Introduction to Business
Introduction to Business

ANN SEBECK, BAY COLLEGE
Contents

Part I. Faculty Resources

1. Request Access 3
2. BUSN 160 Assessments 5
3. Sample Discussion Forums 16
4. Sample Assignments 22
5. Case Study: "Salty Pawz" Performance Assessments 34
6. 1.8 Cases and Problems 36
7. 2.6 Environmentalism 42
8. 2.8 Cases and Problems 51
9. 3.7 Cases and Problems 59
10. 5.8 Cases and Problems 65
11. 8.7 Cases and Problems 71
12. 9.10 Cases and Problems 77
13. 10.9 Cases and Problems 83
14. 11.8 Cases and Problems 89
15. 12.6 Cases and Problems 95
16. 13.8 Cases and Problems 102
17. 14.5 Cases and Problems 111
18. 15.8 Cases and Problems 113
19. I Need Help 118
Part II. Module 1: Role of Business

20. Why It Matters: Role of Business
22. Reading: Getting Down to Business
23. Outcome: For-Profit vs. Non-Profit
24. Reading: Making a Profit
25. Outcome: Factors of Production
26. Reading: Factors of Production: Inputs and Outputs
27. Reading: The Flow of Inputs and Outputs
28. Outcome: Functional Areas
29. Reading: Functional Areas of Business
30. Outcome: Stakeholders
31. Reading: Business Stakeholders
32. Outcome: External Forces
33. Reading: External Forces
34. Putting It Together: Role of Business

Part III. Module 2: Economic Environment

35. Why It Matters: Economic Environment
36. Outcome: What Is Economics?
37. Video: What Is Economics?
38. Reading: Economics and Scarcity
39. Reading: The Division of and Specialization of Labor
40. Reading: Microeconomics and Macroeconomics
41. Outcome: Forces Behind Supply and Demand
42. Reading: Demand, Supply, and Equilibrium in Markets for Goods and Services
<table>
<thead>
<tr>
<th>Reading/Outcome</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>43. Reading: Shifts in Demand</td>
<td>198</td>
</tr>
<tr>
<td>44. Simulation: Demand for Food Trucks</td>
<td>209</td>
</tr>
<tr>
<td>45. Reading: Shifts in Supply</td>
<td>210</td>
</tr>
<tr>
<td>46. Simulation: Supply of Food Trucks</td>
<td>220</td>
</tr>
<tr>
<td>47. Simulation: Food Trucks and Changes in Equilibrium</td>
<td>221</td>
</tr>
<tr>
<td>48. Video: Indiana Jones (Demand, Supply, Equilibrium, Shifts)</td>
<td>222</td>
</tr>
<tr>
<td>49. Outcome: Economic Systems</td>
<td>224</td>
</tr>
<tr>
<td>50. Reading: How Economies Can Be Organized</td>
<td>226</td>
</tr>
<tr>
<td>51. Reading: Control of Economic Decisions</td>
<td>233</td>
</tr>
<tr>
<td>52. Outcome: Health of the Economy</td>
<td>240</td>
</tr>
<tr>
<td>53. Reading: Measuring the Health of the Economy</td>
<td>242</td>
</tr>
<tr>
<td>54. Outcome: Stages of an Economy</td>
<td>252</td>
</tr>
<tr>
<td>55. Reading: The Business Cycle: Definition and Phases</td>
<td>254</td>
</tr>
<tr>
<td>56. Putting It Together: Economic Environment</td>
<td>261</td>
</tr>
</tbody>
</table>

Part IV. Module 3: Business Ethics

<table>
<thead>
<tr>
<th>Reading/Outcome</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>57. Why It Matters: Business Ethics</td>
<td>267</td>
</tr>
<tr>
<td>58. Outcome: Moral, Legal, and Ethical Behavior</td>
<td>269</td>
</tr>
<tr>
<td>59. Simulation: Ethics</td>
<td>271</td>
</tr>
<tr>
<td>60. Reading: Moral, Ethical, and Legal Perspectives</td>
<td>272</td>
</tr>
<tr>
<td>61. Outcome: Ethical Behavior in Business</td>
<td>279</td>
</tr>
<tr>
<td>62. Reading: Ethical and Unethical Business Decisions</td>
<td>281</td>
</tr>
<tr>
<td>63. Outcome: Identifying Ethical Issues</td>
<td>288</td>
</tr>
<tr>
<td>64. Reading: Identifying Ethical Issues</td>
<td>290</td>
</tr>
<tr>
<td>65. Outcome: Corporate Ethics</td>
<td>296</td>
</tr>
<tr>
<td>66. Reading: The Organizational Approach to Ethics</td>
<td>297</td>
</tr>
<tr>
<td>Number</td>
<td>Reading/Outcome</td>
</tr>
<tr>
<td>--------</td>
<td>----------------</td>
</tr>
<tr>
<td>67.</td>
<td>Outcome: Corporate Social Responsibility</td>
</tr>
<tr>
<td>68.</td>
<td>Reading: Corporate Social Responsibility</td>
</tr>
<tr>
<td>69.</td>
<td>Outcome: Stakeholders and Social Responsibility</td>
</tr>
<tr>
<td>70.</td>
<td>Reading: Demands for Corporate Social Responsibility</td>
</tr>
<tr>
<td>71.</td>
<td>Reading: Stakeholder Theory and Corporate Social Responsibility</td>
</tr>
<tr>
<td>72.</td>
<td>Putting It Together: Business Ethics</td>
</tr>
<tr>
<td>73.</td>
<td>Why It Matters: Entrepreneurship</td>
</tr>
<tr>
<td>74.</td>
<td>Outcome: The Role of Entrepreneurs</td>
</tr>
<tr>
<td>75.</td>
<td>Reading: The Importance of Small Business to the U.S. Economy</td>
</tr>
<tr>
<td>76.</td>
<td>Outcome: Characteristics of Entrepreneurs</td>
</tr>
<tr>
<td>77.</td>
<td>Reading: What Is an Entrepreneur?</td>
</tr>
<tr>
<td>78.</td>
<td>Reading: Why Start Your Own Business?</td>
</tr>
<tr>
<td>79.</td>
<td>Outcome: Opportunities and Challenges</td>
</tr>
<tr>
<td>80.</td>
<td>Reading: Advantages and Disadvantages of Business Ownership</td>
</tr>
<tr>
<td>81.</td>
<td>Reading: Is Entrepreneurship for You?</td>
</tr>
<tr>
<td>82.</td>
<td>Reading: Twenty Questions Before Starting a Business</td>
</tr>
<tr>
<td>83.</td>
<td>Outcome: Steps to Starting a Business</td>
</tr>
<tr>
<td>84.</td>
<td>Reading: Ten Steps to Starting a Business</td>
</tr>
<tr>
<td>85.</td>
<td>Outcome: Business Plans</td>
</tr>
<tr>
<td>86.</td>
<td>Reading: Create Your Business Plan</td>
</tr>
<tr>
<td>87.</td>
<td>Outcome: Why Some Ventures Fail</td>
</tr>
<tr>
<td>88.</td>
<td>Reading: Why Do So Many Small Business Startups Fail?</td>
</tr>
</tbody>
</table>

