Place | Access | Allow customers to purchase when where and how they want, instead of static distribution |

**Solution**
The "Product" in the four Ps model is replaced by "Solution" in order to shift focus to satisfying the consumer needs. The product is no longer a one-size-fits-all offering, but rather a solution created to solve a problem for the customer. The customer-centric focus allows customers to feel cared for because they are offered a custom solution.

**Information**
The "Promotion" in the four Ps model is replaced by "Information," which represents a broader focus. Information can include advertising, public relations, personal selling, viral advertising, and any form of communication between the firm and the consumer. The "I" also stands for "Incentives," such as trade promotions. A trade promotion is a marketing technique aimed at increasing demand for products based on special pricing, display fixtures, demonstrations, value-added bonuses, no-obligation gifts, et cetera.

**Value**
The "Price" in the four Ps model is replaced by "Value," reflecting the total value gained through purchasing the product. Value can be defined as the extent to which goods or services are perceived by customers to meet their needs or wants. It refers to the benefits a buyer receives when their needs are met. Value is measured in terms of a customer's willingness to pay for a product and often depends more on the customer's perception of a product's worth rather than its intrinsic value.

**Access**
The “Place” in the four Ps model is replaced by “Access”. With the rise of the internet and hybrid models of purchasing, geography is becoming less relevant. Access takes into account the ease of buying the product, finding the product, finding information about the product, and several other factors.

# 5. Marketing Environment

In this chapter, we will assess the marketing environment. We will group and classify different groups of relevant stakeholders and discuss how to design, implement and evaluate different communication strategies to reach these stakeholders.

## Communication to Stakeholders

Stakeholders are involved in or affected (negatively or positively) by the outcome and impact of a marketing action, project or program. Stakeholders can be divided into two main categories:

- **Internal Stakeholders** are engaged in economic transactions with the business (for example, stockholders, customers, suppliers, creditors, and employees).
- **External Stakeholders** are affected by or can affect a business’s actions without being directly engaged in the business (for example, the general public, communities, activist groups, business support groups, and the media).

Marketing communication can be divided into two flows directed at different target audiences. This necessitates different yet compatible communication strategies. A company **cannot** be telling customers one story and stockholders another.

Preparing a good communication and marketing strategy for all stakeholders typically involves four key points:

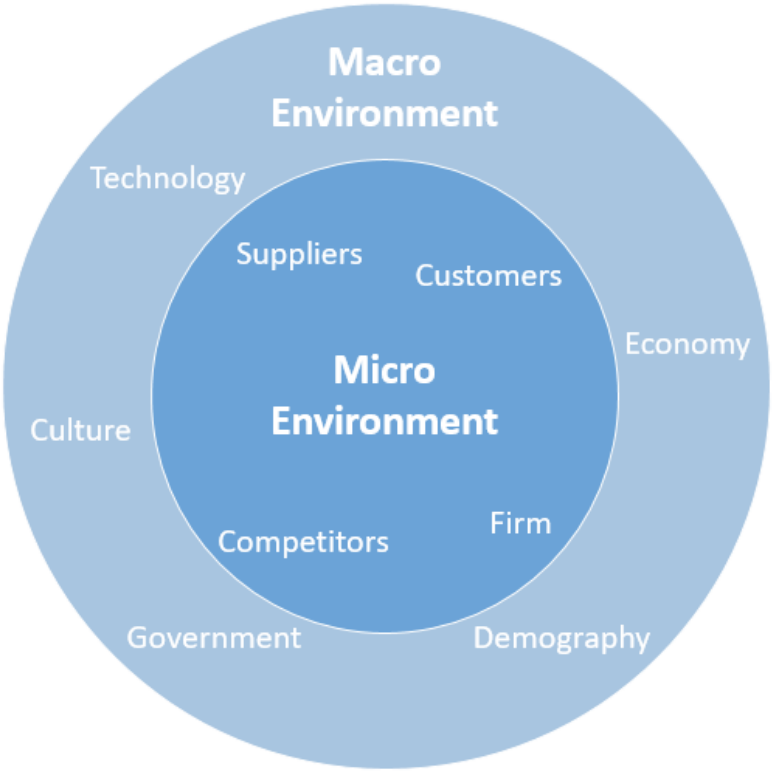

- **Determine stakeholder groups** (defining the audience): List the key stakeholders that need information.
- **Assess groups with stakeholder mapping:** Once the stakeholders are clearly defined, you can deep-dive into assessing and grouping them. To do so, stakeholder mapping has proven to be the best method. You can visually organize and classify different stakeholders according to characteristics like significance, urgency, interest, etc.
- **Define communication/marketing strategy per group:** A flexible yet consistent strategy needs to be tailored for each stakeholder group.
- **Measure the effectiveness of your communication/marketing strategy:** If possible, the effectiveness of the strategy should be measured (with quantitative and qualitative methods).

# Micro and Macro Environment

A successful marketing campaign increases a company's profits and helps it reach its strategic goals. However, there are challenges to marketing because the **business environment is constantly changing**. Customer preferences and attitudes keep evolving and require managers to adapt rapidly. Another challenge involves reaching different target markets with culturally relevant propositions.

**Proactive attention** to the environment allows marketers to prosper by efficiently marketing in areas with the greatest customer potential. **Reactive attention** to the environment, on the other hand, can lead to a disconnect with potential customers and can allow competitors to gain advantages that will win them a higher market share.

Two key levels of the marketing environment are the micro-environment (near environment) and the macro-environment (far environment):




**The Micro Environment:**
The micro-environment includes the company itself, its suppliers, marketing intermediaries, customer markets, and competitors. It also includes consumers, collaborators, and centers of influence. Let's take a closer look at three of them:

- The **company** aspect of micro-environment refers to the internal environment of the company. Each internal department has an impact on marketing decisions. For example, research and development has input on the features a product can have, and accounting approves the financial side of marketing plans and budgets.
- The **suppliers** of a company are also a part of the micro-environment because even the slightest delay in receiving supplies can result in customer dissatisfaction. Examples of suppliers for such companies as automobile manufacturers would include providers of steel, aluminum, leather, and even audio system manufacturers.
- **Competitors** include companies with similar offerings for goods and services. To remain competitive, a company must consider who their biggest competitors are and simultaneously consider its own size and position in the industry. The company should aim to develop a strategic advantage over their competitors.

**The Macro Environment:**
The macro-environment includes concepts such as demography, economy, natural forces, technology, politics, and culture.

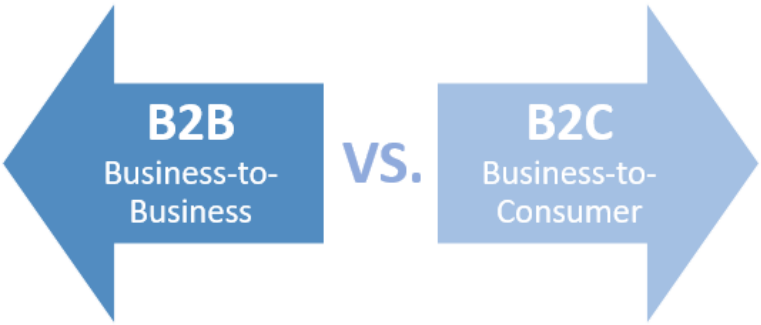
- **Demography** refers to studying human populations in terms of size, density, location, age, gender, race, and occupation. This helps to divide the population into market segments which can be beneficial to a marketer in deciding how to tailor their marketing plan to attract that demographic.
- The **economic** environment refers to the purchasing power of potential customers and the ways in which people spend their money.
- **Technology** includes all developments from antibiotics and surgery to nuclear missiles and chemical weapons to automobiles and credit cards. As these markets develop, it can create new markets and new uses for products. It also requires a company to stay ahead of others and update their own technology.
- The **political** environment includes all the laws, government agencies, and groups that influence or limit organizations and individuals within a society. It is important for marketers to be aware of these restrictions as they can be complex and can change often. For example, regulations on packaging, such as the necessary inclusion of ingredients for food products or the

limitation on product capability claims, must be understood by marketers to avoid negative public perception or sanctions.

- The **cultural** environment consists of institutions and the basic values and beliefs of a group of people. The values can also be further categorized into core beliefs, which are passed on from generation to generation and are very difficult to change, and secondary beliefs, which tend to be easier to influence. As a marketer, it is important to know the difference between the two and to focus your marketing campaign to reflect the values of a target audience.

Since the business environment is constantly changing and customer preferences keep evolving, marketers are required to adapt rapidly. It is important to place equal emphasis on both the macro and micro-environment and to react accordingly to changes within them.

# B2B and B2C Marketing




There is a difference between marketing to businesses and marketing to consumers. Business-to-Business (**B2B**) markets differ from Business-to-Consumer (**B2C**) markets in many ways and thus require different marketing actions.

For one, the **number of products** sold in business markets dwarfs the number sold in consumer markets.

Suppose you buy a computer from Dell. The sale amounts to a single transaction for you. But think of all the transactions Dell had to go through to sell you that one computer. Dell had to purchase many parts from many computer component makers. It also had to purchase equipment and facilities to assemble the computers; hire and pay employees; pay money to create and maintain its website and advertisements; and buy insurance, accounting, and financial services to

keep its operations running smoothly. Many transactions had to happen before you could purchase your computer.

Business marketing generally entails **shorter and more direct channels of distribution**. While consumer marketing is aimed at large groups through mass media and retailers, the negotiation process between the buyer and seller is more personal in business marketing. A single customer can account for a huge amount of business. Some businesses, like those that supply the U.S. auto industry, have just a handful of customers, i.e., General Motors, Chrysler, Ford, etc.

However, B2B and B2C marketing do share some basic principles. Namely, the marketer must always:

- successfully match the product or service strengths with the needs of a definable target market
- position and price to align the product or service with its market, often an intricate balance
- communicate and sell the product in the fashion that demonstrates its value effectively to the target market

# 6. Marketing Strategies

Identifying the right strategy to market your business can be challenging. How do you get your message to the right audience effectively, and how do you beat your competitors? In this chapter, we will discuss how to choose the best marketing strategy for your product or service.

## Creating a Strategy

The benefits of a planned marketing strategy are numerous. Business owners often rely solely on their intuition to make business decisions. While this informal knowledge is important in the decision-making

process, it may not provide you with all the facts you need to achieve the best marketing results.

A marketing strategy will help you define business goals and develop activities to achieve them. Creating a marketing strategy generally involves the following **six steps**:

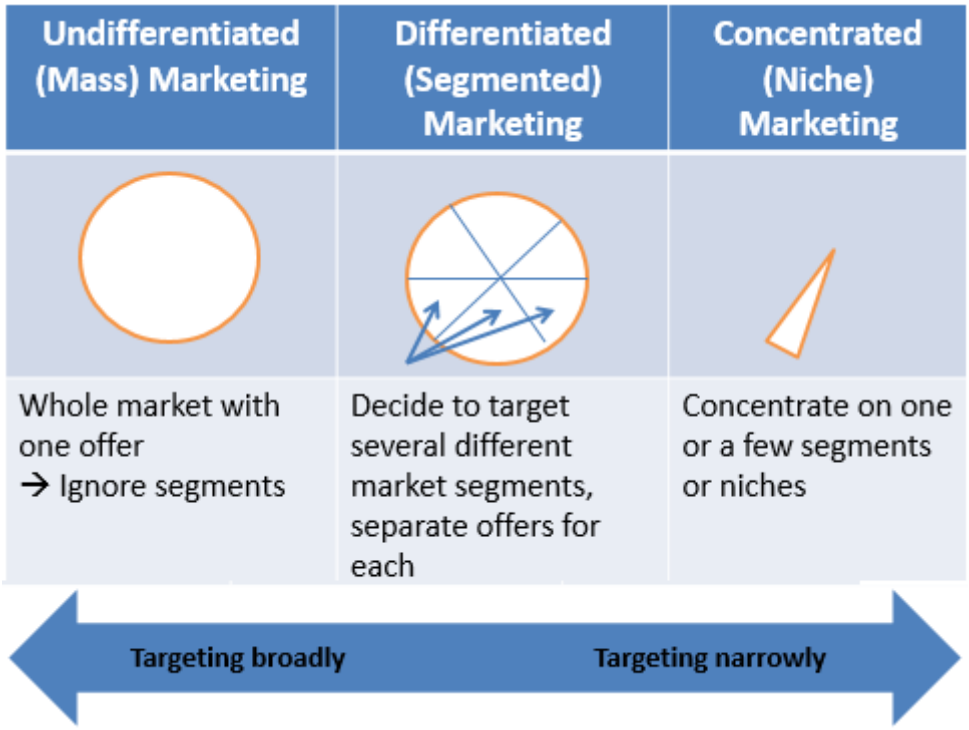

- **Information Gathering**: Research potential customers, their needs and spending habits in order to understand what sort of product, service or idea they wish to buy. A specific method of information gathering is targeting, which is the process of finding customers whose needs and preferences match the product range offered by a company.
- **Evaluation of Organization Capabilities**: Decide what your organization can produce and what your organization is not capable of producing based on the organization's specific strengths and weaknesses.
- **Identify Market Opportunities**: Research the current market for a product idea with no competition or strong demand.

- **Set Objectives of Marketing Strategy**: Decide what results need to be achieved in order to reach the organization's goals. An objective is a specific result that an organization aims to achieve within a certain time-frame and with available resources.
- **Formulate an Action Plan**: List the specific steps the organization needs to take to implement the marketing plan and assign the responsibilities to specific staff members. One such step is product positioning, which is the process by which marketers try to create an image or identity in the minds of their target market. Action plans should be based around the 4 Ps of marketing or SIVA analysis.
- **Monitor & Evaluate**: Study the marketing plan at least once per quarter to track performance against the set objectives.

Everyone knows you need a business plan, yet many entrepreneurs don't realize a marketing plan is just as vital. Unlike a business plan, a marketing plan focuses on winning and keeping customers; it's strategic and includes numbers, facts, and objectives. A good marketing plan spells out all the tools and tactics you'll use to achieve your sales goals. It's your plan of action—what you'll sell, who'll want to buy it and the tactics you'll use to generate leads that result in sales.

# Three Main Marketing Strategies

There are different types of marketing strategies, and every marketing manager should decide what's the appropriate one. This step is important because it has a big impact on the marketing mix. A manager needs to pick one of the following marketing strategies:




**1. Mass Marketing**
This is a "push" market strategy, in which segmentation is completely ignored, and an attempt is made to reach the largest possible number of potential customers. This technique relies on the persuasion potential of communication. Traditional mass marketing methods are radio, television, and print advertising.

Coca Cola's original marketing strategy was based on this format, at a time that they offered only one product, which they believed had universal appeal. However, now that Coca Cola has introduced other products, it has changed its marketing strategy to differentiated marketing.

**2. Differentiated Marketing**
This marketing strategy is also known as a multi-segment marketing strategy. Each customer segment is handled uniquely so that you target each customer segment with a different solution. This strategy keeps your team more focused and is more efficient in spending your marketing dollars.

An airline company offering first, business, and economy class tickets, with separate marketing programs to attract customers for each of the ticket types, is an example of a differentiated marketing strategy.

**3. Concentrated Marketing**
This strategy targets a single well-defined segment of the customer population. The marketing costs are low, but so is your sales potential. It is particularly effective for small companies with limited resources, as it does not believe in the use of mass production, mass distribution, and mass advertising.

The car-manufacturer Rolls Royce only targets the premium segment of the car market.

# Tool: Ansoff Opportunity Matrix

The Ansoff Matrix is a strategic planning tool that provides a framework to help executives, senior managers, and marketers devise strategies for future growth.

According to this tool, there are four possible combinations for growth. Each company needs to decide which strategy to use based on the strengths and weaknesses of the organization and its competitors. Each strategy has a different level of risk, with market penetration having the lowest risk and diversification having the highest risk.


**Market Penetration**
This occurs when a company infiltrates a market in which current

products already exist. The best way to achieve this is by gaining the customers of competitors. Other ways include attracting non-users of your product or convincing current clients to use more of your product.

While market penetration may come with the lowest risk, at some point the company will reach market saturation with the current product and will have to switch to a new strategy.

**Market Development**
Market development targets non-buying customers in currently targeted segments. It also targets new customers in new segments in order to expand the potential market. New users can be defined as new geographic, demographic, institutional, or psychographic segments.

If a company believes that its strength lies with its products and they believe their products would be enticing to new customers, then a company may want to use a market development strategy.

**New Product Development**
New product development is a process that has two parallel paths: one involves the idea generation, product design, and detail engineering; the other involves market research and marketing analysis. Companies typically see new product development as the first stage in the overall strategic process of product life cycle management used to maintain or grow market share.

If a company believes that its strength lies with the customers, then they should consider a product development strategy.

**Diversification**
Diversification seeks to increase profitability through greater sales volume obtained from new products and new markets. At the business unit level, diversification is most likely to expand into a new segment of an industry that the business is already in. At the corporate level, it is generally via investing in a promising business outside of the scope of the existing business unit.

Because of the high risk involved with diversification, many marketing experts believe a company shouldn’t attempt diversification unless there is a high return on investment.

The Ansoff Matrix is a useful tool for organizations wanting to identify and explore their growth options. It is one of the most commonly used tools for this type of analysis due to its simplicity and ease of use.

# Implementing Global Strategies

We are seeing the emergence of an interdependent global economy. This global market is characterized by faster communication, transportation, and financial flows, all of which are creating new marketing opportunities and challenges. Companies recognize that worldwide competition, international marketing trends, and Internet technologies must be considered when launching campaigns both domestically and internationally.

As a result of this rapid shift towards an integrated, global economy, brands must adjust all aspects of the marketing mix to fit local tastes and needs, while maintaining a consistent product and brand image.

Oxford University Press defines a global marketing strategy as “marketing on a worldwide scale reconciling or taking commercial advantage of global operational differences, similarities and opportunities in order to meet global objectives. “

The four “P’s” of marketing–product, price, placement, and promotion–are affected as a domestic or multinational company adjusts its strategy to become a global company. At the global marketing level, global marketing plans must be tailored so that companies speak in many voices rather than just one. Developing marketing plans for different regions gives companies flexibility when reacting against competition or defending their position (market leadership, low-cost provider, etc.) in a particular market.


- **Product**: A global company will have to tweak certain elements of its products for different markets. Even a single product will need to be modified according to the market it will be sold in. Product packaging features, including color, shape, and form, may be similar. However, messaging and language are tailored according to the country's native language and customs.
- **Price**: Because it is affected by several variables, the price will always vary from market to market. For example, cost of product development (produced locally or imported), cost of ingredients, cost of delivery (transportation, tariffs, etc.), and other variables will determine product pricing. Product positioning, including whether the product is high-end, low-cost, or middle ground, compared with competing brands also influences the ultimate profit margin.
- **Placement**: Product distribution will also be determined by local and global competition, as well as the product's positioning in the marketplace. For example, brands would not want to place high-end products in "dollar stores" in the United States. Likewise, a low-cost product in France would find limited success in an expensive boutique.
- **Promotion**: After product research, development and production, promotional tactics, such as advertising, are generally the largest line item in a global marketing budget. An integrated marketing communications (IMC) strategy is key to achieving marketing goals, since IMC reduces costs, minimizes organizational redundancies, maximizes the speed of implementation, and unifies brand messaging.