**Part V. Module 4: Entrepreneurship**
89. Putting It Together: Entrepreneurship

Part VI. Module 5: Global Environment

90. Why It Matters: Global Environment
91. Outcome: Globalization and International Business
92. Reading: What Is International Business?
93. Video: Globalization Explained
94. Outcome: Reasons for Global Trade
95. Video: Chinese Manufacturing for American Products
96. Video: Why Do Nations Trade?
97. Reading: The Balance of Trade
98. Outcome: Principles of Advantage
99. Reading: Absolute and Comparative Advantage
100. Game: Trade Ruler
101. Outcome: Barriers to Trade
102. Reading: The Global Business Environment
103. Reading: The Global Economic and Regulatory Environment
104. Outcome: Ethics in International Markets
105. Reading: Global Business Ethics
106. Reading: Ethics and Corruption
107. Video: Ethics and International Standards of Behavior
108. Outcome: Currency Valuation
109. Reading: Currency Valuations and Exchange Rates
110. Outcome: The IMF and the World Bank
111. Reading: The IMF and the World Bank: How Do They Differ?
112. Outcome: GATT and the WTO 518
113. Video: GATT/WTO 520
114. Reading: International Economic Cooperation among Nations 522
115. Putting It Together: Global Environment 532

Part VII. Module 6: Management

116. Why It Matters: Management 539
117. Outcome: Skills of a Manager 541
118. Reading: Managerial Skills 543
119. Outcome: Functions of Management 552
120. Reading: What Do Managers Do? 553
121. Outcome: Planning 556
122. Reading: Planning 558
123. Outcome: Organizational Structure 571
124. Reading: Organizing 573
125. Reading: The Organization Chart and Reporting Structure 581
126. Outcome: Leadership Styles 590
127. Reading: Leadership Styles 592
128. Outcome: Control 598
129. Reading: Controlling: A Five-Step Process 600
130. Putting It Together: Management 605

Part VIII. Module 7: Legal Ownership

131. Why It Matters: Legal Ownership 611
132. Outcome: Forms of Business Ownership 613
133. Reading: Selecting a Form of Business Ownership 616
134. Reading: Sole Proprietorship and Partnerships 619
<table>
<thead>
<tr>
<th>Outcome/Reading</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Types of Corporations</td>
<td>628</td>
</tr>
<tr>
<td>Corporations</td>
<td>629</td>
</tr>
<tr>
<td>Hybrid Forms of Organization</td>
<td>638</td>
</tr>
<tr>
<td>Franchising</td>
<td>648</td>
</tr>
<tr>
<td>Franchising</td>
<td>649</td>
</tr>
<tr>
<td>Mergers and Acquisitions</td>
<td>653</td>
</tr>
<tr>
<td>Mergers and Acquisitions</td>
<td>655</td>
</tr>
<tr>
<td>Assistance in Starting a Business</td>
<td>661</td>
</tr>
<tr>
<td>An Introduction to the SBA</td>
<td>663</td>
</tr>
<tr>
<td>Business Resources for Veterans</td>
<td>665</td>
</tr>
<tr>
<td>Assistance in Starting a Business</td>
<td>661</td>
</tr>
<tr>
<td>Video: An Introduction to the SBA</td>
<td>663</td>
</tr>
<tr>
<td>Video: Business Resources for Veterans</td>
<td>665</td>
</tr>
<tr>
<td>Legal Ownership</td>
<td>667</td>
</tr>
</tbody>
</table>

**Part IX. Module 8: Managing Processes**

<table>
<thead>
<tr>
<th>Outcome/Reading</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managing Processes</td>
<td>673</td>
</tr>
<tr>
<td>Operations Management</td>
<td>676</td>
</tr>
<tr>
<td>Operations Management in Manufacturing and Production</td>
<td>678</td>
</tr>
<tr>
<td>Facility Layouts</td>
<td>690</td>
</tr>
<tr>
<td>Facility Layouts</td>
<td>691</td>
</tr>
<tr>
<td>Technology and Production of Goods</td>
<td>696</td>
</tr>
<tr>
<td>The Technology of Goods Production</td>
<td>698</td>
</tr>
<tr>
<td>Operations Management in Service Businesses</td>
<td>705</td>
</tr>
<tr>
<td>Operations Management for Service Providers</td>
<td>707</td>
</tr>
<tr>
<td>Scheduling Tools</td>
<td>719</td>
</tr>
<tr>
<td>Graphical Tools: Gantt and PERT Charts</td>
<td>721</td>
</tr>
<tr>
<td>Logistics and Supply Chain Management</td>
<td>727</td>
</tr>
<tr>
<td>Supply Chain Management</td>
<td>729</td>
</tr>
</tbody>
</table>
159. Outcome: Quality of Goods and Services 733
160. Reading: Producing for Quality 735
161. Reading: Outsourcing 743
162. Putting It Together: Managing Processes 748

Part X. Module 9: Teamwork and Communication

163. Why It Matters: Teamwork and Communication 755
164. Outcome: Groups and Teams 758
165. Reading: The Team and the Organization 759
166. Outcome: Team Development 770
167. Reading: Stages of Team Development 772
168. Outcome: Team Success 777
169. Reading: Why Teamwork Works 779
170. Outcome: Effective Communication 787
171. Reading: Effective Communication in Business 789
172. Outcome: Appropriate Communication in Business 815
173. Reading: Appropriate Business Communications 816
174. Outcome: Communication Flow 828
175. Reading: Communication Channels 830
176. Outcome: Barriers to Communication 840
177. Reading: Communication Barriers 842
178. Putting It Together: Teamwork and Communication 860

Part XI. Module 10: Motivating Employees

179. Why It Matters: Motivating Employees 867
180. Outcome: Scientific Management 869
181. Reading: Introduction to Motivational Theory 871
182. Reading: Fredrick Taylor's Scientific Management 873
183. Outcome: The Hawthorne Effect 879
184. Reading: The Hawthorne Studies 881
185. Outcome: Need-Based Theories 885
186. Reading: Need-Based Motivation Theories 886
187. Outcome: Process-Based Theories 897
188. Reading: Process-Based Theories 898
189. Outcome: Theory X vs. Theory Y 917
190. Reading: Douglas McGregor's Theory X and Theory Y 918
191. Outcome: Strategies for Motivating Employees 923
192. Reading: Job Models and Goals 924
193. Videos: Motivation in Today's Workplace 937
194. Putting It Together: Motivating Employees 941

Part XII. Module 11: Human Resource Management

196. Outcome: Human Resource Management 949
197. Video: Hiring the Right Employees 951
198. Reading: Human Resource Management 952
199. Outcome: Legislation and Employer-Employee Relationships 965
200. Video: The Top Five Manager Mistakes That Cause Lawsuits 968
201. Reading: Working with Labor Unions 970
202. Reading: Collective Bargaining 989
203. Reading: Employee Rights: Job Protection and Privacy 997
204. Reading: Multiculturalism and the Law 1007
Part XIII. Module 12: Marketing

212. Why It Matters: Marketing
213. Outcome: What Is Marketing?
214. Reading: Defining Marketing
215. Outcome: The Four Ps of Marketing
216. Reading: The Four Ps of Marketing
217. Outcome: External Marketing Environment
218. Reading: The Marketing Environment
219. Reading: Generation Effects and Consumer Behavior
220. Outcome: Market Research
221. Reading: Using Market Research to Understand Consumers
222. Reading: The Market Research Process
223. Video: Market Research in "Real Time"
224. Outcome: Marketing Strategies and Plan
225. Reading: Developing Organizational Objectives and Formulating Strategies
226. Reading: Overview of the Marketing Plan
227. Outcome: Branding
Part XIV. Module 13: Information Technology and Business

239. Why It Matters: Information Technology and Business 1211
240. Outcome: Data vs. Information 1213
241. Reading: Data vs. Information 1216
242. Outcome: Managing Data 1227
243. Reading: Managing Data 1228
244. Outcome: Information in Networks 1235
245. Reading: Computer Networks and Cloud Computing 1237
246. Outcome: Ethical and Social Issues 1247
247. Reading: Ethical and Social Issues 1249
248. Outcome: Information Security and Cybersecurity 1255
249. Reading: Security Issues in Electronic Communication 1257
250. Putting It Together: Information Technology and Business 1269
<table>
<thead>
<tr>
<th>Module 14: Financial Markets and System</th>
</tr>
</thead>
<tbody>
<tr>
<td>251. Why It Matters: Financial Markets and System</td>
</tr>
<tr>
<td>252. Outcome: Money</td>
</tr>
<tr>
<td>253. Reading: The Functions of Money</td>
</tr>
<tr>
<td>255. Outcome: Federal Reserve System</td>
</tr>
<tr>
<td>256. Reading: The Federal Reserve System</td>
</tr>
<tr>
<td>257. Simulation: Chair the Fed</td>
</tr>
<tr>
<td>258. Outcome: Financial Institutions</td>
</tr>
<tr>
<td>259. Reading: Financial Institutions</td>
</tr>
<tr>
<td>260. Outcome: Technology and Money</td>
</tr>
<tr>
<td>261. Reading: Electronic Alternatives to Raw Cash: The Advent of Cashless Society</td>
</tr>
<tr>
<td>262. Reading: Bitcoin and Virtual Currencies</td>
</tr>
<tr>
<td>263. Reading: Mobile Commerce and Mobile Payment Systems</td>
</tr>
<tr>
<td>264. Outcome: Securities Exchanges</td>
</tr>
<tr>
<td>265. Reading: Investments and Markets: A Brief Overview</td>
</tr>
<tr>
<td>266. Outcome: Risks and Rewards</td>
</tr>
<tr>
<td>267. Reading: Measuring Return</td>
</tr>
<tr>
<td>268. Reading: Measuring Risk</td>
</tr>
<tr>
<td>269. Putting It Together: Financial Markets and System</td>
</tr>
</tbody>
</table>
PART I

FACULTY RESOURCES
1. Request Access

To preserve academic integrity and prevent students from gaining unauthorized access to faculty resources, we verify each request manually.

Contact oer@achievingthedream.org, and we'll get you on your way.

Overview of Faculty Resources

This is a community course developed by an Achieving the Dream grantee. They have either curated or created a collection of faculty resources for this course. Since the resources are openly licensed, you may use them as is or adapt them to your needs.

Now Available

- Discussions
- Assignments
- Cases
Share Your Favorite Resources

If you have sample resources you would like to share with other faculty teaching this course, please send them with an explanatory message and learning outcome alignment to oer@achievingthedream.org.
2. BUSN 160 Assessments

All YOUTUBE assignments and copyrighted links are supplemental.

Module 1 – Role of Business

Forum introduction and discussion: “Why is Business Important?”

Quiz on chapter content

Module 2 – Economic Environment

Forum discussion: Watch this video and answer the question below.

https://www.youtube.com/watch?v=nWPrMmvITis

Explain how current economic indicators, such as inflation and unemployment, affect you personally? Explain how they may affect you if you were a manager of a business?

Homework/Casework:

Consider a Product, Good or Service for which you believe there is, if not perfect, close to “Price Inelasticity of Demand.”

1. Research the Product, Good or Service so that you have a general understanding of the market, customers, suppliers, competition. For this, you should supply one source you consulted. This does not have to be a formal citation, but be certain I can see where you got your information.

2. Answer the following questions(s) about this Product, Good or Service:

• Describe in words, in a 1 to 1.5 page paper, the Product, Good or Service that you chose and why you chose this Product,
Good or Service?
• Why do you believe the demand is inelastic as to price? What factors are at work here? (Hint: Think back to the External Factors we studied in Module 1).
• What, if anything, could change this?

Quiz on chapter content

Module 3 – Business Ethics

Forum discussion: What factors determine an individual’s ethics? For you, which factor has been most significant? Please provide examples when answering these questions. The more you make your answers relate to “real life experiences” the more meaningful they will be and others can see varying perspectives.

Quiz on chapter content

Module 4 – Entrepreneurship

Forum discussion: Why are small businesses important to the U.S. economy? Would you ever consider opening your own business? If so, what type of business and why?

Please be thorough in your answers and make them “real”

Homework/Casework:
Do You Want to Be an Entrepreneur?
Want to learn what it’s like to be an entrepreneur? To help you decide whether life as an entrepreneur might be for you, go to http://entrepreneurs.about.com/od/interviews/null.htm; then link to the Famous Entrepreneurs section and review the entrepreneurs. Select one entrepreneur who interests you, and do the following, in a 1 to 1.5 page paper:
1. Describe the company that he or she founded.
2. Explain the reasons why he or she became an entrepreneur.
3. Explain what qualities, background, or both, prepared the individual to start a business.