The global economy provides many **advantages** for companies that are able to introduce their products on a global scale while customizing their marketing strategies for different languages, cultures, and socio-economic demographics. Nevertheless, many companies struggle with meeting the **challenge** of a larger and more complex marketplace:

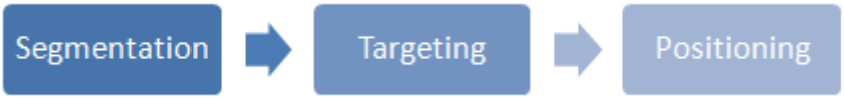
| Advantages | Challenges |
| --- | --- |
| ▪ Economies of scale in production and distribution<br>▪ Lower marketing costs<br>▪ Enhanced power and scope<br>▪ Consistency in brand image<br>▪ Ability to leverage good ideas quickly and efficiently<br>▪ Uniformity of marketing practices | ▪ Differences in consumer needs and wants<br>▪ Differences in brand and product development and the competitive environment<br>▪ Differences in the legal environment, which may conflict with laws in the home market<br>▪ Differences in product placement or distribution channels |

# 7. Segmentation & Positioning

Segmentation allows marketers to divide a market of potential customers into different groups that share similar characteristics. They then try to position the product by carrying out consumer surveys and extensive research in order to find the perfect product-market fit.

## STP Process

The STP process is an important concept in the study and application of marketing. The STP process demonstrates the links between an overall market, and how a company chooses to compete in that market. STP stands for the three main steps: segmentation, targeting, and positioning.




**Step 1: Segment your market**
Your organization, product, or brand can't be all things to all people. That's why you need to use market segmentation, and divide your customers into groups of people with common characteristics and needs. This allows you to tailor your approach, and meet each group's needs cost-effectively, which gives you a huge advantage over competitors who use a "one size fits all" approach. There are many ways to segment your target markets. For example, you can use the following approaches:

- **Demographic Segmentation** – By personal attributes such as age, marital status, gender, ethnicity, sexuality, education, or occupation.
- **Geographic Segmentation** – By country, region, state, city, or neighborhood.
- **Psychographic Segmentation** – By personality, risk aversion, values, or lifestyle.
- **Behavioral Segmentation** – By how people use the product, how loyal they are, or the benefits that they are looking for.

**Step 2: Target your best customers**
Next, you decide which segments to target by finding the most attractive ones. It can take a lot of effort to target a segment effectively. Choose only one segment to focus on at any one time. There are several factors to consider here.

- First, look at the **profitability** of each segment. Which customer groups contribute most to your bottom line?
- Next, analyze the **size and potential growth** of each customer group. Is it large enough to be worth addressing? Is steady growth possible? And how does it compare with the other segments? (Make sure that you won't be reducing revenue by shifting your focus to a niche market that's too small.)
- Last, think carefully about how well your organization can service this market. For example, are there any legal, technological or social **barriers** that could have an impact? Conduct an environmental analysis to understand the opportunities and threats that might affect each segment.

**Step 3: Position your offering**
In this last step, your goal is to identify how you want to position your product to target the most valuable customer segments. Then, you can select the marketing mix that will be most effective for each of them. According to Michael Treacy and Fred Wiersema, two famous marketing experts, most successful firms fall into one of three categories:

- **Operationally excellent firms**, which maintain a strong competitive advantage by maintaining exceptional efficiency, thus enabling the firm to provide reliable service to the customer at relatively low costs.
- **Customer intimate firms**, which excel in serving the specific needs of the individual customer well. There is less emphasis on efficiency, which is sacrificed for providing more precisely what is wanted by the customer.
- **Technologically excellent firms**, which produce the most advanced products currently available with the latest technology, constantly maintaining leadership in innovation.

Market segmentation is the process of dividing a broad market into sub-groups of consumers (known as segments) based on some type of shared characteristics. Targeting involves concentrating your marketing efforts on one or a few key segments. Positioning refers to the place that a brand occupies in the mind of the customers and how it is distinguished from products from competitors.

# Perceptual Mapping

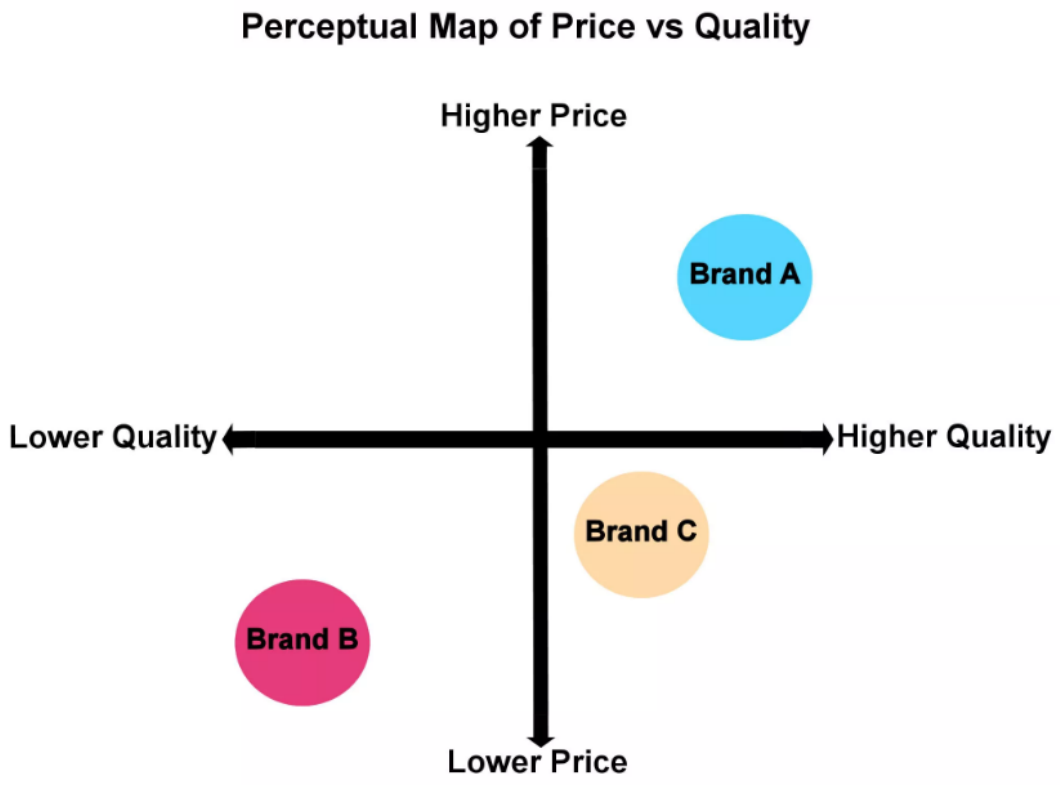
One of the biggest headaches for marketing professionals is deciding where a new product or service fits into the marketplace. In this lesson, we will show how your business can benefit from using perceptual maps to decide where to position your product or service against those of the competitors.

Perceptual mapping is a diagrammatic technique used by marketers, in an attempt to visually display the perceptions of potential customers. Typically, the position of a product, product line, brand, or company is displayed relative to their competition. This kind of visual representation can give valuable information about the current position, as well as the future strategy of a company.

The data for perceptual maps comes from customer surveys of products or services – customers are typically asked to rate their views on various criteria such as:

- Performance
- Ease of use
- Price
- Reliability
- Quality
- Customer support

Survey results are compiled and plotted on a graph according to their scale values. These graphs commonly have two dimensions. In the example below, customer perceptions of price versus quality for three different brands are displayed on a graph, providing an excellent visual representation of how brands can be differentiated in the minds of consumers.



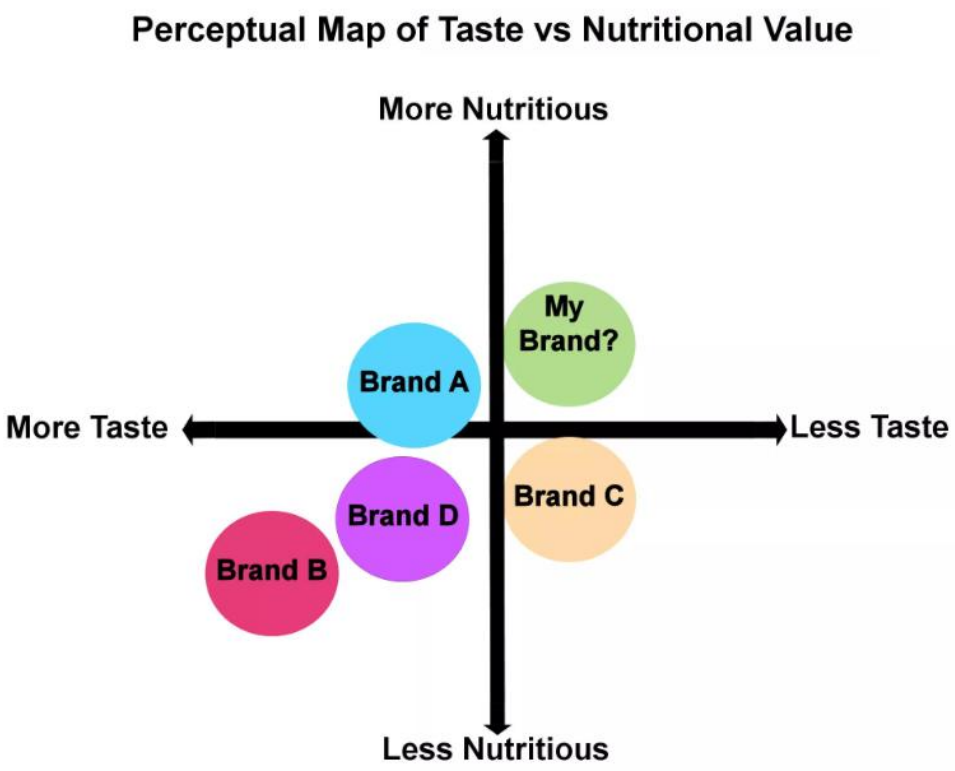

Aside from price versus quality, perceptual maps can be made for a variety of product/service attributes. For example:

- Trucks: Towing capacity versus fuel consumption

- Landscaping services: Appearance versus effect on the environment
- Coffee: Price versus sustainability
- Food/drink: Taste versus sugar or salt content
- Hotels: Price versus location, amenities, etc.

As an example, let's say you think you have developed a winning recipe for a granola bar and wish to use perceptual mapping to help you decide where to position the product in the marketplace.

- Define the attributes that are of the highest importance to the consumer and will influence their purchasing decisions. In this example, we have decided to use taste and nutritional value as the determinant attributes.
- Compile a list of the competing products that will be included in your market survey and plotted on your perceptual map. Depending on the product a minimum of four or five competitors should be surveyed, preferably those with the largest market share.
- Develop a rating scale for the determinant attributes (in this case taste and nutrition) and distribute the survey to customers. A simple 1-5 rating works well.
- Once you have your perceptual map, you will need to determine where to position your product versus the competition – preferably where there appears to be a gap in the marketplace.

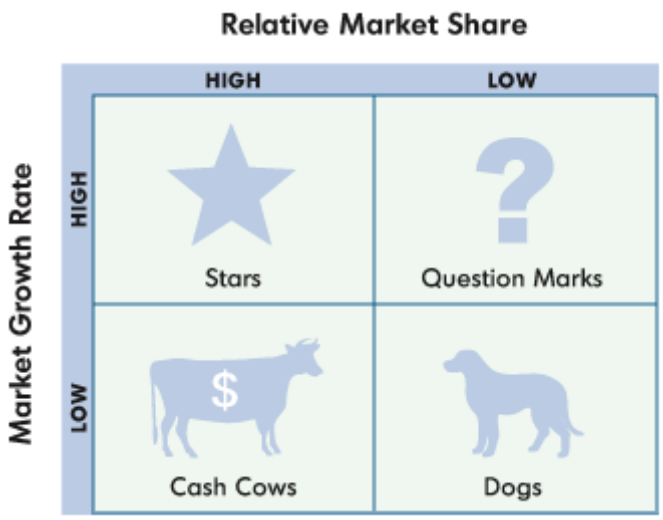



In the above example, you may decide that a segment of the market would prefer to sacrifice a degree of taste for more nutrition. Competing for head to head with another brand is generally risky, but the price may enter into the decision. You may be able to take market share from a competing product that has the same or similar attribute rankings if you are able to set the price of your product sufficiently low enough.

# BCG Matrix

The BCG Matrix, named after its inventors from Boston Consulting Group, assess products on two dimensions. The first dimension looks at the products general level of **growth** within its market. The second dimension then measures the product's **market share** relative to the largest competitor in the industry. Analyzing products this way provides a useful insight into the likely opportunities and problems with a particular product.

Products are classified into four distinct groups: Stars, Cash Cows, Question marks, and Dogs.




Let's have a look at what each of these four outcomes means for the product and the decision making process:

- **Stars:** Star products all have rapid growth and dominant market share. This means that star products can be seen as market-leading products. These products will need a lot of investment to retain their position, to support further growth as well as to maintain its lead over competing products. Star products will also be generating a lot of income.
- **Cash Cows:** Cash cows don't need the same level of support as stars. This is due to less competitive pressures within a low growth market where they usually enjoy a dominant position. Cash cows are still generating a significant level of income but are not costing the organization much to maintain. These products can be "milked" to fund Star products.
- **Dogs:** Products classified as dogs always have a weak market share in a low growth market. These products are very likely making a loss or a very low profit at best. The question for managers is whether the investment currently being spent on keeping these products alive could be spent on making something that would be more profitable.
- **Question Marks (also called Problem Children):** These products are in a high growth market but do not seem to have a high share of the market. One reason for this might be that a very new product was recently added to the market. If this is not the case, then some questions need to be answered. What is the organization doing wrong? What are competitors doing right?

The BCG Matrix is easy to perform, it helps to understand the strategic positions of the business portfolio, and it's a good starting point for further analysis. Nevertheless, this growth-share analysis has been heavily criticized for its oversimplification. Market growth is one of many factors that determine industry attractiveness and relative market share is only one of many factors that determine competitive advantage. This matrix does not take into account any other factors that may have a bearing on both industry attractiveness and competitive advantage.

**Example: BCG Matrix for Nestle**

The BCG matrix analysis for Nestle reveals some interesting perspectives. As a global multinational in the food and beverage industry, the Swiss company is one of the biggest corporations in the world. Over 8000 brands fall within its umbrella and are as widespread as bottled water and pet food. The company announced plans to sell off under-performing brands which were consistently showing poor sales.

**Question Marks:**
There are products that formulate a part of the industry that is still in the phase of development, yet the organization has not been able to create a significant position in that industry. The small market share obtained by the organization makes the future outlook for the product uncertain, therefore investing in such domains is seen as a high-risk decision. With increasing competition and growing need to consume healthy products among consumers, Nestle's Milk products and Nutrition requires significant investment from the brand to maintain and grow its market share. Nestle's Chocolates and confectionaries is another business unit that can be placed in the Question Mark quadrant of the BCG Matrix of Nestle. High competition and small market share of the product in the industry is what makes it being placed in this quadrant.

**Stars:**
The products or business units that have a high market share in high growth industry are the stars of the organization. In the case of Nestle, Nestle's Mineral Water and Nestle's Nescafe Coffee fall in the Star quadrant of the BCG Matrix of Nestle. Growing healthier lifestyle trends and emerging markets have prompted the brand to invest large amounts of investments in order to differentiate the bottled water brands from competitors in mature markets and grow brand awareness in emerging markets.

**Dogs:**
Dogs are those products that were perceived to have the potential to grow but however failed to create magic due to the slow market growth. Failure to deliver the expected results makes the product a source of loss for the organization, propelling the management to withdraw future investment in the venture. Since the product is not expected to bring in any significant capital, future investment is seen as a wastage of company resources, which could be invested in a Question mark or Star category instead. Nestle's Milo was launched as chocolate and malt powder for Milk and water, however, the product failed to create any significant impact on the business and is placed in the Dog Quadrant of BCG Matrix of Nestle.

**Cash Cows:**
Cash cows are the products that have a high market share in a market that has low growth. For Nestle, there is one product that has undoubtedly been the Cash Cow and its Nestle's Maggi Noddles. With a market share of 80-85 %, Maggi Noddles holds a very stronghold in the market and have high customer loyalty. The product requires very less investment to maintain its market share and fight off any competition.

The BCG matrix helps organizations determine which areas of their business deserve more resources and investment. This is especially helpful for corporations like Nestle that offer a broad range of products in many different markets.

# Customer Value Analysis

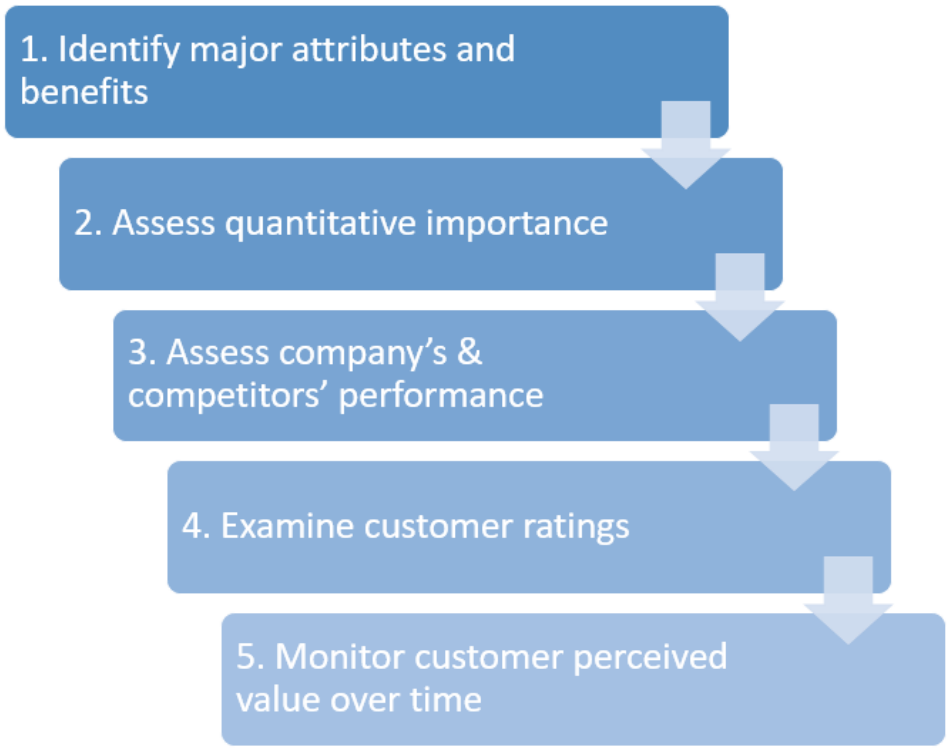
To deliver value to their customers, marketers must consider what is known as the "**total market offering**." This includes the reputation of the organization, staff representation, product benefits, and technological

characteristics as compared to the market offerings and prices of competitors. Value, in this sense, can be defined as the relationship of a firm's market offerings to those of its competitors.