After reading the interviews with the entrepreneur, answer the following questions:

1. What aspects of being an entrepreneur are particularly rewarding?
2. What’s the downside of being an entrepreneur?
3. What challenges do entrepreneurs face?
4. Is entrepreneurship for you? Why, or why not?

**Quiz on chapter content**

**Module 5 – Global Environment**

**Forum discussion**: To or not to, Globalize!

Watch this video and answer the questions below.
https://www.youtube.com/watch?v=JJ0nFD19eT8

Are the benefits of globalization worth the costs? Should governments work to encourage or discourage globalization? Please be thorough in your answers and provide thoughts for your classmates to consider and to join in on your posts.

**Quiz on chapter content**

**Module 6 – Management**

**Forum discussion**: This week you are to create a Blog, using a fictional character and explaining why you chose this character as a representative of an outstanding leader. Let’s have some fun with
this! You can use cartoon characters, tv show/movie characters, book characters, etc. You will need to include a small picture of your character and you will need to comment on two other blogs. The blog needs to be posted by noon Thursday and your 2 responses by Sunday evening.

You must choose someone who no one else has already chosen. No repeating of characters!

**Homework/Casework:**

Sugarcoating the News at Krispy Kreme

According to Krispy Kreme’s “Code of Ethics for Chief Executive and Senior Financial Officers,” the company’s top executives are expected to practice and promote honest, ethical conduct. They’re also responsible for the health and overall performance of the company. Recently, however, things have gone wrong in the top echelons of the doughnut-shop chain.

First, a little background. Founded as one small doughnut shop in Winston-Salem, North Carolina, in 1937, the brand became increasingly popular over the next six decades, taking off in the 1980s and 1990s. By 2003, Krispy Kreme (which went public in 2000) was selling more than a billion doughnuts a year. That’s when things started to go stale. (For more details on the company’s ups and downs, go to http://jacksonville.com/tu-online/apnews/stories/012205/D87OTSIG0.shtml and read the article “Krispy Kreme: The Rise, Fall, Rise and Fall of a Southern Icon.”)

When sales first started to decline in the fall of 2003, CEO Scott Livengood offered a variety of creative explanations, mostly for the benefit of anxious investors: high gas prices discouraged people from driving to doughnut shops; supermarket sales were down because grocery stores were losing business to Wal-Mart; people were cutting back on carbohydrates because of the popular Atkins diet. Unfortunately, other (more plausible) explanations were beginning to surface. To complete this exercise, you’ll need to find out what they were. Go to http://www.usatoday.com/money/industries/food/2005-08-10-krispy-kreme_x.htm?POE=MONISVA to link to the USA Today Web sites, and then read these articles:
“The Best and Worst Managers of the Year” and “Krispy Kreme Must Restate Earnings by $25.6M.” Once you have a good grasp of the company’s problems and you’ve read about the people who are responsible, answer the following questions in a 1 to 1.5 page paper, being sure to provide explanations for your responses:

1. What factors contributed to the problems at Krispy Kreme? What happened to the company? Who was hurt?
2. Should the firm’s problems be attributed to poor management, unethical behavior on the part of the executive team, or both?
3. Judging from the lessons of the Krispy Kreme case, how important do you think it is for a firm to have strong top-down leadership?
4. If you’d been the CEO of Krispy Kreme, what things would you have done differently?

Quiz on chapter content

Module 7 – Legal Ownership

Forum discussion: SBA – Please watch the video and answer the question below.
https://www.youtube.com/watch?v=Wl_llcTlV8
If you have an original idea or you’ve got a franchise in mind for a future business venture, how can you navigate the startup business waters safely without being eaten by the sharks?
Quiz on chapter content
Midterm Exam
Module 8 – Managing Processes

**Forum discussion:** In this week’s announcement, there was an example of how operations management was used in creating a beautiful Thanksgiving dinner? I want you to use this as an example and create your own example of operations management in action. Please make sure your example contains: Planning, scheduling, technology, logistics, supply chain management, quality assurance—all the aspects of operations management!

Be creative, let's have fun with this!

**Homework/casework:** In this chapter/module you learned about the four facility layouts of Process, Product, Cellular, and Fixed Position. You know need to choose one of these layouts and a product or a service and explain how equipment, machinery, and people will be arranged to make the production process as efficient as possible, for your chosen product or service. Please complete a one page paper to explain your choice. Be creative and have fun!

**Quiz** on chapter content

Module 9 – Teamwork and Communication

**Forum discussion:** This week I would like you to find a short (1-6) minute video on Teamwork or Communication, and post the link for all of us to view. Please provide a short comment on why you choose this video to represent your topic. Keep in mind, you still need to comment on two other classmate's videos.

No duplications of videos will be accepted, so make sure you are checking what has already been posted!

**Quiz** on chapter content
Module 10 – Motivating Employees

**Forum discussion:** The following videos give examples of motivational theory being used in today's companies. As you watch, see if you can recognize any of the theories you've studied. Choose one of these videos and answer the following questions. Are they need based or process based? What are the results of the different motivational strategies these companies use? Which company would you like to work for and why?

- https://youtu.be/QO6AWhDy_Ac
- https://youtu.be/WI8DXW8gYZA
- https://youtu.be/4hNu98BQFVl

**Homework/Casework:**

Which Are the Best Companies to Work For?

Despite stories of bad bosses and demotivating bureaucracy, some companies are able to come up with creative ways to keep employees motivated and satisfied. Each year the Great Place to Work Institute ranks America’s top employers in the annual “Best Companies to Work For:”

1. Go to the institute’s web site (http://www.greatplacetowork.com)
2. List five companies that have made the Best Companies to Work For list.
3. Choose one company from your list and use an Internet search engine (such as www.google.com, www.ask.com, or www.yahoo.com) to research the company.
   1. Summarize the company's background, mission, products, services.
   2. Why do you think they made the list while others did NOT?

Your assignment should be approximately 1 to 1.5 pages in length.

**Quiz on chapter content**
Module 11 – Human Resource Management

Forum discussion: What’s Your (Emotional) IQ?

If you were an HR manager, on what criteria would you base a hiring decision—intelligence (IQ), education, technical skills, experience, references, or performance on the interview? All these can be important determinants of a person’s success, but some experts believe that there’s an even better predictor of success. It’s called emotional intelligence (or EI), and it gained some currency in the mid-1990s thanks to Daniel Goleman’s book Emotional Intelligence: Why It Can Matter More Than IQ. EI is the ability to understand both our own emotions and those of others, as well as the ability to use that understanding in managing our behavior, motivating ourselves, and encouraging others to achieve goals.