Value in marketing can be defined by both qualitative and quantitative measures. On the **qualitative** side, value is the perceived gain composed of an individual's emotional, mental, and physical condition plus various social, economic, cultural, and environmental factors. On the **quantitative** side, value is the actual gain measured in terms of financial numbers, percentages, and dollars.

One way for an organization to increase its **perceived value** to show consumers that its products will help them solve a problem, offer a solution, produce results, make them happy, and comes at a great quality-price-ratio.

To reveal the company's strengths and weaknesses compared to other competitors, it is important to conduct a **customer value analysis**. This is the collection and evaluation of data associated with customer needs and market trends. The steps are as follows:




- Identify the major attributes and benefits, such as ease of use or improved social standing, that customers value for choosing a

product. It is important to identify and define benefits as opposed to features.

- Assess the quantitative importance of the different attributes and benefits. In other words, attempt to assign an actual price differentiation for products with value-adding benefits.
- Assess the company's and competitors' performance on each attribute and benefit. It is important to be honest with yourself about who your actual closest competitors are and how they price their products.
- Examine how customers in the particular segment rated the company against major competitors on each attribute.
- Monitor customer perceived value over time.

**Example: customer value analysis of smartphone operating systems**

The customer value analysis identifies a firm's key competitors and compares them using industry's critical success factors. The analysis also reveals a company's relative strengths and weaknesses against its competitors, so a company would know which areas it should improve and which areas it should protect. An example is demonstrated below.

| | | Android OS | | iOS | | Windows Phone | |
|---|---|---|---|---|---|---|---|
| Critical Success Factor | Weight | Rating | Score | Rating | Score | Rating | Score |
| Market share | 0.13 | 4 | 0.52 | 2 | 0.26 | 2 | 0.26 |
| Number of apps in store | 0.10 | 4 | 0.40 | 4 | 0.40 | 2 | 0.20 |
| Frequency of updates | 0.06 | 3 | 0.18 | 4 | 0.24 | 2 | 0.12 |
| Design | 0.07 | 3 | 0.21 | 3 | 0.21 | 3 | 0.21 |
| Product brand reputation | 0.05 | 3 | 0.15 | 3 | 0.15 | 2 | 0.10 |
| Distribution channels | 0.11 | 4 | 0.44 | 2 | 0.22 | 3 | 0.33 |
| Usability | 0.11 | 3 | 0.33 | 3 | 0.33 | 3 | 0.33 |
| Customization features | 0.04 | 4 | 0.16 | 2 | 0.08 | 2 | 0.08 |
| Marketing capabilities | 0.04 | 2 | 0.08 | 4 | 0.16 | 2 | 0.08 |
| Company brand reputation | 0.10 | 4 | 0.40 | 4 | 0.40 | 3 | 0.30 |
| Openness | 0.02 | 4 | 0.08 | 2 | 0.04 | 2 | 0.04 |
| Cloud integration | 0.12 | 4 | 0.48 | 2 | 0.24 | 2 | 0.24 |
| Rate of OS crashes | 0.08 | 1 | 0.08 | 4 | 0.32 | 3 | 0.24 |
| Total | 1.00 | - | 3.51 | - | 3.05 | - | 2.53 |

The analysis reveals that Android is the strongest player in the industry with relative strengths in market share, distribution channels, customization features, openness, and cloud integration. On the other hand, iOS prevails in frequency updates, marketing capabilities and the rate of OS crashes. Windows Phone is the weakest of them all and doesn't have any relative strengths against its rivals. The companies

should create their strategies according to their strengths and weakness and improve their ratings in the most significant industry's areas.

# 8. Marketing Performance

At some point, every company has to assess the success of its marketing activities. Marketing effectiveness is the measure of how effective a marketing strategy is in maximizing their spending to achieve positive results, in both the short- and long-term.

## Marketing Effectiveness

One way to assess whether a company successfully practices marketing is to assess its overall level of marketing effectiveness. Marketing effectiveness is based on five dimensions, including a firm's degree of holding to a customer-oriented philosophy, strategic marketing orientation, ability to gather relevant and timely market intelligence, level of integration of the marketing organization, and operational efficiency.


**1. Customer Orientation**
Successful marketing is based on being able to meet customers' needs. Marketing is highly dependent on knowing, analyzing, and meeting customer needs, as opposed to a singular focus on the product or general sales. Does the company respond quickly to the customers' issues or troubles?

**2. Strategic Orientation**
From a strategic point of view, the marketing professionals in a company must function with the long-term strategy and success in mind. This

typically takes the form of formal marketing planning, and a culture of strategic, long-term thinking.

**3. Market Intelligence**
To serve the customers' needs, a company and its marketing professionals should obtain as much objective information as possible, regarding its status in the marketplace. In addition to having the necessary information for planning and resource allocation, from their own internal data and sources, key decision-makers should also have at their disposal up-to-date information about the external market.

**4. Organizational Integration**
Based on the competitive intelligence the company gains, a company must react in an integrated and efficient manner, to maintain its level of customer service, and if necessary, adjust its strategy. Integration focuses on how good marketing and other departments in an organization communicate and work together.

**5. Operational Efficiency**
Operational efficiency speaks to how effective the organization is at its business. How well are the decisions, made at the higher levels of marketing, filtered throughout the organization? How responsive is the marketing department to problems and issues? How responsive is the organization to customer requests?

# Performance Measurement

Marketing performance metrics, or key performance indicators (KPIs), are useful not only for marketing professionals but also for non-marketing executives. From the chief executive officer to the vice president of sales, the senior management team needs marketing KPIs to measure how marketing activities and spending impact the company's bottom line. This is particularly important since companies are prone to reduce marketing budgets during economic downturns, downsizing, and mergers.

As marketers face more and more pressure to show a return on investment (ROI) on their activities, marketing performance metrics help measure the degree to which marketing spending contributes to profits. It also highlights how marketing contributes to initiatives in other areas of the organization, such as sales and customer service.

Other reasons why companies evaluate marketing performance include:

- Monitoring the marketing department's progress towards its annual goals.
- Determining what areas of the marketing mix – product, price, place, and promotion – need modification or improvement to increase some aspect of performance.
- Assessing whether company goods, services, and ideas meet customer and stakeholder needs.
- Establishing marketing performance metrics is an essential part to help brands satisfy customers, establish a clear company image, be proactive in the market, and fully incorporate marketing into the company's overall business strategy.

To measure the effectiveness of a marketing campaign, a business needs to agree upon the goals of the campaigns, and the KPIs (key performance indicators) that it needs to track. For example, the goal of a campaign could be to increase a company's online brand reputation. A good KPI to measure the success of this campaign might be, the number of website visitors.

# 9. Digital Marketing

Digital marketing encompasses all marketing efforts that use an electronic device or the internet. Businesses leverage digital channels such as search engines, social media, email, and websites to connect with current and prospective customers.

# Digital Marketing Channels

Digital marketing features a key characteristic traditional marketing has often struggled with: it makes marketing actions easily **measurable**. Though marketing always used data, the newest integrations with technology have allowed many companies to work more efficiently with bigger data sets. With modern web analytics software, the success of

specific digital marketing actions (such as an ad on Google, a post on social media, an email campaign or a blog post) can be tracked and reported.

Digital marketing is defined by the use of numerous digital tactics and **channels** to connect with customers where they spend much of their time: online. From the website itself to a business's online branding assets – digital advertising, email marketing, online brochures, and beyond – there's a spectrum of tactics that fall under the umbrella of "digital marketing."

Here's a quick rundown of some of the most common digital marketing tactics and the channels involved in each one:


- **Search Engine Optimization (SEO)**
  This is the process of optimizing your website to "rank" higher in search engine results pages (like Google or Bing), thereby increasing the amount of organic (or free) traffic your website receives. Typically this is achieved by researching and including important user-relevant keywords to your website or blog.

However, it normally takes a lot of time and effort to receive a good Google ranking.

- **Search Engine Advertising (SEA)**
  One of the most common types of online advertising is using Google Ads. Google Ads allow you to pay for top slots on Google's search engine results pages. You get charged for every click that your ad receives. This is the reason why this type of marketing is also known as Pay-per-Click (PPC). SEA will often lead to faster results than SEO, but it will also come with a price tag.
- **Content Marketing**
  This term denotes the creation and promotion of content assets for the purpose of generating brand awareness, traffic growth, lead generation, and customers. Since many potential customers are looking for information on the internet, this can be a great technique to combine consumer-relevant information with the products and services your company has to offer. Providing high-quality content can also be useful for SEO, social media postings, downloadable ebooks, email campaigns, etc.
- **Social Media Marketing**
  This practice promotes your brand and your content on social media channels and video platforms to increase brand awareness, drive traffic, and generate leads for your business. The channels you can use in social media marketing include Facebook, Twitter, LinkedIn, Instagram, Snapchat, YouTube, Pinterest, and many more. Social networks also offer companies the possibility to run paid ads in order to reach even more potential customers.
- **Email Marketing**
  Companies use email marketing as a way of communicating with their audiences. Email is often used to promote content, discounts, and events, as well as to direct people toward the business's website. The types of emails you might send in an email marketing campaign include blog subscription newsletters, follow-up emails to website users or customer welcome emails.

Digital marketing tactics can help your organization get found online by the right people to attract, engage and convert with your products and services.

# Digital Marketing Roles & KPIs

Digital marketers are in charge of driving **brand awareness** and **lead generation** through all the digital channels that are at a company's disposal. As you already know, these channels include social media, the company's own website, search engine rankings, email, display advertising, the company's blog, and many more.

The digital marketer usually focuses on different **key performance indicators** (KPIs) for each channel so they can properly measure the company's performance across each one.

Digital marketing is carried out across many marketing roles. In small companies, one generalist might own several of the digital marketing channels at the same time. Larger companies have multiple specialists who focus on just one or two of the firm's digital channels.

Here are some examples of these specialists:


- **SEO Manager** (main KPIs: Organic traffic, Google ranking)
  In short, SEO managers get the business to rank on Google. Using a variety of approaches to search engine optimization, this

person might work directly with content creators to ensure the content they produce performs well on Google.

- **Content Marketing Specialist** (main KPIs: Time spent on a webpage, overall blog traffic, YouTube channel subscribers)
  Content marketing specialists are digital content creators. They frequently keep track of the company's blogging calendar and come up with a content strategy that includes texts, images, podcasts, videos, and much more. These professionals often work with people in other departments to ensure the products and campaigns the business launches are supported with promotional content on each digital channel.
- **Social Media Manager** (main KPIs: Follows, Likes, Fans, Impressions, Shares)
  The role of a social media manager is easy to infer from the title, but which social networks they manage for the company depends on the industry. Above all, social media managers establish a posting schedule for the company's written and visual content. This employee might also work with the content marketing specialist to develop a common strategy.
- **Performance Marketing Manager** (main KPIs: Cost-per-Click, Cost-per-Lead, Return-on-Investment)
  A performance marketing manager is responsible for developing, implementing and managing paid online advertising campaigns that promote a company and its products and services (for example with Google Ads or Facebook Ads). He or she plays a major role in acquiring leads and customers and typically is a number-driven and analytical person.
- **Email Marketing Manager** (main KPIs: Email open rate, Email click rate)
  This person is responsible for editing the company's email campaigns, analyzing the results of the latest emails, and making recommendations for further improvement.

The best digital marketers have a clear picture of how each digital marketing activity supports their overarching goals. Depending on the goals of their marketing strategy, marketers can support a larger campaign through the free and paid channels at their disposal.

# 10. Case Study & Conclusion

Marketing is about putting the right product in the right place, at the right time, and with the right price. The difficult part is doing this well. To complete this course and highlight its core concepts, we will take a closer look at the marketing of Mercedes-Benz and we will summarize the key takeaways.

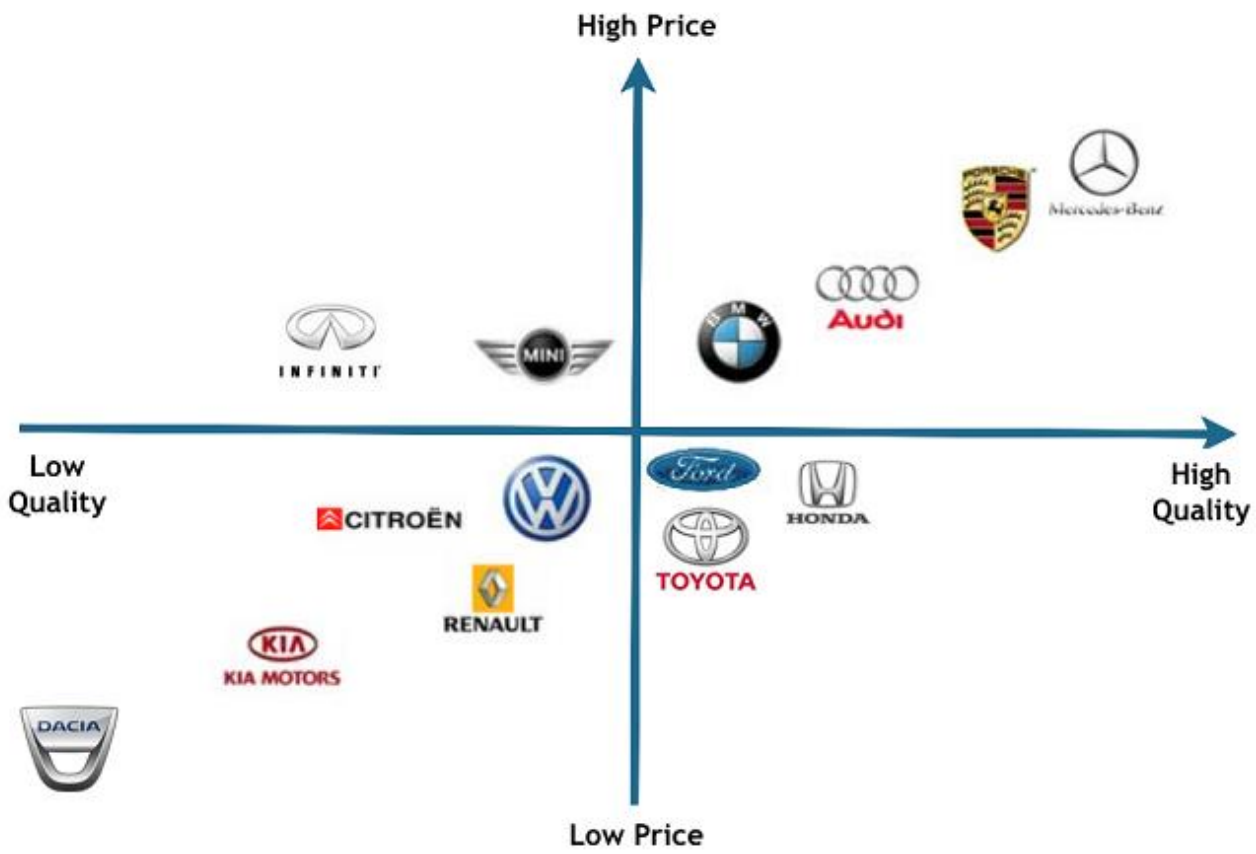
# Case Study: Mercedes-Benz

Mercedes-Benz is part of the German automaker Daimler. The German automaker is the best-selling premium brand in the automotive industry and one of the largest (volume) selling automakers in the world. High performance and high-quality cars produced by Mercedes have helped the company in selling more than two million cars in the year 2018.

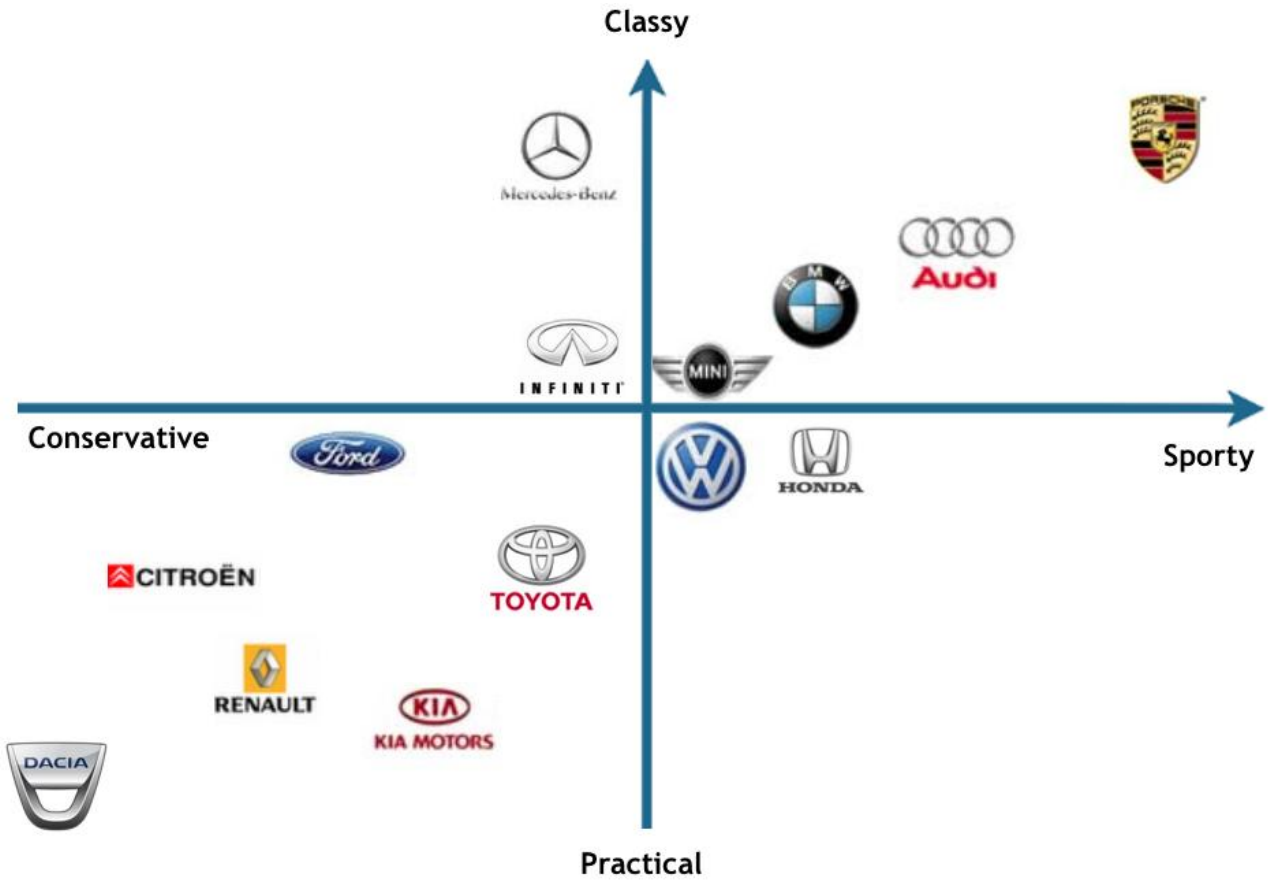
In this case study, we will discuss how Mercedes-Benz used perceptual mapping and marketing segmentation in order to change its marketing mix and appeal to a younger target audience.

## Perceptual Mapping

Research shows that Mercedes-Benz is seen as a premium car brand that offers **high-quality** cars. The perceptual map below shows that consumers felt that Mercedes cars were the most prestigious but also the most **expensive** cars in the study.




However, the same sample of consumers also rated Mercedes as a classy, yet **conservative** brand. Rivals such as BMW, Audi, and Porsche were described as rather **sporty**. As a result, the study showed that Mercedes had difficulties to attract younger customers.




## Marketing Segmentation

Mercedes-Benz noticed that its Marketing Mix needed to change: while the firm continued to break sales records, the average Mercedes buyer reached the age of 53 years. Research also revealed that twice as many Millennial buyers chose competitors Audi and BMW over Mercedes.

As the Mercedes-Benz demographic began to age, the company faced the challenge of appealing to a younger audience without losing the prestige of the brand, risking the loss of its core customers.

Mercedes-Benz intensified marketing segmentation to reach a younger audience in 2010 with the creation of “Generation Benz” – an online community of approximately 200 to 250 people between the ages of 20 to 39. This online community provided consulting to the Mercedes-Benz marketing team about buyer habits and preferences in this demographic. The “Generation Benz” community helped to produce a new customer profile.

The company leveraged the insight from the community to update its marketing mix by launching new car models, changing its pricing strategy, facilitating online sales, and creating innovative marketing campaigns.

## Marketing Mix

The marketing mix of Mercedes-Benz shows how the company was able to become the most recognized global automobile brand. This high profile success is not an accident but hard work, patience and excellent application of effective marketing strategy all rolled into one. Updates to its marketing mix indicate how the brand tries to better connect with a younger audience.

**1. Product**
Mercedes Benz is one of the leading premium car brands in the world. The company offers a wide range of passenger cars, light commercial and heavy equipment vehicles. However, the strongest in its product portfolio will be the luxury car segment which consists of Sedans, SUVs, sports cars, cabriolets, and roadsters. Mercedes-Benz sells products with a lot of variety available, which allows customers to select the product variety that best suits them. Three common key factors of all Mercedes-Benz cars are design, technology, and performance.

In order to appeal to a younger audience, Mercedes-Benz has given its conservative designs a fresher and more sportive look. The car marque has also shifted its product development to resonate with younger drivers and launched new and “younger” models such as the Mercedes-Benz CLA.


**2. Price**
The company deals in a niche segment where the customer is most concerned with the value and quality they are getting on the product. Therefore, Mercedes-Benz has tried to ensure it makes high-quality cars first and foremost. The company has a price structure ranging up to $100,000, depending on the model. Thus, the Mercedes-Benz marketing mix pricing strategy uses premium pricing.

The primary method to entice the younger and less affluent consumers has been the introduction of new models with a lower price point. A lower price reduces the barrier to entry and the price objection for less affluent customers while leveraging the luxury brand appeal. Mercedes-Benz has launched the CLA at a starting price of just under $30,000.

**3. Place**
Mercedes Benz cars are present all across the world. Mercedes caters to a number of countries worldwide, with its dealerships and service stations present across various countries. The major markets are Europe, North America, and the Asia Pacific region. Mercedes Benz traditionally sells its products to wholesalers who then sell to different retailers located all over the country. These then sell to its customers.

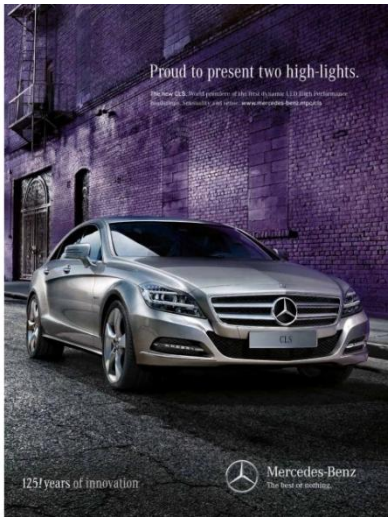
Nowadays, however, Mercedes-Benz increasingly sells its cars directly to its customers through its online website. The firm also follows an omnichannel distribution system where it has integrated its online and offline stores to allow customers easy access to its products.

## 4. Promotion

Mercedes Benz has always been an aggressive promoter. The company uses multiple channels to promote its products. It uses traditional media, which includes advertisements on television, radio, and print. This is beneficial due to its large reach and ability to attract a large number of people.

Competition has now propelled Mercedes-Benz to adjust its promotion message and channels to reach younger customers. Today, its marketing strategy focuses on presenting a more energetic, fun-loving and approachable side of Mercedes-Benz (see examples below). The firm now uses digital and social media channels to target millennials with a mix of owned media, paid media, influencers, and celebrities in the target demographic to create brand awareness and ultimately brand equity.






## Conclusion

Mercedes-Benz provides an example of how a prestige brand can effectively segment and target a different audience without losing its brand prestige. Mercedes-Benz had struggled in this area before but had learned from its past mistakes. The launch of the CLA model proved to be a huge success: it was the best product launch for Mercedes-Benz in the last 20 years while reaching an average customer age of 46 (compared to the company-wide 53 years).

# Summary

The heart of your business success lies in its marketing effectiveness. Marketing does not start with a new idea or innovative product. It begins with the customers – these are the people who make your business successful, and this is where good marketing can really make a difference.

Marketing enables you to position a product or service and to target different groups of customers more efficiently. It helps you to quickly zoom in on the most profitable parts of your business so that you can fully exploit the opportunities present. Start by segmenting your market into groups. Next, choose which of these groups you want to target. Last, identify how you want to position your product, based on the personality and behavior of your target market.

In this course, we have seen that marketing is not just a single advertisement or public relations campaign, but rather a continual process of creating value for customers, and meeting their needs. Through managing and adjusting the four primary marketing mix variables (product, price, place, and promotion), identifying appropriate customers (segmentation and targeting), and placing the desired product or service image in the minds of those customers (positioning), marketing professionals are putting their companies in a position to achieve success.

In this course, you learned about:

- the most essential marketing concepts,
- the evolution of marketing over the years,
- analyzing the micro and macro environment,
- the importance of preparing a marketing strategy,
- the most important tools for marketing segmentation and positioning,
- ways to measure marketing performance,
- and the importance of digital marketing.

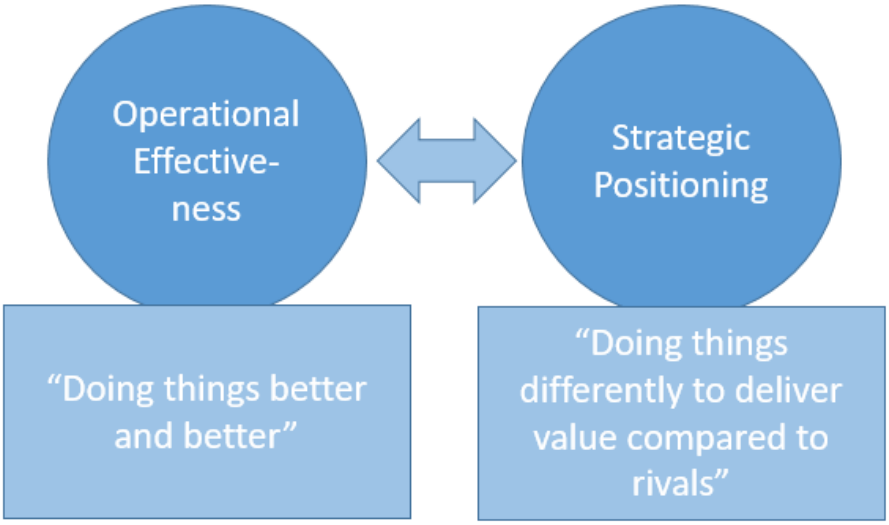
# Strategy and Operations

# 1. Introduction

**Welcome to Strategy and Operations!**
In today's competitive business world, effective managers need to understand the differences and similarities between the operational side and the strategic side of business. They need to understand and bring together both disciplines.

Expanded knowledge of how strategy and operations can work in parallel with one another will drive better performance and competitiveness for the organization.

Understanding the tension that exists between these two business functions will help managers recognize ways to reconcile those differences. When that happens, managers will begin to identify strategic opportunities.




To provide greater clarity, think of operations and strategy as two separate, but related, engines on a boat. Both engines propel the boat forward. While forward movement can occur with only one engine, the boat moves faster and is more responsive if both engines are running efficiently.

Each engine is important, and each engine requires fuel, maintenance, and skillful attention so the boat's ability to deliver results is optimized.

Think of your organization as a big boat. If we focus all of our attention, effort, and resources solely on the operations side of the business, we put the whole organization at risk. This risk comes from the operational engine running harder.

Being so focused on operations may seem like the smart thing to do at the moment, but over the long run, your efficiency may suffer. Running one engine hard could quickly move you in a direction that will backfire, taking your future competitive advantage with it. The idea of focusing solely on the strategic engine is equally bad.

Without the operational capacity to implement or take advantage of our insights about future innovations, processes, or market needs, all efforts towards our strategy and planning will be for nothing. We must understand and balance both sides of the business, and to do that well, a greater depth of understanding is necessary.

In the first part of this course (chapters 2-4), you are going to learn the basics of **Strategic Management**. In the second part of this course (chapters 5-8), we will discuss the most essentials tools and models of **Operations Management**.

# 2. Strategic Management

Strategic management is the continuous planning, monitoring, analysis and assessment of all that is necessary for an organization to meet its goals and objectives. In the first chapters of this course, we will discuss the most important strategic management tools every manager needs to understand.

## Defining "Strategy"

The word “strategy” is derived from the Greek word “stratçgos” – a combination of stratus (meaning army) and “ago” (meaning leading/moving).

A **strategy** is an action that managers take to attain one or more of the organization’s goals. Strategy can also be defined as a general direction set for the company and its various components to achieve a desired state in the future. Strategy results from the detailed strategic planning process.

A strategy is all about integrating organizational activities and utilizing and allocating the scarce resources within the organizational environment so as to meet the present objectives. While planning a strategy it is essential to consider that decisions are not taken in a vacuum and that any action taken by a firm is likely to be met by a reaction from those affected: competitors, customers, employees or suppliers.

Strategy can also be defined as knowledge of the goals, the uncertainty of events and the need to take into consideration the likely or actual behavior of others. Strategy is the blueprint of decisions in an organization that shows its objectives and goals, reduces the key policies, and plans for achieving these goals, and defines the business the company is to carry on, the type of economic and human organization it wants to be, and the contribution it plans to make to its shareholders, customers, and society at large.

**But why is a strategy so important?**

- A strategy is significant because it is not possible to foresee the future. Without perfect foresight, firms must be ready to deal with the uncertain events which constitute the business environment.
- A strategy deals with long term developments rather than routine operations, i.e. it deals with the probability of innovations or new products, new methods of productions, or new markets to be developed in the future.
- A strategy is created to take into account the probable behavior of customers and competitors. Strategies dealing with employees will predict employee behavior.

A strategy is a well-defined road map of an organization. It defines the overall mission, vision and direction of an organization. The objective of

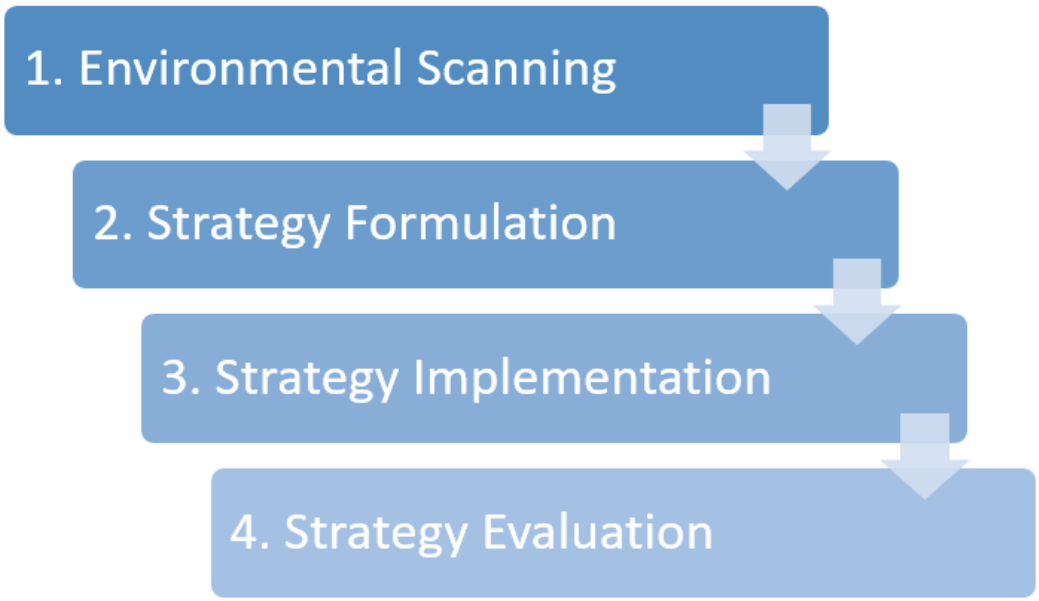
a strategy is to maximize an organization's strengths and to minimize the strengths of the competitors. Strategy, in short, is the link between "where we are" and "where we want to be".

A strategy is a road map of an organization and defines its overall mission, vision, and direction.

# Strategic Management

The strategic management process means **defining the organization's strategy**. It is also defined as the process by which managers make a choice of a set of strategies for the organization that will enable it to achieve better performance. Strategic management is a continuous process that appraises the business and industries in which the organization is involved; appraises it's competitors; and fixes goals to meet all the present and future competitor's and then reassesses each strategy.

The strategic management process has the following four steps:




**1. Environmental Scanning**
Environmental scanning refers to a process of collecting, scrutinizing and providing information for strategic purposes. It helps in analyzing the internal and external factors influencing an organization. After executing the environmental analysis process, management should evaluate it on a continuous basis and strive to improve it.

**2. Strategy Formulation**
Strategy formulation is the process of deciding best course of action for accomplishing organizational objectives and hence achieving organizational purpose. After conducting environment scanning, managers formulate corporate, business and functional strategies.

**3. Strategy Implementation**
Strategy implementation implies making the strategy work as intended or putting the organization's chosen strategy into action. Strategy implementation includes designing the organization's structure, distributing resources, developing decision making process, and managing human resources.

**4. Strategy Evaluation**
Strategy evaluation is the final step of strategy management process. The key strategy evaluation activities are: appraising internal and external factors that are the root of present strategies, measuring performance, and taking remedial / corrective actions. Evaluation makes sure that the organizational strategy as well as it's implementation meets the organizational objectives.

These components are steps that are carried, in chronological order, when creating a new strategic management plan. Present businesses that have already created a strategic management plan will revert to these steps as per the situation's requirement, so as to make essential changes. However, strategic management is an ongoing process. Therefore, it must be realized that each component interacts with the other components and that this interaction often happens in chorus.

Remember: strategic management is an ongoing process.

# Competitive Advantage

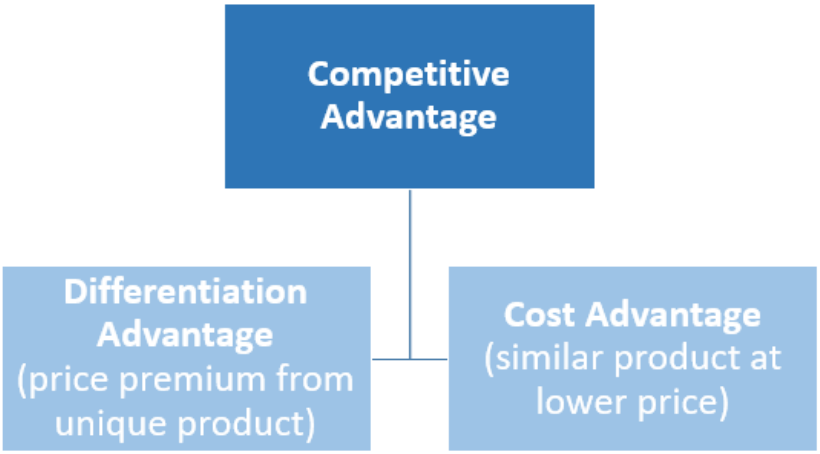
An organization is said to have a competitive advantage if its **profitability is higher** than the average profitability for all companies in its industry. But there is not only one correct way to measure it, and for the right reason. Nearly everything can be considered as competitive edge, e.g. higher profit margin, greater return on assets, valuable resources such as brand reputation or unique competence in producing jet engines.

Every company must have at least one advantage to successfully compete in the market. If a company can't identify one or just doesn't possess it, competitors soon outperform it and force the business to leave the market.

An organization can achieve an edge over its competitors in the following two ways:

- **Through external changes**
  When external factors change, many opportunities can appear that, if seized upon, could provide many benefits for an organization. A company can also gain an upper hand over its competitors when it is capable to respond to external changes faster than other organizations.
- **By developing them inside the company**
  A firm can achieve cost or differentiation advantage when it develops rare resources, unique competencies or through innovative processes and products.

Although there are many ways to achieve an advantage, American economist Michael Porter has identified two basic types of competitive advantage: cost and differentiation advantage.




- **Cost advantage**
  A company can achieve superior performance by producing similar quality products or services but at lower costs. The company that tries to achieve cost advantage is pursuing cost leadership strategy. Higher profit margins lead to further price

reductions, more investments in process innovation and ultimately greater value for customers.

- **Differentiation advantage**
  Differentiation advantage is achieved by offering unique products and services and charging a premium price for that. Differentiation strategy is used in this situation and company positions itself more on branding, advertising, design, quality and new product development rather than efficiency, outsourcing or process innovation. Customers are only willing to pay higher prices for unique features and the best quality.

An organization that is capable of outperforming its competitors over a long period of time has a **sustainable competitive advantage.**

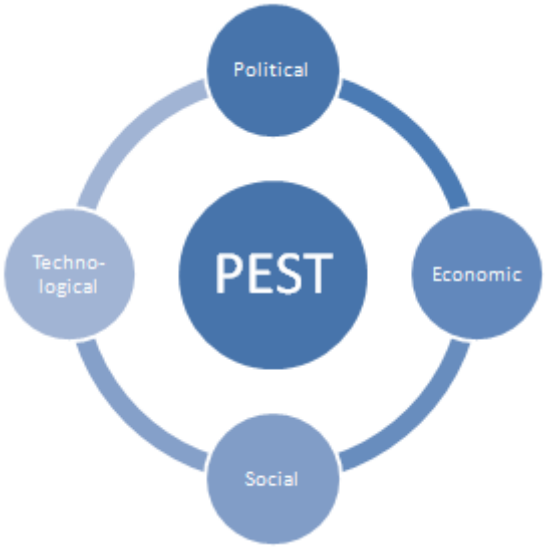
# 3. Environment Analysis

Environmental analysis is the process of identifying external elements that affect an organization's performance. It is an essential foundation for every business strategy. In this chapter, we will discuss the two most popular techniques: the PESTLE analysis as well as Porter's Five Forces.