An attractive aspect of EI is that, unlike IQ, it’s not fixed at an early age. Rather, its vital components—self-awareness, self-management, social awareness, and relationship management—can be strengthened over time. To assess your level of EI, go to the Web site maintained by the Hay Group, a management-consulting firm, and take the ten-item test that’s posted there (http://psychology.about.com/library/quiz/bl_eq_quiz.htm?questnum=6&cor=2399). After completing the test, you’ll get your EI score, some instructions for interpreting it, and an answer key.

When you’ve finished with the test, rank the following items according to the importance that you’d give them in making a hiring decision: intelligence, education, technical skills, experience, references, interview skills, and emotional intelligence. Explain your ranking.

Quiz on chapter content
Module 12 – Marketing

Forum discussion: How Social Media Reveals the Hidden You

In 2012, U.S. companies spent $170 billion on direct marketing campaigns, yet the response rate was only around 2 percent. To address this meager return, computer experts are using new approaches to profile individual users and do more efficient marketing online—especially through social media. The following video discusses these developments in greater detail.

https://youtu.be/pgnRTuxQXfE

Watch this video and then give an example of how Social Media Marketing has had an impact on you. Was it a positive or negative impact? Do you feel Social Media Marketing is effective? Why or why not?

Homework/Casework:

Market Research in “Real Time”

Technological advances in mobile computing, smart phones, social networking, and data collection have changed the way companies capture information about consumer interest and behavior. One of the results of this new type of “research” is predictive advertising. This video gives you a glimpse of the impact this has had on consumer data collection.

https://youtu.be/I4JdGaVNrgU

Using big data analysis is transforming the way advertising works. By mining the massive amount of data ordinary people create every day, advertisers can tailor ads specifically to the patterns of consumption of an individual.

Write a 1 to 1.5 page paper on your opinions of data hunters, data mining, and predictive advertising. Do you agree or disagree? Explain what you feel the advantages and disadvantages may be.

Quiz on chapter content

Module 13 – Information Technology and
Business

Forum discussion: In this week’s announcement this video was posted. I stated you would be watching it for this week’s forum. If you have not watched this, now is the time. It is a bit lengthy, 7.3 minutes, but it is worth every second of your time. Please view it in its entirety, you will not regret it!

https://youtu.be/XrJjfDUzD7M

Once you have viewed this, I would like you to answer these questions. What was the most interesting take-away you have from the video and why? Also, what technology has impacted your life? Was it a good or not so good impact, why? Lastly, try and come up with a technology that has basically removed the “old” way of performing a task? Example: The cell phone, seriously, how many of us have a land-line anymore!

Homework/Casework: Could You Manage a Job in IT or IS?

Do you have an aptitude for dealing with IT? Would you enjoy analyzing the information needs of an organization? Are you interested in directing a company’s Internet operations or overseeing network security? If you answered yes to any of these questions, then a career in IT and IS might be for you. Go to the U.S. Department of Labor Web site (http://www.bls.gov/oco/ocos258.htm) and learn more about the nature of the work, qualifications, and job outlook in IT and IS management. Bearing in mind that many people who enter the IT field attain middle-management positions, look for answers to the following questions:

1. What kinds of jobs do IT managers perform?
2. What educational background, work experience, and skills are needed for positions in IT management?
3. What’s the current job outlook for IS and IT managers? What factors drive employment opportunities?
4. What’s the median annual income of a mid-level IT manager?

Quiz on chapter content
Module 14 – Financial Markets and Systems

Forum discussion: Well, you made it! Yes, it is the last week of class with the exception of Finals Week.

This week’s forum is very different from all of the others. This week, I would like you to provide what you liked most about this class. Was it a certain chapter, certain topic, a certain forum, etc.? Explain why in detail. And then, yes, I would like you to provide what you dislike the most. Was it any of what I have already mentioned and why? Please do not provide answers such as I don’t like the timed quizzes or doing the homework, etc. I know you don’t like any of those! But, they are necessary to judge your learning of the material.

So, sound off, be respectful and let it out!

Quiz on chapter content

Final Exam
3. Sample Discussion Forums

EXTERNAL FORCES
You have now read about the external forces that impact business. Now it is time to find a “real life” example! For this Discussion Board Forum you need to complete the following:

1) Identify one of the External Forces that influences business that you would like to focus on for this discussion.

2) Select an individual company that has been significantly influenced by the force you have chosen.

3) Go to the Internet and research your company’s activities over the past 6 – 12 months. For example in the area of “Corporate Citizenship,” McDonald’s and the Ronald McDonald House Charities awarded over $400 million in grants worldwide.

Once you have identified the company and the force, come back here and post the following:

- The “External Force” and company you selected.
- WHY did you make the selection you did?
- HOW does this external force influence the functional areas of the business/company? In other words, based on external force – what changes, actions or decision need to be made in the functional, internal areas within the company?
- LONG TERM – what do you think the prospects are for this company as it relates to this external force? (For my example of McDonald’s, I might say that “I would think that the slow economy, and high unemployment may put more pressure on McDonald’s to provide even more assistance to families and people in need. This in turn requires the company to increase profits.”)

Be sure to give us the web site (URL) of any sources you use or that you think would be of interest to your classmates.

There are TWO deadlines here: the initial posting of 150-200 words, and your two response posts (50 – 100 words each).
Three Little Words: The China Price

According to business journalists Pete Engardio and Dexter Roberts, the scariest three words that a U.S. manufacturer can hear these days are the China price. What is The China Price? In general, it means 30% to 50% less than what you can possibly make something for in the U.S. In the worst cases, it means below your cost of materials. Makers of apparel, footwear, electric appliances, and plastics products, which have been shutting U.S. factories for decades, know well the futility of trying to match the China price. It has been a big factor in the loss of 2.7 million manufacturing jobs since 2000. Meanwhile, America’s deficit with China keeps soaring to new records.

1) Go to the Internet and research “The China Price.” Once you’ve done your research, you should be able to explain the paradoxical effect of U.S.–Chinese business relationships—namely, that they can hurt American companies and workers while helping American companies and consumers.

2) Next, draw up two lists: a list of the top five positive outcomes and a list of the top five negative outcomes of recent Chinese business expansion for U.S. businesses, workers, and consumers.