# PEST Analysis

PEST-Analysis is a framework used to scan the organization's external environment. The letters PEST stand for Political, Economic, Social, and Technological. Some approaches will add in extra factors, such as Legal and Environmental (PESTLE-Analysis). However, all approaches are all merely variations on a theme. The important principle is identifying the key factors from the wider, uncontrollable external environment that might affect the organization.

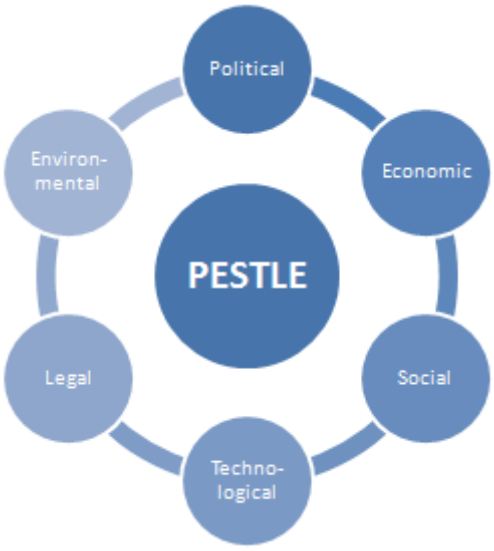
The basic PEST analysis includes four factors:




- **Political –** Here government regulations are assessed in terms of their ability to affect the business environment and trade markets. The main issues addressed in this section include political stability, tax guidelines, trade regulations, safety regulations, and employment laws.
- **Economic –** Through this factor, businesses examine the economic issues that are bound to have an impact on the company. This would include factors like inflation, interest rates, economic growth, the unemployment rate, policies, and the business cycle followed in the country.
- **Social –** With the social factor, a business can analyze the socio-economic environment of its market via elements like customer demographics, cultural limitations, lifestyle attitude, and education. With these, a business can understand how consumer needs are shaped.
- **Technological –** How technology can either positively or negatively impact the introduction of a product or service into a marketplace is assessed here. These factors include technological advancements, the lifecycle of technologies, and the role of the Internet.

# Extended to PESTLE

Expanding the PEST analysis to PESTLE adds two more factors:




- **Legal –** These factors include discrimination law, consumer law, antitrust law, employment law, and health and safety law. These factors can affect how a company operates, its costs, and the demand for its products.
- **Environmental –** Those factors include ecological and environmental aspects such as weather, climate, and climate change, which may especially affect industries such as tourism, farming, and insurance. Furthermore, a growing awareness of the potential impacts of climate change is affecting how companies operate.

When using PESTLE as a tool for analysis it is possible to get overlap between an issue which can be put into two sections. For example, legal factors are often connected to political factors.

As with all techniques, there are advantages and disadvantages to using it to help plan an organizational strategy. On the one hand, it provides a simple and easy-to-use framework for your analysis. It helps to reduce the impact and effects of potential threats to your organization and provides a mechanism that enables your organization to identify and exploit new opportunities. On the other hand, users can oversimplify the information that is used for making decisions. Also, the process has to be conducted regularly to be effective and often organizations do not make this investment.

To maximize the benefit of the PESTLE analysis, it should be used on a regular basis within an organization. The impact of a certain external factor may have more severe consequences for a particular division or

department and the PESTLE technique can help to clarify why change is needed. Furthermore, this analysis technique should be used in conjunction with other tools (such as SWOT) to produce the best results.

# PESTLE Example


In this part, we will take a look at the American coffee company **Starbucks**. The macroeconomic environment that Starbucks operates in is characterized by the last global economic recession. However, consumers have not cut down on their coffee consumption and instead, are shifting to lower-priced options. This means that Starbucks can still leverage the buying power of consumers by offering cheaper alternatives.

We can use the PESTLE tool to screen the environment of the company and analyze the consequences for Starbucks:

**1. Political Factors:**
The sourcing process of Starbuck's raw materials has attracted the attention of the politicians in the West and in the countries from where it sources its raw materials. This is the reason why Starbucks is keen on adhering to social and environmental norms and to follow sourcing strategies that are appropriate and in conformance to the "Fair Trade" practices that have been agreed upon by global corporations and the governments.

**2. Economic Factors:**
The foremost external economic driver for Starbucks is the last global economic recession, which has dented the profitability of many companies. However, studies have shown that consumers instead of

cutting down on their coffee consumption are shifting to lower-priced alternatives which is an opportunity for Starbucks.

**3. Social Factors:**
Though Starbucks can offer cheaper alternatives as mentioned previously, it has to do so without sacrificing the quality and this is the key socio-cultural challenge that the company faces as it expands its consumer base to include the consumers from the lower and the middle tiers of the income pyramid.

**4. Technological Factors:**
The company has already introduced WiFi capabilities in its outlets so that consumers can surf the web and do their work while sipping coffee. Furthermore, it has introduced app-based discount coupons and mobile payments.

**5. Legal Factors:**
Starbucks has to ensure that it does not run afoul of the laws and regulations in the countries from which it sources its raw materials as well as the home markets in the United States.

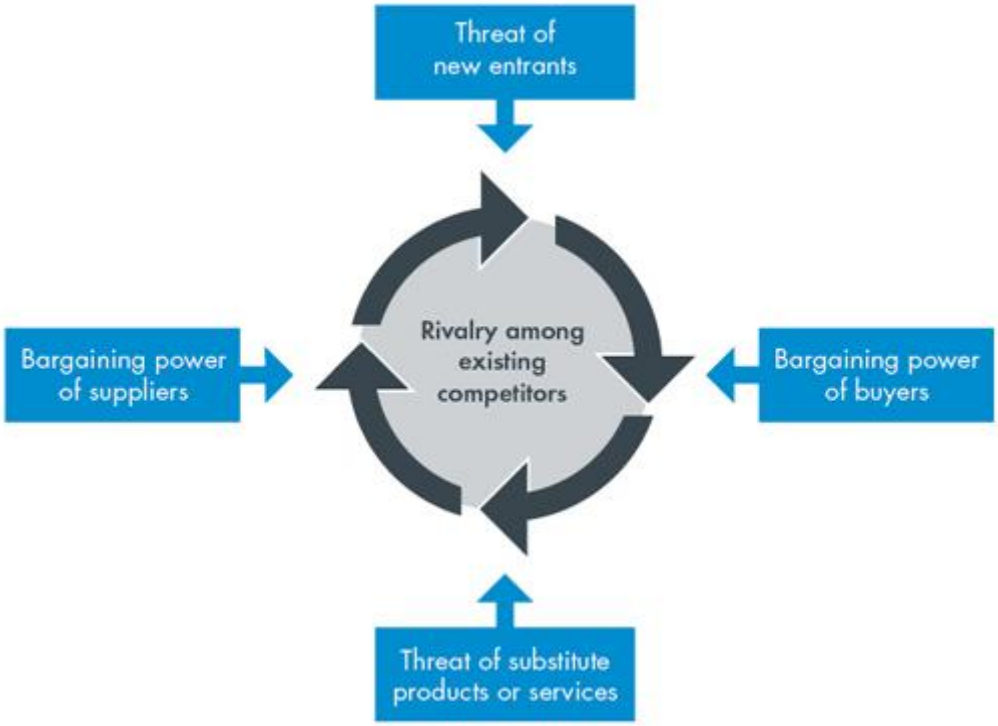
**6. Environmental Factors:**
There have been several concerns about the business practices of Starbucks from the activists and from the consumers themselves. Therefore, Starbucks has to take into account these concerns if it has to continue holding on to the trust it enjoys with its consumers.

**Conclusion**
The analysis proves the point that Starbucks is operating in a relatively stable external environment. The main reason for this is the fact that it operates in the Food and Beverages space which means that despite the recession, consumers cut down on the consumption to a certain extent and not completely. Therefore, the task before Starbucks is to lower costs and increase the value so that it retains its consumer base and attracts consumer loyalty.

# Porter’s Five Forces

**Porter’s Five Forces** model, named after Michael Porter, identifies five forces that shape every market and industry in the world. The five forces

are frequently used to measure competition intensity, attractiveness, and profitability of an industry or market. These five forces are:




- **Threat of New Entry:** A company's power is affected by the force of new entrants into its market. The less time and money it costs for a competitor to enter a company's market and be an effective competitor, the more a company's position may be significantly weakened. An industry with strong barriers to entry is an attractive feature for companies that allows them to charge higher prices and negotiate better terms.
- **Buyer Power:** This specifically deals with the ability that customers have to drive prices down. It is affected by how many buyers or customers a company has, how significant each customer is, and how much it would cost a company to find new customers or markets for its output. A smaller and more powerful client base means that each customer has more power to negotiate for lower prices and better deals. A company that has many, smaller, independent customers will have an easier time charging higher prices to increase profitability.
- **Threat of Substitution:** Substitute goods or services that can be used in place of a company's products or services pose a threat. Companies that produce goods or services for which there are no close substitutes will have more power to increase

prices and lock in favorable terms. When close substitutes are available, customers will have the option to forgo buying a company's product, and a company's power can be weakened.

- **Supplier Power:** This force addresses how easily suppliers can drive up the cost of inputs. It is affected by the number of suppliers of key inputs of a good or service, how unique these inputs are, and how much it would cost a company to switch from one supplier to another. The fewer the number of suppliers, and the more a company depends upon a supplier, the more power a supplier holds to drive up input costs and push for advantage in trade. On the other hand, when there are many suppliers or low switching costs between rival suppliers a company can keep input costs lower increasing profits.
- **Competitive Rivalry:** This force refers to the number of competitors and their ability to undercut a company. The larger the number of competitors, along with the number of equivalent products and services they offer, the lesser the power of a company. Suppliers and buyers seek out a company's competition if they are able to offer a better deal or lower prices. Conversely, when competitive rivalry is low, a company has greater power to charge higher prices and set the terms of deals to achieve higher sales and profits.

Frequently used to identify an industry's structure to determine corporate strategy, Porter's model can be applied to any segment of the economy to search for profitability and attractiveness.

Understanding Porter's Five Forces and how they apply to an industry, can enable a company to adjust its business strategy to better use its resources to generate higher earnings for its investors.

# Porter's Five Example

In this short example, we will look at how **Under Armour** fits into the athletic footwear and apparel industry. Under Armour is an American company headquartered in Baltimore, US that manufactures footwear, sports, and casual apparel.

- **Competitive rivalry:** Under Armour faces intense competition from Nike, Adidas, and newer players. Nike and Adidas, which have considerably larger resources at their disposal, are making a play within the performance apparel market to gain market

share in this up-and-coming product category. Under Armour does not hold any fabric or process patents, hence its product portfolio could be copied in the future.

- **Bargaining power of suppliers:** A diverse supplier base limits their bargaining power. Under Armour's products are produced by dozens of manufacturers based in multiple countries.
- **Bargaining power of customers:** Under Armour's customers include both wholesale customers as well as end customers. Wholesale customers, like Dick's Sporting Goods and the Sports Authority, hold a certain degree of bargaining leverage, as they could substitute Under Armour's products with those of UA's competitors to gain higher margins. The bargaining power of end customers is lower as UA enjoys strong brand recognition.
- **Threat of new entrants:** Large capital costs are required for branding, advertising and creating product demand, and hence limits the entry of newer players in the sports apparel market. However, existing companies in the sports apparel industry could enter the performance apparel market in the future.
- **Threat of substitute products:** The demand for performance apparel, sports footwear and accessories is expected to continue, and hence this force does not threaten Under Armour in the foreseeable future.

**Conclusion:**
By thinking about how each force affects you, and by identifying the strength and direction of each force, you can quickly assess the strength of your position and your ability to make a sustained profit in the industry. You can then look at how you can affect each of the forces to move the balance of power in your favor.

# 4. Strategic Planning & Internal Analysis

After having analyzed the environment, it is now time to take an organization's internal strengths and weaknesses into account. This is

essential for crafting a powerful strategy that distinguishes your business from your competitors and leads to long-term success.

# SWOT Analysis

**SWOT analysis** is a relatively quick way to look at organizational **Strengths, Weaknesses, Opportunities,** and **Threats**. The overall purpose of a SWOT analysis is to examine the internal and external factors that help or hinder you in achieving each of your objectives. Strengths (S) and Weaknesses (W) are considered to be internal factors over which you have some measure of control. However, Opportunities (O) and Threats (T) are considered to be external factors over which you have essentially no control. In other words, the framework views all positive and negative factors inside and outside the firm that affect success.


**1. Strengths**

Strengths are the qualities that enable us to accomplish the organization's mission. These are the basis on which continued success can be made and continued/sustained. Strengths are the beneficial aspects of the organization or the capabilities of an organization, which includes human competencies, process capabilities, financial resources, products and services, customer goodwill and brand loyalty. Examples of organizational strengths are huge financial resources, broad product line, no debt, committed employees, etc.

**2. Weaknesses**
Weaknesses are the qualities that prevent us from accomplishing our mission and achieving our full potential. Weaknesses in an organization may be depreciating machinery, insufficient research and development facilities, narrow product range, poor decision-making, etc. Examples of organizational weaknesses are huge debts, high employee turnover, complex decision making process, narrow product range, large wastage of raw materials, etc. Weaknesses are controllable. They must be minimized and eliminated.

**3. Opportunities**
Opportunities are presented by the environment within which our organization operates. These arise when an organization can take benefit of conditions in its environment to plan and execute strategies that enable it to become more profitable. Organizations can gain a competitive advantage by making use of opportunities. Opportunities may arise from market, competition, industry/government and technology. Increasing demand for telecommunications accompanied by deregulation is a great opportunity for new firms to enter the telecom sector.

**4. Threats**
Threats arise when conditions in the external environment jeopardize the reliability and profitability of the organization's business. Threats are uncontrollable. When a threat comes, stability and survival can be at stake. Examples of threats are ever-changing technology; increasing competition leading to excess capacity, and massive price wars reducing industry profits.

SWOT analysis (or SWOT matrix) is a strategic planning technique used to evaluate the strengths, weaknesses, opportunities, and threats of an organization.
The popularity of SWOT analysis is down to its simplicity and flexibility. It is easy for everyone to understand and its implementation does not require any technical knowledge or specialist training. However, the SWOT methodology does encourage a tendency to oversimplify the situation. Another problem with SWOT is that there are no obvious limits as to what is and is not relevant. During SWOT discussions, you need to keep everyone focused on what is important in achieving the objectives, rather than just creating lists of issues.

# SWOT Example

This chapter analyzes the strategy of the world's leading furniture retailer, IKEA using the SWOT methodology. The Swedish company is known for its simple yet effective approach to retailing with the Do It Yourself (DIY) concept: The products sold by IKEA are mostly ready to use and flat packed meaning that they can be assembled by the customers themselves.

**1. Strengths**
The biggest strength that IKEA has is its clear vision, which is to add value to its customers irrespective of the market conditions. This has translated into an articulate and well-defined business strategy and an approach to retailing, which is pioneering in its simplicity and deadly in its targeting of competitors and effective in its positioning. Another key strength of the company is its clear concept which translates into an array of products that can be assembled by the customers themselves leading to humongous cost reductions which are then passed on to the customers.

**2. Weaknesses**
Given the fact that IKEA operates in multiple countries around the world, it is difficult to control standards across locations. Though the company tries its best to implement uniform quality across its product range and throughout its locations, replicable and scalable control of quality is a key weakness. Furthermore, with its obsessive focus on cost leadership, quality sometimes goes for a toss. The point to be noted here is that it is sometimes difficult to maintain quality in the context of increasing costs and the need to replicate standards across its locations worldwide.

**3. Opportunities**
Perhaps the biggest opportunity that the company has is its cost leadership, which means a single-minded focus on cost at the expense of everything else. While this has raised concerns about quality, the customers do not seem to mind as they are getting their money's worth. The other opportunity lies in the company's expansion into the emerging markets and the developing world where it has an untapped customer base that can be leveraged for effective profitability.

**4. Threats**
IKEA's low-cost business model has been imitated and copied by its rivals, which means that the company needs to constantly innovate if it has to stay ahead of the competition. For instance, several regional and local companies have caught on to the DIY bandwagon and are also focusing on costs which means that to stay nimble and agile, IKEA has to come up with newer strategies. With the advent of the internet and online shopping, DIY as a key driver of strategic success is no longer the sole USP (Unique Selling Proposition) of IKEA.

**Conclusion**
Through its innovative business model and its focus on products, processes, and systems, IKEA has managed to stay ahead of the competition in the furniture retailing business.

The company can diversify into other products and product lines as it can replicate its business model in other realms as well. This requires fresh thinking and a new approach to its strategy that would combine low-cost leadership with additional drivers of success like scalability and focus on quality.

Finally, the company can enter the emerging markets where its products and its business model are likely to be met with success and the untapped customer base can be leveraged.

# BCG Matrix

The BCG Matrix, named after its inventors from Boston Consulting Group, assess products on two dimensions. The first dimension looks at the products general level of **growth** within its market. The second dimension then measures the product's **market share** relative to the largest competitor in the industry. Analyzing products this way provides a

useful insight into the likely opportunities and problems with a particular product.

Products are classified into four distinct groups: Stars, Cash Cows, Question marks, and Dogs.


Let's have a look at what each of these four outcomes means for the product and the decision making process:

- **Stars:** Star products all have rapid growth and dominant market share. This means that star products can be seen as market-leading products. These products will need a lot of investment to retain their position, to support further growth as well as to maintain its lead over competing products. Star products will also be generating a lot of income.
- **Cash Cows:** Cash cows don't need the same level of support as stars. This is due to less competitive pressures within a low growth market where they usually enjoy a dominant position. Cash cows are still generating a significant level of income but are not costing the organization much to maintain. These products can be "milked" to fund Star products.
- **Dogs:** Products classified as dogs always have a weak market share in a low growth market. These products are very likely making a loss or a very low profit at best. The question for managers is whether the investment currently being spent on

keeping these products alive could be spent on making something that would be more profitable.

- **Question Marks (also called Problem Children):** These products are in a high growth market but do not seem to have a high share of the market. One reason for this might be that a very new product was recently added to the market. If this is not the case, then some questions need to be answered. What is the organization doing wrong? What are competitors doing right?

The BCG Matrix is easy to perform, it helps to understand the strategic positions of the business portfolio, and it's a good starting point for further analysis. Nevertheless, this growth-share analysis has been heavily criticized for its oversimplification. Market growth is one of many factors that determine industry attractiveness and relative market share is only one of the factors that determine competitive advantage. This matrix does not take into account any other factors that may have a bearing on both industry attractiveness and competitive advantage.

# BCG Matrix Example

The BCG matrix analysis for **Nestlé** reveals some interesting perspectives. As a global multinational in the food and beverage industry, the Swiss company is one of the biggest corporations in the world. Over 8000 brands fall within its umbrella and are as widespread as bottled water and pet food.

**Question Marks:**
There are products that formulate a part of the industry that is still in the phase of development, yet the organization has not been able to create a significant position in that industry. The small market share obtained by the organization makes the future outlook for the product uncertain, therefore investing in such domains is seen as a high-risk decision. Nestlé's Chocolates and confectioneries can be placed in the Question

Mark quadrant of the BCG Matrix due to high competition and small market share in the industry.

**Stars:**
The products that have a high market share in a high growth industry are the stars of the organization. In the case of Nestlé, it's Mineral Water and its Nescafe Coffee fall in the Star quadrant. Growing healthier lifestyle trends and emerging markets have prompted the brand to invest large amounts of investments in order to differentiate the bottled water brands from competitors in mature markets and grow brand awareness in emerging markets.

**Dogs:**
Dogs were perceived to have the potential to grow but failed to create magic due to the slow market growth. Failure to deliver the expected results makes the product a source of loss for the organization, propelling the management to withdraw future investments. The capital could be invested in a Question mark or Star category instead. Nestlé's Milo was launched as chocolate and malt powder for Milk and water, however, the product failed to create any significant impact on the business in many countries.

**Cash Cows:**
Cash cows are the products that have a high market share in a market that has low growth. For Nestlé, one Cash Cow is Maggi Noddles. With a market share of 80-85 %, Maggi Noddles holds a very stronghold in the market and has high customer loyalty. The product requires very less investment to maintain its market share and fight off any competition.

The BCG matrix helps organizations determine which areas of their business deserve more resources and investment. This is especially helpful for corporations like Nestlé that offer a broad range of products in many different markets.

# Ansoff-Matrix

The Ansoff Matrix is a strategic planning tool that provides a framework to help executives, senior managers, and marketers devise strategies for future growth.

According to this tool, there are four possible combinations for growth. Each company needs to decide which strategy to use based on the strengths and weaknesses of the organization and its competitors. Each strategy has a different level of risk, with market penetration having the lowest risk and diversification having the highest risk.


**Market Penetration**
This occurs when a company infiltrates a market in which current products already exist. The best way to achieve this is by gaining the customers of competitors. Other ways include attracting non-users of your product or convincing current clients to use more of your product.

While market penetration may come with the lowest risk, at some point the company will reach market saturation with the current product and will have to switch to a new strategy.

**Market Development**
Market development targets non-buying customers in currently targeted segments. It also targets new customers in new segments in order to expand the potential market. New users can be defined as new geographic, demographic, institutional, or psychographic segments.

If a company believes that its strength lies with its products and they believe their products would be enticing to new customers, then a company may want to use a market development strategy.

**New Product Development**
New product development is a process that has two parallel paths: one involves the idea generation, product design, and detail engineering; the other involves market research and marketing analysis. Companies typically see new product development as the first stage in the overall strategic process of product life cycle management used to maintain or grow market share.

If a company believes that its strength lies with the customers, then they should consider a product development strategy.

**Diversification**
Diversification seeks to increase profitability through greater sales volume obtained from new products and new markets. At the business unit level, diversification is most likely to expand into a new segment of an industry that the business is already in. At the corporate level, it is generally via investing in a promising business outside of the scope of the existing business unit.

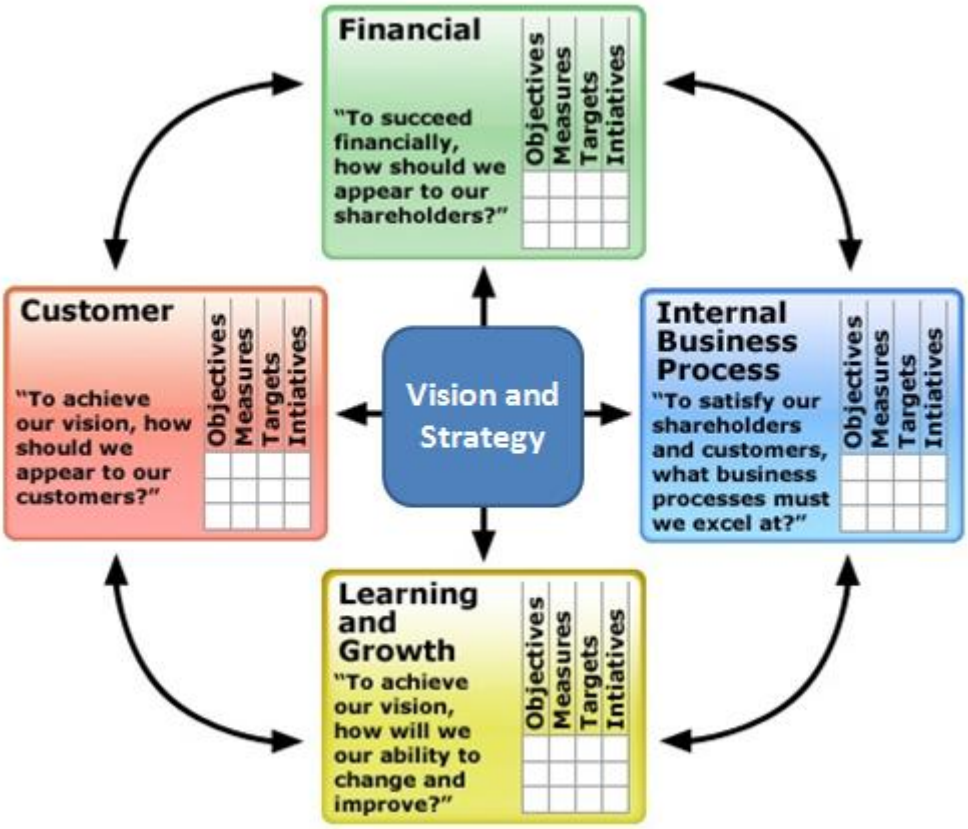
Because of the high risk involved with diversification, many marketing experts believe a company shouldn't attempt diversification unless there is a high return on investment.

The Ansoff Matrix is a useful tool for organizations wanting to identify and explore their growth options. It is one of the most commonly used tools for this type of analysis due to its simplicity and ease of use.

# Balanced Scorecard

The Balanced Scorecard, invented by Kaplan and Norton, is a strategic management system used by businesses from all over the globe to align their business activities to the overall strategy and vision of their organizations. We all know that business success, whether public or private, is ultimately down to performance. Hence, managing and measuring that performance is vital for any organization that wants to thrive in its niche or industry.

This management system enables your business to set, trace and ultimately achieve your objectives and strategies. After you develop your business strategies and goals, they can be set and tracked using the Four Legs of the Balanced Scorecard. Each leg deals with a distinct business perspective. These legs are the **Financial** one, the **Internal Business Process** Leg, the **Customer** Leg and the **Learning & Growth** Leg.




**1. Financial**

Norton and Kaplan have not disregarded the need for financial data. Accurate and timely data is always a priority, being paramount for managers who want to get the complete picture. With the implementation of a large corporate database, the financial leg aims to automate processes. The financial leg tracks your business financial performance and requirements, including return on investment (ROI), cash flow, financial results (quarterly and annually) and return on capital employed.

**2. Customer**

More and more, managers and researchers are coming to realize the huge importance of customer focus and customer satisfaction. If customers are not happy with your company, they will eventually migrate

to the competition. Hence, poor performance from the customer perspective is an indicator of decline. Some of the areas assessed by this indicator include customer retention rate, delivery performance to the customer, customer percentage of market, customer satisfaction rate and quality performance for the customer.

**3. Internal Business Processes**
This perspective allows you to measure customer process needs, requirements and procedures. Metrics based on this leg allow you to know how well your business is running and whether your services and products conform to your company's mission. Some of the areas that relate to internal business processes are process automation, process bottlenecks, duplicate activities across functions, number of activities per function and process alignment.

**4. Learning and Growth**
This perspective focuses on teaching you to educate your employees, how you gain knowledge and how you can use this knowledge to maintain an edge in your niche. This leg deals with subjects like job satisfaction, training & learning opportunities for your employees, employee turnover and level of expertise for the job. According to Norton and Kaplan, learning is considered a much more important criterion than training. Additionally, they emphasize the importance of using high-performance work systems (or technological tools) in order to create a better work environment.

**Conclusion**
Each of these unique perspectives or legs is inter-dependent. In other words, you need to improve all of them in order to reap the benefits of Balanced Scorecard. Hence, these four legs have to be analyzed and improved together, on a regular basis, in order for your company to thrive. Ignoring one of these legs is like sitting on a four-legged stool with one broken leg – an impossibility. You will eventually lose your balance and fall to the ground, flat on your face.

The main benefit of this system is that it reflects all the elements that define a company's functions. This powerful management system also helps you study those areas where performance measurements are not normally present. However, there are a few downsides to using balanced scorecards. Scorecards tend to evolve into complex management

instruments. Moreover, maintaining these scorecards is a daunting task which can take large amounts of time.

In a nutshell, the Balanced Scorecard is a very good management assessing tool that allows managers to make positive changes in their organizations and complement smart strategies with smarter implementations.

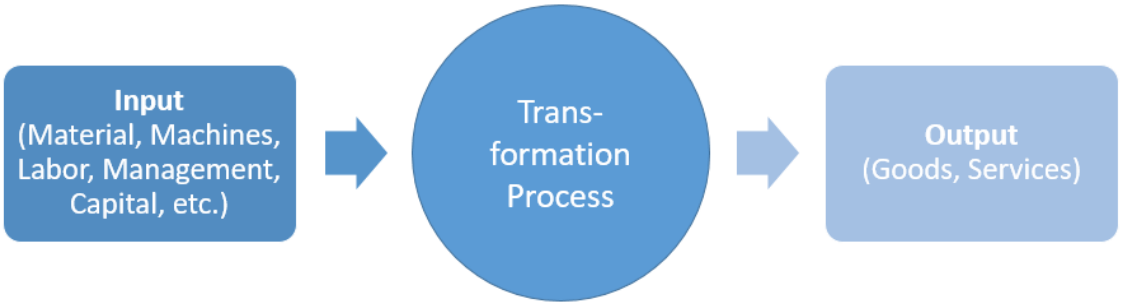
# 5. Operations Management

Operations management is the administration of business practices to create the highest level of efficiency possible within an organization. It is concerned with converting materials and labor into goods and services as efficiently as possible to maximize the profit of an organization.

## Definition

Operations Management is an area of management concerned with overseeing, designing, and controlling the process of production and redesigning business operations in the production of goods or services. It involves the responsibility of ensuring that business operations are efficient in terms of using as few resources as needed and effective in terms of meeting customer requirements.

Operations Management is concerned with managing the process that converts **inputs** (in the forms of raw materials, machines, labor, management, capital, energy, etc.) into **outputs** (in the form of goods and/or services):




In this second part of the course, we will take a look at management methods and analytical techniques to perform more efficient and more effective operations and production processes. For example, you will learn…

- the essentials of **value and supply chain management** by carrying out a Value Chain Analysis as well as a VIRO Analysis of Resources
- the basics of **business decision management** by carrying out Break-Even Analysis and drawing Decision Trees
- the fundamentals of **inventory management** by carrying out an ABC-Analysis as well as using the Reorder Point Model

# Basic Principles

Before discussing the first practical tools, it makes sense to get familiar with some of the fundamental rules of successful operations management. Below you can find a list of essential principles that are important to understand the driving forces behind decisions about planning, designing and organizing processes.

These basic rules are embracing the idea of focusing on the delivery: supporting the organization to **deliver better results and optimizing the input of materials, equipment, technology, and human resources**.

Dr. Richard J. Schonberger, a renowned researcher of American manufacturing, has become widely known in operations management for his set of customer-focused principles:

| | | | | |
|---|---|---|---|---|
| Constant Improvment | Team Up With Customers | Focus | Organize Resources | Maintain Equipment |
| Cut Times | Cut Setup | Pull System | Total Quality Control | Fix Causes |

- **Continual, rapid improvement:** Aim for non-stop improvement to always deliver the best quality, aim for a quicker response to customer demand, and always offer maximum flexibility
- **Team up with customers:** Know what they buy and use, and organize product families accordingly
- **Focus:** Allow no variations that the customers don't buy or demand
- **Organize resources:** Set priorities in organizing resources in a way the operations are close to the customer rate of use or demand
- **Maintain equipment:** Always think of improvement of current assets first; keep the equipment as simple and flexible as possible.
- **Cut times:** Shorten product path to the customer by making processes and delivery faster
- **Cut setup:** Be prepared to support different processes and get all information and tools ready for on-demand production
- **Pull system:** Improve the workflow and cut the waste by producing on demand
- **Total quality control:** Use only the best materials, processes, and partners
- **Fix causes:** Focus on controlling the root causes that really affect cost and performance

# 6. Value Chain Management

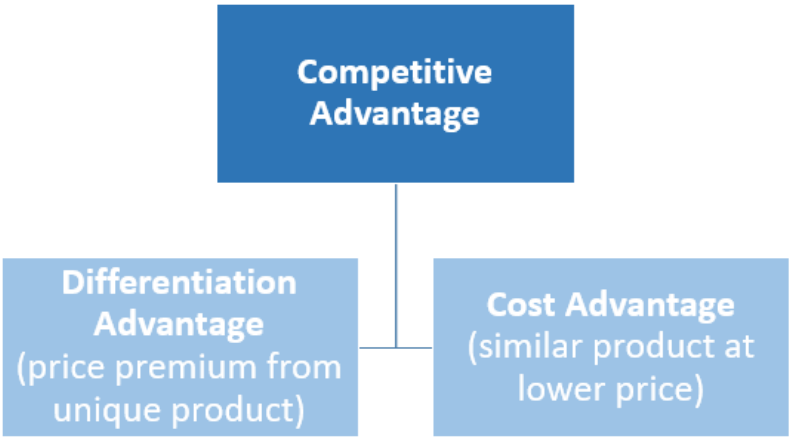
With ever-increasing competition for unbeatable prices, exceptional products, and customer loyalty, businesses must continually evaluate the value they create. In this chapter, you will learn how successful value chain management can give businesses an advantage over their competition.

# Value Chain Analysis

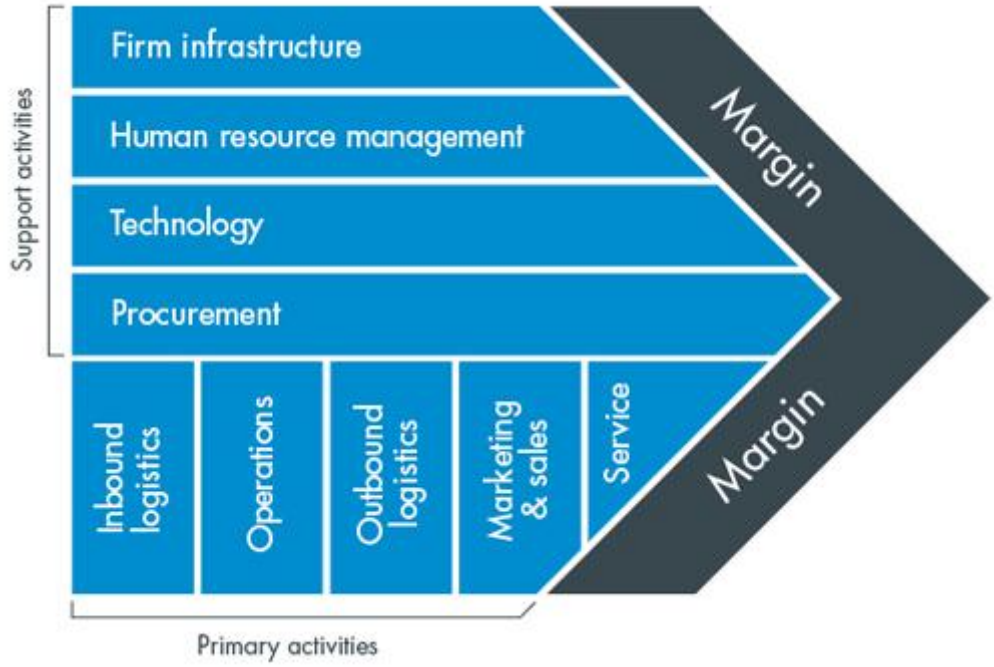
The Value Chain Analysis (VCA) is a process where a firm identifies its primary and support activities that add value to its final product and then analyzes these activities to reduce costs or increase differentiation.

The goal is to recognize which activities are the most valuable to the firm and which ones could be improved to provide a **competitive advantage**. In other words, by looking into internal activities, the analysis reveals where a firm's competitive advantages or disadvantages are.

As pointed out earlier in this course, a firm that competes through **differentiation advantage** will try to perform its activities **better** than competitors would do. If it competes through **cost advantage**, it will try to perform internal activities at **lower costs** than competitors would do. When a company is capable of producing goods at lower costs than the market price or to provide superior products, it earns profits.




Michael Porter introduced the generic value chain model in 1985. The value chain represents all the internal activities a firm engages in to produce goods and services. Below you can see Porter's value chain model:




The value chain is formed of **primary activities** that add value to the final product directly and support activities that add value indirectly.

Although primary activities add value directly to the production process, they are not necessarily more important than **support activities**. Nowadays, competitive advantage mainly derives from technological improvements or innovations in business models or processes. Therefore, support activities are often the most important source of differentiation advantage. On the other hand, primary activities are usually the source of cost advantage, where costs can be easily identified for each activity and properly managed.

# Value Chain Example

There are two different approaches on how to perform the value chain analysis. The approach depends on what type of **competitive advantage** a company wants to create (differentiation or cost advantage). The table below lists all the steps that are necessary.

**Differentiation advantage:**

- **Step 1:** Identify the customers' value-creating activities. These may be related to marketing or design.

- **Step 2:** Evaluate the differentiation strategies for improving customer value, i.e. by adding more features.
- **Step 3:** Identify the best sustainable differentiation by linking activities.

**Cost advantage:**

- **Step 1:** Identify the firm's primary and support activities. This requires adequate knowledge of the company's operations.
- **Step 2:** Establish the relative importance of each activity in the total cost of the product.
- **Step 3:** Identify cost drivers for each activity, i.e. by benchmarking against competitors.
- **Step 4:** Identify links between activities. Does cost reduction in one activity lead to further cost reductions or higher costs in other activities?
- **Step 5:** Identify opportunities for reducing costs. How will you improve the activities precisely?