3) Post to the Discussion Board, considering your list of the pros and cons of China’s emergence as a global business competitor your thoughts and conclusion based on the following questions:

- Considered on balance, has China’s business expansion helped or harmed U.S. companies, workers, and consumers? Justify your answers.
- What will happen to U.S. companies, workers, and consumers in the future if China continues to grow as a global business competitor?
- How should U.S. companies respond to the threats posed by Chinese competitors in their markets?
Franchising

1. For this assignment you need to go to the website www.franchise.com
2. There you will see that there are a large variety of possible business franchise opportunities and that it is possible to search available franchise opportunities. You need to perform that search and select a franchise that is of interest to you!
3. Make your initial post to the Discussion Board (150 – 200 words) that contains the following information:

   - Name of franchise you selected and a brief summary of the business opportunity
   - Start up costs. Include what the owner will have to invest as well as any contributions towards start-up that the Franchisor will make
   - Potential profit or income from the business (this may or may not be available).
   - Support the Franchisor will provided the owner such as training, supplies, materials/equipment, location, building
   - Why you selected the franchise you did.
   - Any other general comments or observations that you feel are relevant to evaluating this opportunity

You will also need to respond to TWO of your classmate's posts (50 – 100 words each).

A Multicultural Virtual Team

You work for Nike, a global company. You just learned that you were assigned to a virtual team whose mission is to assess the feasibility of Nike's making an inexpensive shoe that can be sold in Brazil.
The team consists of twelve members. Three of the members work in the United States (two in Beaverton, Oregon, and one in New York City). Two work in England, two in China, two in India, and three in Brazil. All are Nike employees and all were born in the country in which they work. All speak English, though some speak it better than others.

What challenges do you anticipate the team will face because of its multicultural makeup? How could these challenges be overcome?

Old Spice Marketing Efforts

One of the most successful social media marketing campaigns was for Old Spice. Procter & Gamble enlisted former NFL wide receiver Isaiah Mustafa to star in a number of videos pointing out to women that their men could be as fantastic as he is if only they wore Old Spice aftershave.

(1) Read the following article:

(2) View the following videos (click on the link to launch the videos)

Answer and discuss the following questions.

- Describe the campaign and identify the goal of the campaign.
- How was this campaign different from anything done in the past?
- Did you like the videos? Why or why not?
- Would you buy Old Spice products? Why or why not?
GRADED DISCUSSION ASSIGNMENT:

(1) Post your INITIAL post, responding to the questions above (175 – 250 words).

(2) Post TWO RESPONSE posts to your classmates.
4. Sample Assignments

Career and Education Plan

Career Plan

• Go online and search for the industry that you want to enter or the industry in which you work.
• Find two or three companies that are leaders in your industry and research why they are leaders.
• Identify two or three publications – journals or newsletters – that deal specifically with your industry.
• Find a trade show or seminar that you could attend to learn more about your industry.
• Find out what education you would need to be competitive three to five years from now for good jobs within your chosen industry.

Education Plan

• Identify a Certificate or Degree Program, and a college or university that you could attend.
• State an educational objective.
• List the classes you would need to earn the certificate or degree of your choice.
• Compare the classes you have already taken with the classes you need to take and determine how many (and which) classes you still need to take.
Price Inelasticity of Demand

Consider a Product, Good or Service for which you believe there is, if not perfect, close to “Price Inelasticity of Demand.”

1. Research the Product, Good or Service so that you have a general understanding of the market, customers, suppliers, competition. For this, you should supply one source you consulted. This does not have to be a formal citation, but be certain I can see where you got your information.

2. Answer/Discuss the following question(s) about this Product, Good or Service:

   • Describe in 50 words or less the Product, Good or Service that you chose and why you chose this Product, Good or Service?
   • Why do you believe the demand is inelastic as to price? What factors are at work here? (Hint: Think back to the External Factors we studied in Module 1).
   • What, if anything, could change this?

Business Ownership and Global Business

Assignment

Select a business in your area. Visit the business and ask to speak to the manager or owner of the business. Answer the following
questions:

- Company Name:
- Address:
- Owner/Manager:
- Phone:
- Website:
- What products or services do they manufacture/provide?
- What is the business ownership structure (sole prop., partnership, etc.)?
- How long have they been in business? At this location?
- How has the current economic situation affected the business?

Answer the following questions on your own:

1. Do you feel this is the best business ownership structure? Why/why not?
2. What would be the best ownership structure for the business you interviewed & why?
3. Identify 3–4 reasons why a small business might have problems achieving success because of the ownership structure.
4. Discuss measures that could be taken to avoid these problems – Avoid failure & Achieve Success.
5. How could this business benefit from a global business perspective (becoming an importer or exporter)?
6. What additional challenges might this business encounter if they are global?
7. How will tariffs & duties (taxes) help or hinder a global business to grow/succeed?

Answer the questions in a 2- to 3-page document.
Best Companies to Work For

Which Are the Best Companies to Work For?

Despite stories of bad bosses and demotivating bureaucracy, some companies are able to come up with creative ways to keep employees satisfied. Each year the Great Place to Work Institute ranks America’s top employers in the annual “Best Companies to Work For.”

1. Go to the institute's web site (http://www.greatplacetowork.com)
2. List the top five companies for 2009, 2010 and 2011. What companies were consistently in the “Top 5” ... which are new “Top Five” and which “Top 5” fell down the ladder? What could make this happen?
3. Choose one company from the list and use an Internet search engine (such as www.google.com, www.ask.com, or www.yahoo.com) to research the company.
   1. Summarize the company’s background, mission, products, services.
   2. Why do you think they made the list while others did NOT?

Follow our “Guidelines for Written Assignments”—your assignment should be approximately 2 pages in length, please be certain to include citations for any of your sources!
The Perfect Snack Food

After years of trying to find the perfect Snack Food to fit your special tastes & needs you have decided to launch a NEW product which is NOTHING like any other product on the market. For inspiration you may want to take a walk around a supermarket, drug store, mass merchandiser, health food store, or restaurant. Another option would be to look on the Internet to see what is available and what is not.

Answer the following questions in a 2- to 3-page document.

1. Give a brief description of your new product and provide your rationale as to why this will be the “Best” new product on the market.

2. Using the terminology from the chapters that you have studied outline the product development steps you will follow to create this product. Provide specific details as they relate to your new product for each step.

3. Now that you have developed your new snack food product, outline the specifics details of the product as they relate specifically to the 4 P’s of marketing. Be specific with brand name, product details, benefits, price, etc.

4. Now that your new product has been developed the President of the company has decided that this is the perfect product to help further your company’s goal “To Help Eliminate Child Hunger.” Develop a plan that will address your company’s goal of being a socially responsible company.
BMW and Quality

How to Build a BMW

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

• Click on “Production” to open a drop-down list that looks like this:

  Fascination Production
  Press Shop
  Body Shop
  Paint Shop
  Engine Assembly
  Assembly

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

  Sample Assignments  |  27
shop, engine assembly, and final assembly. You may use a bulleted list or numbered list for each department).