The following example illustrates **all five steps** of the basic Value Chain Analysis for an automobile manufacturing company that competes on **cost advantage**.

| | | | | | | |
|---|---|---|---|---|---|---|
| **1** | Design & Engineering | Purchasing Materials & Components | Assembly | Testing and Quality Control | Sales and Marketing | Distribution and Dealer Support |
| **2** | $200.000,000 medium | $400.000.000 very important | $550.000.000 very important | $50.000.000 not important | $350.000.000 important | $100.000.000 less important |
| **3** | Number of new models<br>Frequency of new models | Order size<br>Location of suppliers | Capacity utilization<br>Location of plants | Frequency of defects | advertising budget<br>Strength of reputation | Number of dealers<br>Sales per dealer |
| **4** | 1. Locating plants near the cluster of suppliers or dealers reduces purchasing and distribution costs.<br>2. Fewer model designs reduce assembling costs.<br>3. Higher order sizes increase warehousing costs. | | | | | |
| **5** | 1. Create just one model design for different regions to cut costs in designing and engineering, to increase order sizes of the same materials, to simplify assembling and quality control processes and to lower marketing costs.<br>2. Manufacture components inside the company to eliminate transaction costs of buying them in the market and to optimize plant utilization. | | | | | |

In **step 1**, the company's primary activities were identified (i.e. design, assembly, distribution. For simplicity reasons, this table does not include the support activities). In **step 2**, the importance of each activity was established (from not important to very important). In **step 3**, the cost drivers for each activity were identified (i.e. order size, frequency of defects, advertising budget). In **step 4**, links between activities were identified and finally, in **step 5**, opportunities for reducing costs were identified.

# VRIO Framework

The VRIO framework is a tool that is used to analyze a company's internal resources. It tries to find out if they can be a source of sustained competitive advantage.

In order to become a source of sustained competitive advantage, resources must have three attributes: they need to be **v**aluable, **r**are, and costly to **i**mitate. Additionally, a firm must be **o**rganized to capture the

value of the resources. A resource that meets all four requirements can bring sustained competitive advantage for the company.

- **Valuable**: The first attribute of the framework asks if a resource adds value by enabling a firm to exploit opportunities or defend against threats. If the answer is yes, then a resource is considered valuable. Resources are also valuable if they help organizations to increase the perceived customer value. This is done by increasing differentiation or/and decreasing the price of the product. The resources that cannot meet this condition will lead to competitive disadvantage.
- **Rare**: Resources that can only be acquired by one or very few companies are considered rare. Rare and valuable resources grant temporary competitive advantage. However, a firm should not neglect resources that are valuable but common. Losing valuable resources and capabilities would hurt an organization because they are essential for staying in the market.
- **Costly to imitate**: A resource is costly to imitate if other organizations are unable to imitate, buy or substitute it at a reasonable price. Imitation can occur in two ways: by directly imitating (duplicating) the resource or providing a comparable product/service (substituting).
- **Organized to capture value**: The resources themselves do not confer any advantage for a company if it’s not organized to capture the value from them. A firm must organize its management systems, processes, operations, and organizational structure to be able to fully realize the potential of its valuable, rare and costly to imitate resources. Only if this is the case, sustained competitive advantage can be achieved.

| Is it valuable? | Is it rare? | Is it hard to imitate? | Is the firm organized around it | What is the result |
|---|---|---|---|---|
| ✗ | | | | Competitive Disadvantage |
| ✓ | ✗ | | | Competitive Equality |
| ✓ | ✓ | ✗ | | Short - Term Competitive Advantage |
| ✓ | ✓ | ✓ | ✗ | Unused Competitive Advantage |
| ✓ | ✓ | ✓ | ✓ | Long - Term Competitive Advantage |

# VRIO Example: Google's HR

There's no doubt that Google/Alphabet is one of the most powerful companies in the world, and its success arguably stems from a sustained competitive advantage in human capital management. If we were to break down **Google's VRIO framework from the HR perspective**, it might look something like this:

- **Value:** Use human capital management data to hire and retain innovative, productive employees. These employees consistently create some of the most popular consumer products and services in the world.
- **Rarity:** No other companies are using data-based employee management so extensively.
- **Imitability:** Data-based human capital management is both costly and difficult to imitate, at least for the near future. Companies have to build the software and invest in training their HR staff on the new technology and strategy.

- **Organization:** Google is organized to capture value from this capability. The IT department has the skills to collect and maintain the data, while HR and team leaders are trained on how to use the data to hire, promote, manage, and improve performance of employees.

Having a VRIO framework in place allowed Google to take a completely different approach to human capital management and make decisions using massive amounts of objective data.

For example, Google's People Operations team set out to identify which characteristics make a great manager. The data used to determine this included surveys, performance evaluations, and great-manager nominations. Google also conducted double-blind interviews with the company's highest- and lowest-rated managers. By determining what qualifies as a great manager, Google strengthens its internal team and the foundation of its sustained competitive advantage.

The VRIO framework complements other strategic analysis methods to provide your organization with clear-cut competitive advantages. A VRIO analysis can be applied company-wide or to individual departments for a well-rounded view of how each aspect of your business should position itself in the marketplace. It's important to continually review your framework—capabilities change over time and competitors adapt.

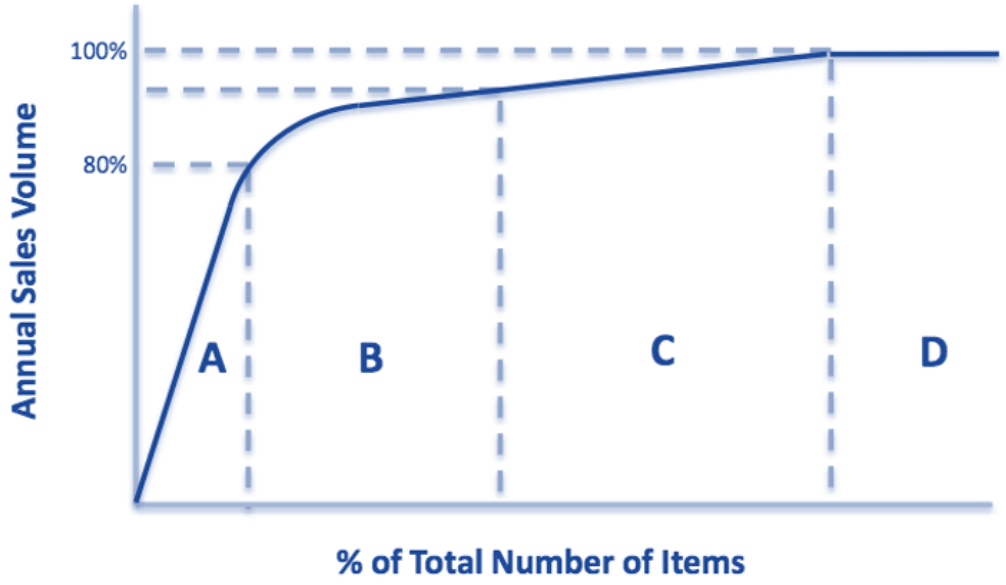
# 7. Inventory Management

Inventory management refers to the process of ordering, storing, and using a company's inventory. These include the management and supervision of raw materials, components, and finished products, as well as warehousing and processing such items.

# ABC Analysis

Typically, a company has thousands of items held in its inventory. However, only a small percentage of these items deserve management's closest attention and tightest control. An ABC analysis is the process of dividing the inventory units into three classes according to their dollar usage so that managers can focus on the items with the highest importance.

- **Class A items:** These items typically represent 20% of the items in the inventory but account for 80% of the dollar usage.
- **Class B items:** These items represent 30% of the items in the inventory but only account for 15% of the dollar usage.
- **Class C items:** These items represent 50% of the items in the inventory but only account for 5% of the dollar usage.




The ABC-classification gives recognition to the varying importance of different types of inventory. Consequently, classifying items into A, B, and C allows management to better identify and control items of greater importance. Loss of control over a few Class A items is considerably more serious than the loss of control over a large number of Class B or C items.

# ABC Example

The following table of a company's item usage is given:

| Item | Quantity/year | Value/item | Dollar usage | % of Total | Class |
|---|---|---|---|---|---|
| Screws | 100,000 | $0.05 | $5,000 | 19% | B |
| Special Glue | 100 | $200 | $20,000 | 76% | A |
| Boxes | 300 | $2.5 | $750 | 3% | C |
| Paper | 3,000 | $0.1 | $300 | 1% | C |
| Cardboard | 1,500 | $0.2 | $300 | 1% | C |
| **Total** | | | **$26350** | **100%** | |

In this example, the item "special glue" is **only used 100 times but accounts for 76% of the total dollar usage**. It is, therefore, **a class A item**. Management should focus on finding cheaper glue, alternatives for glue or reduce the amount of glue used.

Only after this, management should spend time and effort on trying to reduce the costs of Class B items (screws), and then Class C items (boxes, paper, cardboard).

A items are goods where annual consumption value is the highest. Applying the Pareto principle (also referred to as the 80/20 rule where 80 percent of the output is determined by 20 percent of the input), they comprise a relatively small number of items but have a relatively high consumption value. So it's logical that analysis and control of this class is relatively intense since there is the greatest potential to reduce costs.

# Reorder Point Model

The Reorder Point Model identifies the time to order when a stock level drops to a predetermined amount. This amount usually includes a certain quantity of stock to cover for the delay between order and delivery, the lead time, and stock to reduce the risk of running out of stock, the safety stock.

The Reorder Point Model permits you to calculate **when** you need to make a new order to…

- **not run out of stock**, and
- **minimize** inventory and stocking **costs.**

The two main elements of the reorder point model are:

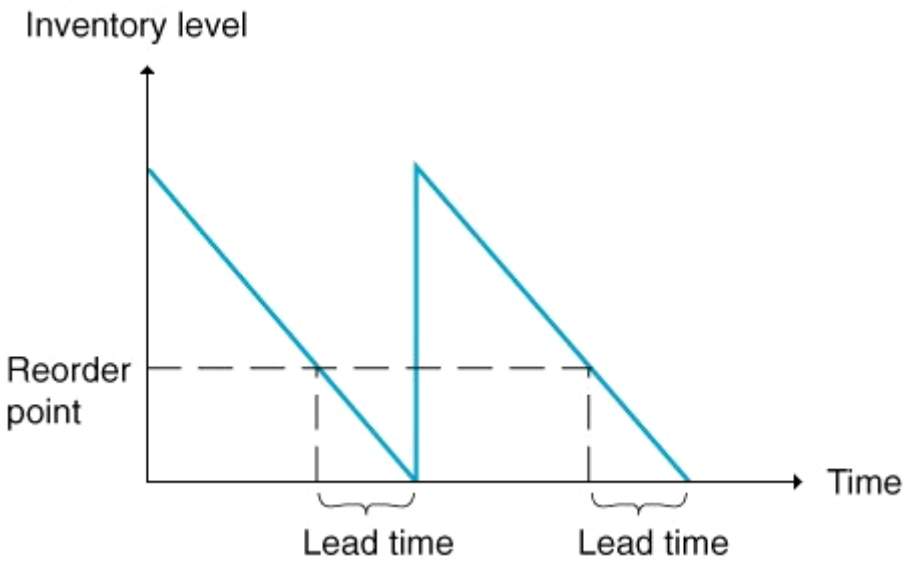
- **Lead Time:** the interval between placing an order and having it ready for dispensing. When calculating lead times in a supermarket, for example, you must also consider the amount of time to stock the shelves.
- **Safety Stock:** the extra units of inventory carried as a protection against possible stock-outs. The safety stock must be carried when the manager is not sure about either the demand for the product or the lead time.

The thing to know about a reorder point is that it's not a static number. It's based on your own purchase and sales cycles, and it varies on a per-product basis. However, once you have a handle on patterns in your purchase and sales orders for a particular product, you're ready to start putting the variables together.

The reorder point is the inventory level at which it is appropriate to replenish stock. The calculation for this is as follows:

**Reorder Point = Average demand during lead time + Safety stock**

The reorder point can also be displayed graphically. You can see that the reorder point depends heavily on the lead time. The longer it is, the earlier the new purchasing order should be placed. So the order cycle can be pictured as follows:



# Reorder Example

You have a great new product on the shelves, and it's selling fast. Every customer purchase means more revenue but also reduces your inventory levels. Of course, you will reorder before it goes out of stock, but if you order too early, you'll need to spend more on storing these excess items. If you order too late, you'll be facing disappointed customers who'll look to your competitors.

So when is the best time to place your order? Let's take a look at an example to find out. Let's assume that the typical demand for the product you are selling is **50 units per day**. The **lead time is 25 days**. Your **safety stock is 300 units**. We can calculate the best moment to place the reorder with the following formula:

**Reorder Point = Average demand during lead time + Safety Stock**

Reorder Point = (50 * 25) + 300

Reorder Point = 1,250 + 300

Reorder Point = 1,550

This means that you should place a reorder as soon as you have 1,550 units left for sale.

Planning reorder points is a crucial part of inventory management. Setting your reorder point to the optimum amount lets you cut down on excess spending while ensuring you'll have enough stock for your customers even when things take an unexpected turn.

# 8. Business Decision Management

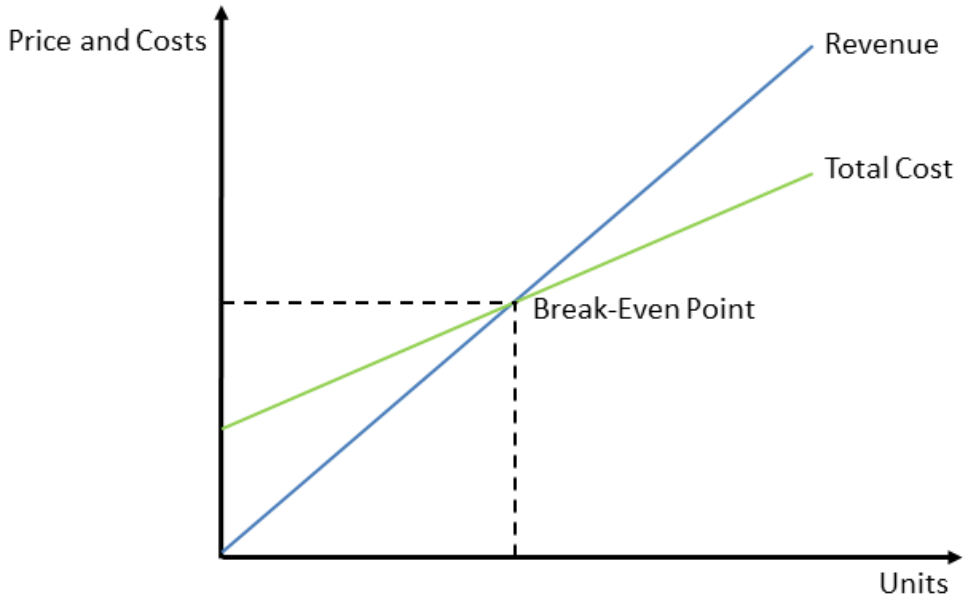
Business decision management entails all aspects of designing, building and managing the decision-making systems that an organization uses to manage its interactions with customers, employees, and suppliers. In this

chapter, you will learn to use two of the most popular decision-making tools.

# Break-Even Analysis

Operations managers have to make many decisions as they manage production processes and supply chains. The break-even analysis helps managers to identify how much change in volume or demand is necessary before a second alternative becomes better than the first alternative.

To evaluate an idea for a new product or service, or to examine the performance for an existing one, the break-even analysis comes in handy. The **break-even quantity** is the production volume at which **total revenues equal total costs**.




Computation of break-even points is very important for every business because it tells business owners and managers how much sales are needed to cover all fixed as well as all variable expenses. It tells exactly **at which sales volume the business will start generating profit**.

Since we want to know when total costs equal total revenues, we can use the following formula:

**Total Revenue = Total Cost**

To carry out a break-even analysis, however, we need more information about the costs of producing a product as well as the revenue that are generated selling a product.

- The **total cost** is typically split into fixed cost and the variable cost:
    - The **variable cost varies** directly with the volume of production, i.e. cost per unit for raw materials and labor.
    - **Fixed cost does not vary** with the volume of production, i.e. facilities, machines, advertising budget.
- **Total revenue** is simply the amount of money a firm receives. If a firm is selling each unit at the same price then total revenue will equal price times quantity.

This leads us to a more precise expression of the formula:

**Price * Quantity = Fixed Cost + (Variable Cost * Quantity)**

Since we are interested in the break-even **quantity**, we can change this formula using basic algebra:

**Quantity = Fixed Cost / (Price – Variable Cost)**

# Break-Even Example

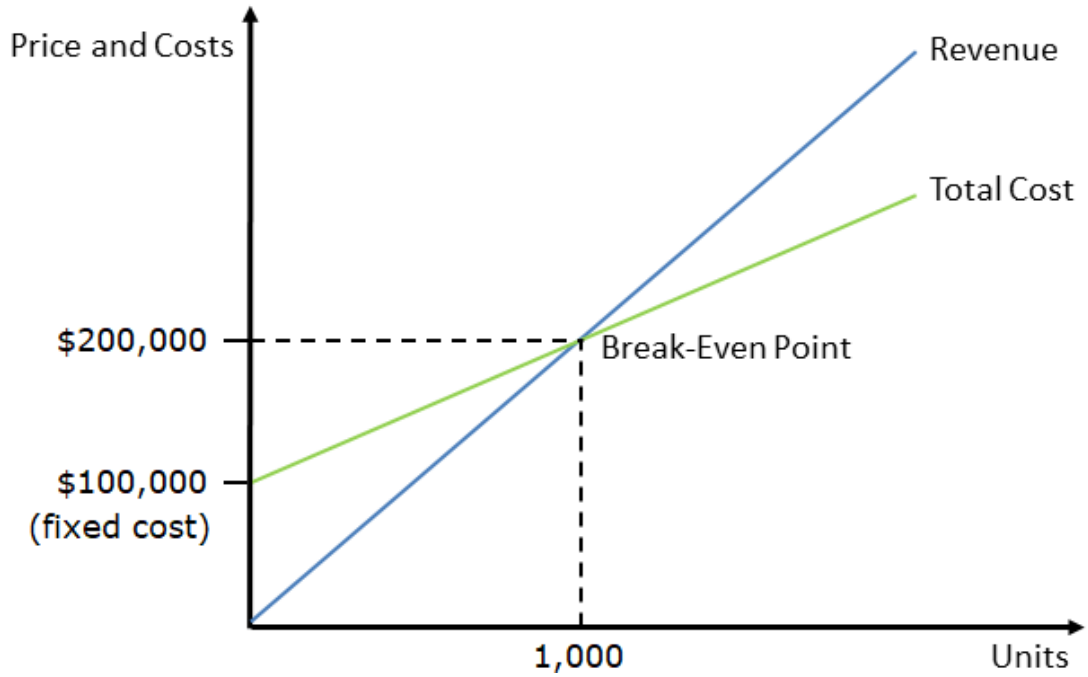
Let's assume you are offering a **product** for **$200** to your customers. **Fixed costs** are **$100,000** per year and **variable costs** are **$100 per product**.

What is the break-even point for this service (starting at which point will you be making money)?

- **Price:** $200
- **Fixed costs:** $100,000
- **Variable cost:** $100
- **Quantity:** ?

**Quantity = fixed cost / (price – variable cost)**
Quantity = $100,000 / ($200 – $100)
Quantity = $100,000 / $100
Quantity = 1,000

Therefore, given the fixed costs, variable costs, and selling price of the product, the company would need to sell **1,000** units to break even.




If the company sells less than 1,000 units, it will actually be losing money. It will only make a profit if it manages to sell more than 1,000 units.

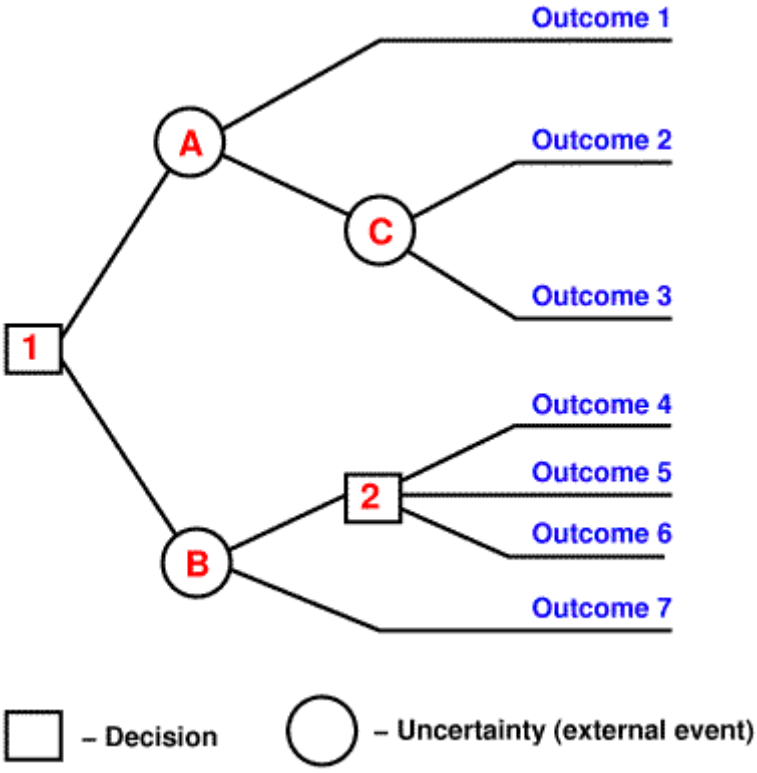
Break-Even Analysis refers to the point in which total cost and total revenue are equal. A Break-Even Analysis is used to determine the number of units needed to cover total costs (fixed and variable costs).

# Decision Tree

A decision tree is a schematic model of alternatives available to the decision-maker, along with their possible consequences. It is a map of the possible outcomes of a series of related choices. It allows an individual or organization to weigh possible actions against one another based on their costs, probabilities, and benefits.

A decision tree method is a general approach to a wide range of processes and supply chain decisions, such as product planning, process capacity, and location. It is particularly valuable for evaluating different capacity expansion alternatives when demand is uncertain and sequential decisions are involved.

A decision tree typically starts with a decision which branches into possible outcomes. Each of those outcomes leads to additional decisions, which branch off into other possibilities. This gives it a treelike shape:




There are three different types of nodes: decision nodes, event nodes, and end nodes.

- A **decision node**, represented by a square, shows a decision to be made, and an end node shows the final outcome of a decision path.
- An **event node**, represented by a circle, shows the probabilities of certain results.
- An **end node** (outcome) shows the final outcome of a decision path.

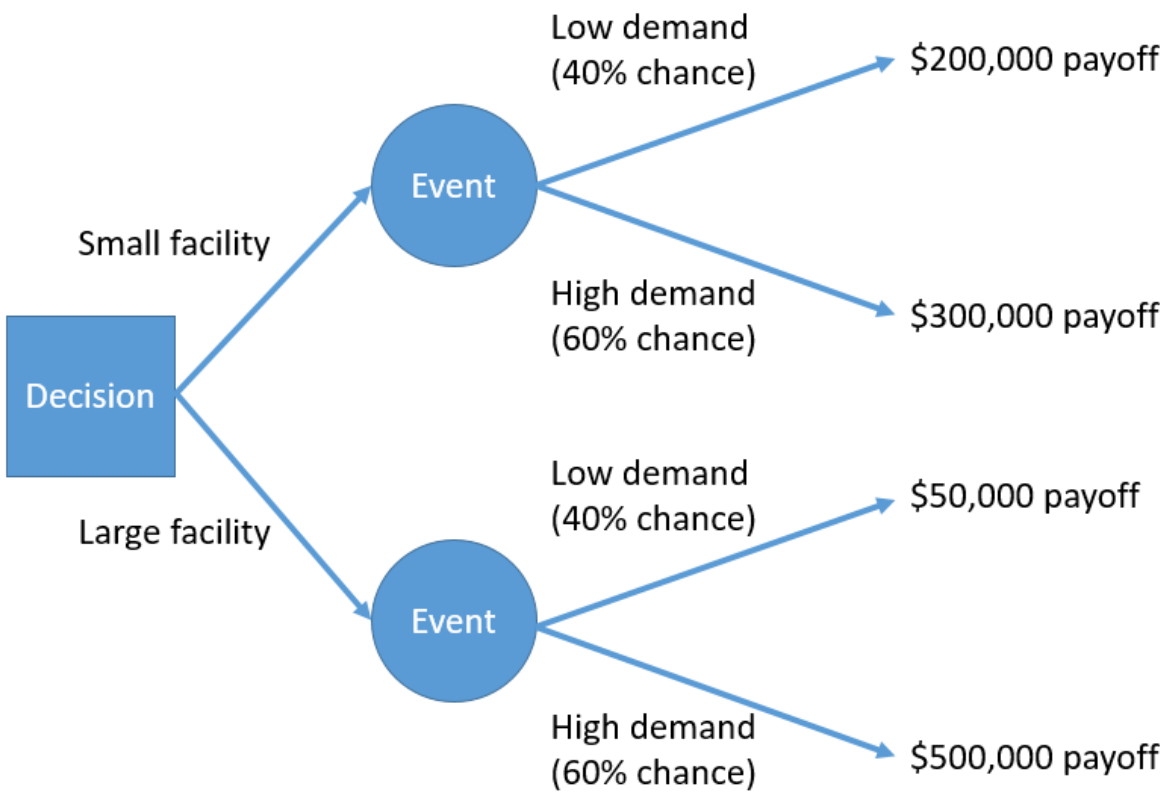
# Decision Tree Example

Let's assume the following scenario: you must decide between building a **small** or **large facility**. However, you are uncertain about the demand for your products. There is a **60% chance that demand will be high** and a **40% chance that demand will be low**. The expected payoffs are:

- Large facility with low demand: $50,000
- Large facility with high demand: $500,000
- Small facility with low demand: $300,000
- Small facility with high demand: $200,000

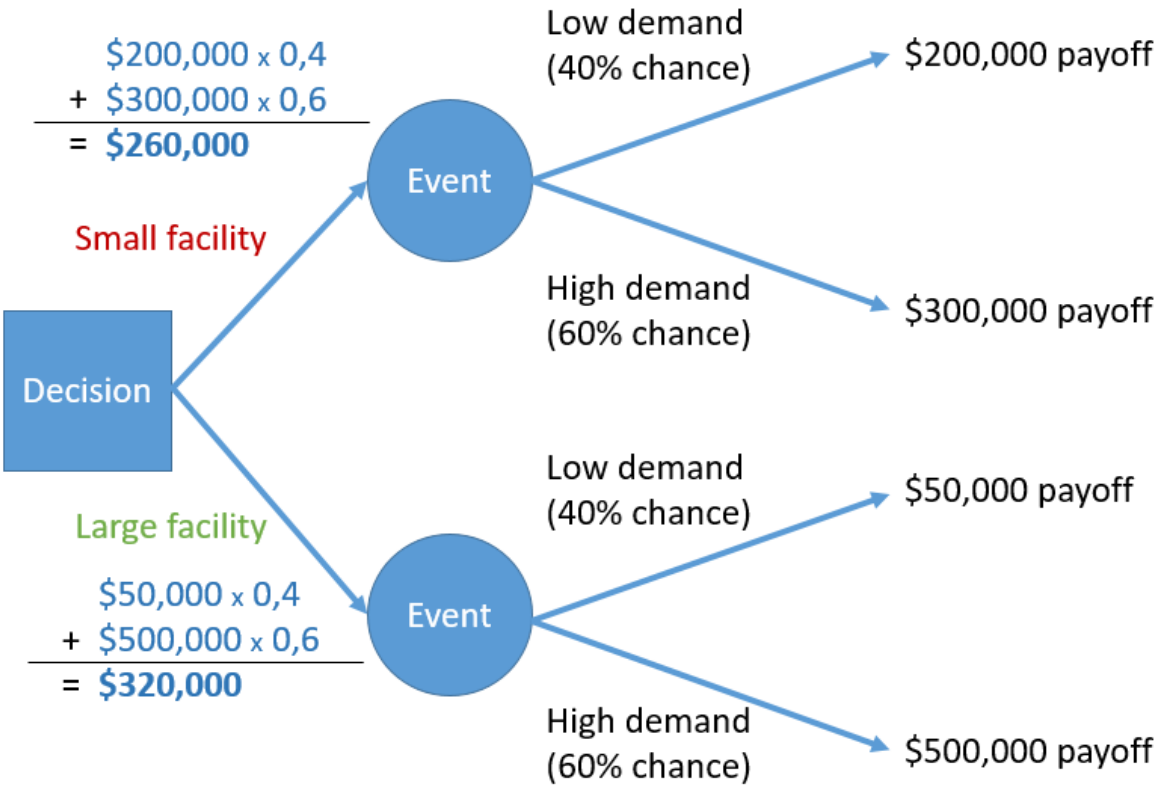
Building a big facility may seem tempting, as a payoff of $500,000 is possible. But it is also a risky choice since the payoff is only $50,000 if demand turns out to be low.

Which option would you choose? A large or a small facility? A decision tree can help **transform the given information into a simple graph** and lead to an informed decision:



So how do we use the information of this decision tree? We simply need to multiply the potential payoffs with the chances of an event taking place. Let's see how this works for our decision tree:

- A **small facility** will have an average payoff of $200,000 * 0.4 (low demand) + $300,000 * 0.6 (high demand) = $260,000
- A **large facility** will have an average payoff of $50,000 * 0.4 (low demand) + $500,000 * 0.6 (high demand) = $320,000
- Since the average payoff of a **large facility** is higher, you should choose this option




A decision tree is a mathematical model used to help managers make decisions. A decision tree uses estimates and probabilities to calculate likely outcomes. A decision tree helps to decide whether the net gain from a decision is worthwhile.

# 9. Case Study: Samsung

Samsung Electronics is a South Korean multinational electronics company headquartered in Suwon, South Korea. The company has assembly plants and sales networks in 80 countries and employs over 300,000 people.

Samsung Electronics is the flagship company of the Samsung “chaebol” (South Korean business conglomerate). As of 2019, Samsung is the world’s largest manufacturer of consumer electronics by revenue. The company produces electronic devices such as mobile phones, smartphones or television sets, as well as electronic components such as lithium-ion batteries or memory chips.

## PESTLE Analysis

The company has global aspirations and was able to expand rapidly into new markets. We can use the PESTLE tool to examine the external environmental drivers of Samsung's strategy:

- **Political**: Political stability plays a major role in the success of a business. Samsung has lately faced political pressures in Africa and Latin America due to unstable political structures. However, emerging economies such as China and India present great market opportunities.
- **Economic**: Samsung was able to expand its market from developed countries to emerging regions. But high volatility in the stock markets and constant fluctuations in exchange rates can have serious implications on the financial health of the business. Nevertheless, Samsung did survive the last economic crisis quite well.
- **Social**: Customs, traditions, and practices differ from one group to another. An international company has to incorporate a strategy of global thinking and local acting. Even after expanding across a large number of countries, Samsung was able to customize its products according to the needs and wants of the local customers.
- **Technological**: Samsung has been able to drive innovation to its competitive advantage. Adopting innovations and new technologies is essential to increase or sustain revenues. Furthermore, modern cellular networks and solid internet infrastructures are both critical.
- **Legal**: Samsung has faced heavy penalties for imitating Apple's iPads and iPhones during the "smartphone wars". The smartphone wars started in 2009 and refer to legal patent battles among manufacturers including Sony, Google, Apple, Samsung, Microsoft, and more. The conflict occurred because one finished smartphone might involve thousands of patents.
- **Environmental:** With rising concerns for sustainability, customers are holding companies accountable for their actions on the environment. Samsung started to reduce its energy consumption as well as the greenhouse emissions throughout the life cycle of its products. The company has to obey various environmental laws in the countries it operates in.

## SWOT Analysis

The SWOT analysis of Samsung Electronics indicates the most relevant internal and external strategic factors for the company and its operating industry environment:

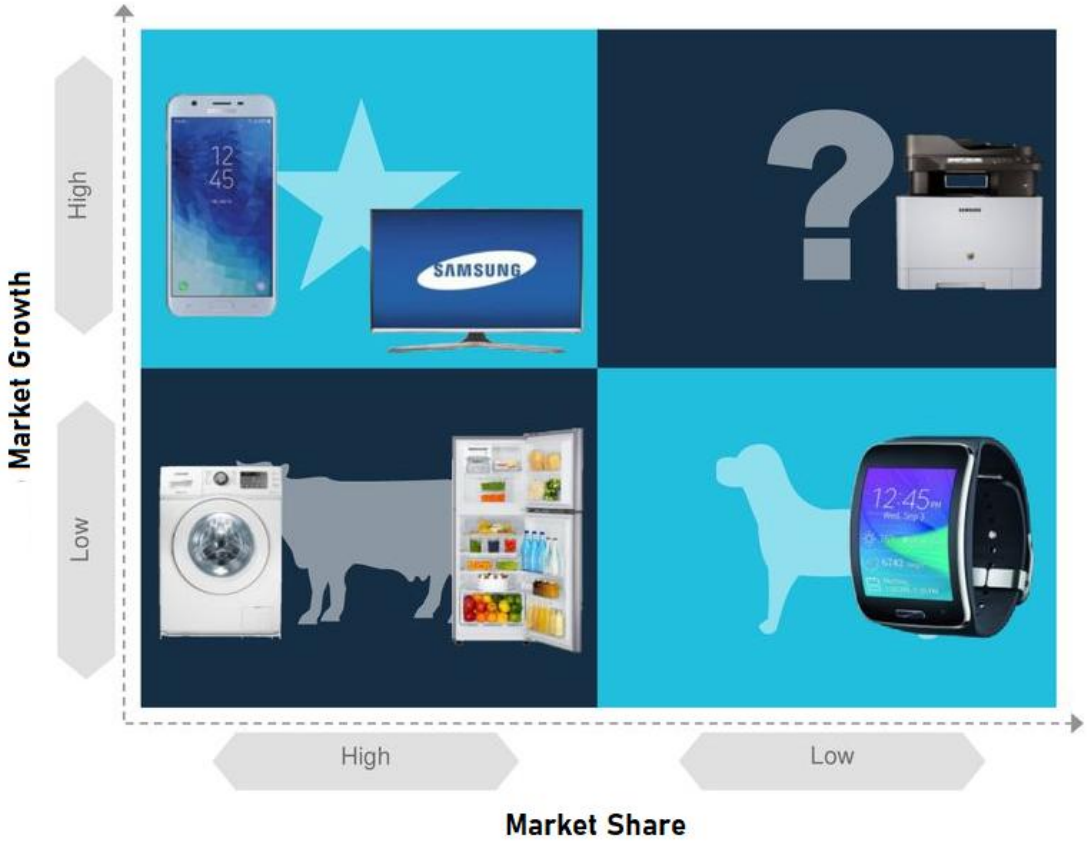
| | |
|---|---|
| **Strengths** | ▪ high customer brand loyalty and stable customer base<br>▪ diversified portfolio and a wide range of products<br>▪ highly innovative and able to meet changing consumer needs<br>▪ high brand value (ranked as one of the most valuable brands in the world)<br>▪ application of new technologies (e.g. unbreakable screens; artificial intellige |
| **Weaknesses** | ▪ failed to offer options in the low-end market (lost market share to Huawei)<br>▪ suffered from poor reputation (explosion of Galaxy Note 7 smartphones in 2<br>▪ no own operating system (dependence on Android OS) |
| **Opportunities** | ▪ economic growth increased consumer spending worldwide<br>▪ growing middle-classes in emerging markets (especially China and India)<br>▪ growing youth population in developing countries (digital natives)<br>▪ diversification and acquisitions of other businesses |
| **Threats** | ▪ challenging economic conditions in key markets (danger of market saturatio<br>▪ intense competition in high-end market (Apple) and low-end market (Huaw<br>▪ growing competition from Chinese manufacturers |

## BCG Matrix

We can use the BCG Matrix (also known as the growth-share matrix) to classify Samsung product groups into four different categories: Cash Cows, Stars, Question Marks, and Dogs.

- **Cash Cows:** Samsung home appliances (e.g. refrigerators and washing machines) are the cash cows for the company. Samsung has been able to attain a good market share across different industry segments and still holds a good potential to grow in the coming future.
- **Stars:** The stars exist in high growth markets and generate the most cash. Samsung's mobile phones and smart TVs with increasingly advanced features fall in this category.

- **Question Marks**: These products consume a lot of cash while very less amount is brought in return. However, they could become stars. Samsung's printer can be placed in this quadrant.
- **Dogs**: Dogs are those products that failed due to slow market growth. For example, Samsung's smart watch failed to achieve success.




## Conclusion

The PESTLE analysis highlights various elements that impact Samsung's performance. The extremely competitive technological market landscape, the inconstant world economic situation, and political changes in developing regions create a complex business environment.

The SWOT analysis underlines Samsung's key challenges and capabilities. The company has still many opportunities to grow – especially in developing countries and thanks to the increasing number of millennials, who are most likely to purchase its electronic products. On the other hand, Samsung's major threat is the intense competition from

other market players like Apple or Huawei. However, the company's huge investments in technological innovation and its wide product portfolio indicate that Samsung is well equipped and well prepared for the future.

Finally, the BCG matrix allows portraying Samsung's product portfolio along relative market share and speed of market growth. Question Marks and Stars are supposed to be funded with investments generated by Cash Cows. Dogs need to be divested or liquidated to prevent long-term losses. In the end, you will need a balanced portfolio of Question Marks, Stars and Cash Cows to assure increasing revenues in the future.

# 10. Conclusion

In the **first part** of this course, you learned the basics of **Strategic Management**. Strategic Management is a continuous process of strategic analysis, strategy creation, implementation and monitoring, used by organizations with to achieve and maintain a competitive advantage.

In order to do so, you learned to use the following tools:

- Analyze the environment based on a PESTLE Analysis and Porter's Five Forces
- Combine this with your company's internal strengths and weaknesses in a SWOT Analysis
- Manage your company with the BCG Matrix and the Balanced Scorecard (BSC)

In the **second part** of this course, you learned the basics of **Operations Management**. Operations Management is an area of management concerned with overseeing, designing, and controlling the process of production and redesigning business operations in the production of goods or services.

In order to do so, you learned to use the following tools:

- Analyze your supply chain by using the Value Chain Analysis
- Analyze your resources with the VIRO Analysis
- Calculate your minimum production targets with the Break-Even Analysis
- Take decisions by using a Decision Tree
- Manage your inventory with an ABC-Analysis and the Reorder Point Model