◦ What technology does BMW use in the production process?
◦ Approximately what percentage of the work was done by people?
◦ What procedures were followed to ensure the production of high-quality vehicles?

• THEN, comment on this FINAL question: Overall, how do you feel/think about BMW and its commitment to Quality? Does this change or reinforce your impression of the Brand?

The Product Liability Debate

The article “Who Should Pay? The Product Liability Debate,” by Claire Andre and Manuel Velasquez, provides the pros and cons of the current product liability legal environment. Read the article, which can be found at http://www.scu.edu/ethics/publications/iie/v4n1/pay.html, and answer these questions:

1. Should consumers bear more responsibility for product injuries?
2. Should drug manufacturers bear more responsibility?
3. Is the current product-liability legal system broken? Why, or why not? If you believe it is broken, how would you fix it?

Your submission will follow the guidelines for the Written Assignments for the class.
Nike and Honduran Workers

Was Nike Responsible for Compensating Honduran Factory Workers?

Honduras is an impoverished country in which 70% of its residents live in poverty. Jobs are scarce, particularly those that pay decent wages along with benefits, such as health care. It is not surprising then that workers at two Honduran factories making products for U.S. companies, including Nike, were extremely upset when their factories closed down and they lost their jobs. Even worse, the owners of the factories refused to pay the 1,800 workers $2 million in severance pay and other benefits due to them by law. Although the factory owners had been paid in full by Nike for the apparel they produced, the workers argued that Nike should be responsible for paying the $2 million in severance that the factory owners had not received.

Nike’s original response was to sympathize with the workers but refuse to pay the workers the severance pay they had not received from the factory owners. This stance did not settle well with student groups around the country who rallied in support of the unpaid workers. In the end Nike gave into pressure from the students and paid $1.5 million to a relief fund for the employees. In addition, the company said it would provide vocational training and health coverage for the unemployed workers.

To learn more about this case, read the following (or Google “Nike and Honduran Workers”):

Working in These Times: Honduran Workers Speak Out Against Nike’s Labor Violations (April 21, 2010)
New York Times: Pressured, Nike to Help Workers in Honduras (July 26, 2010)
This is a written assignment, in which you will answer the following questions:

- Do you think Nike was responsible for compensating the workers in Honduras? Why did it change its stance?
- Did the students, universities, and workers themselves have all of the information they needed before becoming involved in the protest? Are their facts accurate?
- Should students be activists? Do companies such as Nike ignore them at their own peril?

**Ethics in Pharmaceuticals**

Upbeat Pharmaceutical Company (UPC) has been in business for 15 years and has invested heavily in the research, development and FDA approval of flu vaccines to be sold in the US market.

You have been working for UPC for 3 years and while working hard on your degree so you can climb the corporate ladder in the sales department. A management position has recently opened at UPC and you are considering submitting your application.

While doing your research for the management position you run across a memo that confirms that several people who received the vaccine have become ill. One of them required hospitalization for two weeks. Medical experts believe the vaccine was the cause of their illnesses.
Assignment

Answer the following questions in a 2 to 3-page document. Answer the questions as they relate to your employer and the position you are applying for in the hypothetical situation described above.

1. Should you say anything about the memo during your interview?
2. Should you report the memo to the FDA?
3. If you blow the whistle could you lose the job you have?
4. Knowing what you know now do you still want the new management sales position?

In addition to your reading of the course materials, The Legal and Regulatory Environment of Business, read the article, “Who Should Pay? The Product Liability Debate,” by Claire Andre and Manuel Velasquez.

The concluding paragraph of the article states:

“As long as products are produced, product injuries will occur. Who should bear the costs of those injuries? Our answer requires that we weigh the claims of consumers against those of manufacturers—claims which appeal, in different ways, to our desire to minimize harm, our ideal of justice, and our commitment to taking responsibility for the choices we make.”

1. How would you weigh the claims of consumers against those of manufacturers in the situation facing UPC?
2. Do the people who got sick after taking the vaccine have a valid claim against UPC?
3. On what basis?
4. Explain your answer with references to the legal principles and background your readings on Product Liability, and the assigned article.
Where is the Energy in the Chinese Stock Market

Warren Buffett is the third-richest man in the world (behind Bill Gates). As CEO of Berkshire Hathaway, a holding company with large stakes in a broad portfolio of investments, Buffett spends a lot of his time looking for companies with promising futures. His time has been quite well spent: the market price of a share in Berkshire Hathaway now tops $115,000—up from $16 a share in 1964.

In 2002 and 2003, Berkshire Hathaway paid $488 million for two million shares in PetroChina, an energy firm 90 percent owned by the Chinese government. In 2007, he sold the stock for $4 billion, realizing an incredible more than 700 percent gain. To evaluate Buffett's thinking in buying and then selling stock in PetroChina, you'll need to do some research.

First, find out something about the company by going to http://www.petrochina.com.cn/ptr and linking to the English version of the PetroChina Web site. Explore the sections “About PetroChina” and “Investor Relations.” Look for answers to the following questions:

1. What does the company do? What products and services does it provide? How does it distribute its products?
2. On which stock exchanges are its shares sold?

Next, to learn about the company’s financial performance, go to http://finance.yahoo.com to link to the Finance section of the Yahoo.com Web site. Enter the company's stock symbol—PTR—and review the information provided on the site. To see what analysts think of the stock, for example, click on “Analyst Opinion.” To gain insight into why Buffett sold his stock and whether it was a good or a bad move, read these articles: “Should We Buy the PetroChina Stock Warren Buffett Sold?” and “Buffett’s PetroChina Sale: Fiscal or Social Move.”

Now, answer the following questions:
1. What do analysts think of the stock?
2. Should Buffett have bought the stock in PetroChina? Was it a good decision at the time? Why or why not?
3. Should Buffett have sold his stock in the company? Why do you think he sold the stock? Was it a good decision at the time? Why or why not?
4. If you personally had $50,000 to invest, how likely is it that you'd buy stock in PetroChina? What factors would you consider in making your decision?

To learn more about the pros and cons of buying stock in Chinese companies, go to http://www.newsweek.com/id/54174 to link to the MSNBC Web site and read the article “Nice Place to Visit.” Then answer these final questions:

1. What are the advantages of investing in the stock of Chinese companies? What are the disadvantages?
2. In your opinion, should the average investor put money in Chinese stock? Why, or why not?
5. Case Study: "Salty Pawz"
Performance Assessments

How the “Salty Pawz” Case Study Works

Lumen Mastery's *Introduction to Business* includes a case study-style set of sample performance assessments. The case study creates a common framework for applying knowledge and skills developed through the course, encouraging the student to demonstrate mastery of the course content with “real world” tasks and work products.

The subject of this case study is a fictional company called “Salty Pawz.” According to background materials, its CEO is relatively inexperienced, and so the performance assessments take the form of explaining and showing to Wanda how she ought to run things to grow her business successfully.

This sample performance assessment includes:

- A case study
- One or more questions related to all 16 primary learning outcome in the Lumen Mastery *Introduction to Business* course, as well as scoring rubrics
- An Excel spreadsheet for student use, containing supporting data for the quantitative questions
- A second Excel spreadsheet for instructor use, containing answers for the quantitative questions

After choosing where to place human-graded performance assessments, instructors can effectively mix-and-match performance assessment questions from among those provided their course design and flow.
You may download the “Salty Pawz” case study performance assessments from the links below.

Salty Pawz Performance Assessments
Student Edition: Salty Pawz Case Quantitative Assessments
Teacher Edition: Salty Pawz Case Quantitative Assessments
6. 1.8 Cases and Problems

1.8 Cases and Problems

Learning on the Web (AACSB)

The “Economy” section of the CNNMoney Web site provides current information on a number of economic indicators. Go to http://money.cnn.com and search for “jobs” or “job growth” to find answers to the following questions:

1. You read in the chapter that an important goal of all economies is to make jobs available to everyone who wants one. Review the CNNMoney discussion on job growth and then answer the following questions:
   1. Is the current level of unemployment rising or falling?
   2. What do economists expect will happen to unemployment rates in the near future?
   3. Is the current level of unemployment a burden or an asset to the economy? In what ways?

2. Do you remember the first dollar you earned? Maybe you earned it delivering newspapers, shoveling snow, mowing lawns, or babysitting. How much do you think that dollar is worth today? Go to the WestEgg site at http://www.westegg.com/inflation and find the answer to this question. After determining the current value of your first dollar, explain how the calculator was created. (Hint: Apply what you know about CPI.)
Career Opportunities

Is a Career in Economics for You?
Are you wondering what a career in economics would be like? Go to the U.S. Department of Labor Web site (http://www.bls.gov/oco/ocos055.htm) and review the occupational outlook for economists. Look for answers to the following questions:

1. What issues interest economists?
2. What kinds of jobs do government economists perform? What about those who work in private industry? In education?
3. What educational background and training is needed for these jobs?
4. What is the current job outlook for economists?
5. What is the entry-level salary for an economist with a bachelor's degree? With a master's degree?

Ethics Angle (AACSB)

How Much Is That CD in the Window?
The early 1990s were a good time to buy CDs, mainly because discounters such as Wal-Mart and Best Buy were accumulating customers by dropping prices from $15 to $10. They were losing money, but they figured that the policy still made good business sense. Why? They reasoned that while customers were in the store to shop for CDs, they'd find other, more profitable products.

The policy was a windfall for CD buyers, but a real problem for traditional music retailers such as Tower Records. With discounters slashing prices, CD buyers were no longer willing to pay the prices asked by traditional music retailers. Sales plummeted and companies went out of business.

Ultimately, the discounters’ strategy worked: stores such as Wal-
Mart and Best Buy gained customers who once bought CDs at stores like Tower Records.

Let’s pause at this point to answer the following questions:

1. Does selling a product at below cost make business sense?
2. Whom does it hurt? Whom does it help?
3. Is it ethical?

Let’s continue and find out how traditional music retailers responded to this situation.

They weren’t happy, and neither were the record companies. Both parties worried that traditional retailers would put pressure on them to reduce the price that they charged for CDs so that retailers could lower their prices and compete with discounters. The record companies didn’t want to lower prices. They just wanted things to return to “normal”—to the world in which CDs sold for $15 each.

Most of the big record companies and several traditional music retailers got together and made a deal affecting every store that sold CDs. The record companies agreed with retail chains and other CD outlets to charge a minimum advertised price for CDs. Any retailer who broke ranks by advertising below-price CDs would incur substantial financial penalties. Naturally, CD prices went up.

Now, think about the following:

1. Does the deal made between the record companies and traditional retailers make business sense?
2. Whom does it hurt? Whom does it help?
3. Is it ethical?
4. Is it legal?
Team-Building Skills (AACSB)

Get together in groups of four selected by your instructor and pick any three items from the following list:

- Pint of milk
- Gallon of gas
- Roundtrip airline ticket between Boston and San Francisco
- Large pizza
- Monthly cost of an Internet connection
- CD by a particular musician
- Two-day DVD rental
- Particular brand of DVD player
- Quarter-pound burger

Outside of class, each member of the team should check the prices of the three items, using his or her own sources. At the next class meeting, get together and compare the prices found by team members. Based on your findings, answer the following questions as a group:

1. Are the prices of given products similar, or do they vary?
2. Why do the prices of some products vary while those of others are similar?
3. Can any price differences be explained by applying the concepts of supply and demand or types of competition?

The Global View (AACSB)

Life Is Good in France (if You Have Le Job)

A strong economy requires that people have money to spend on goods and services. Because most people earn their money by working, an important goal of all economies is making jobs available.
to everyone who wants one. A country has “full employment” when 95 percent of those wanting work are employed. Unfortunately, not all countries achieve this goal of full employment. France, for example, often has a 10 percent unemployment rate overall and a 20 percent unemployment rate among young people.

Does this mean that France isn’t trying as hard as the United States to achieve full employment? A lot of people in France would say yes.

Let’s take a quick trip to France to see what’s going on economically. The day is March 19, 2006, and more than a million people are marching through the streets to protest a proposed new employment law that would make it easier for companies to lay off workers under the age of twenty-six during their first two years of employment. Granted, the plan doesn’t sound terribly youth-friendly, but, as usual, economic issues are never as clear-cut as they seem (or as we’d like them to be).

To gain some further insight into what’s going on in France, go to a BusinessWeek Web site (http://www.businessweek.com/globalbiz/content/mar2006/gb20060321_896473.htm) and read the article “Job Security Ignites Debate in France.” Then answer the following questions:

1. Why does the French government support the so-called First Employment Contract? Who’s supposed to be helped by the law?
2. Which two groups are most vocal in protesting the law? Why?
3. If you were a long-time worker at a French company, would you support the new law? Why, or why not?
4. If you were a young French person who had just graduated from college and were looking for your first job, would you support the law? Why, or why not?
5. What do you think of France’s focus on job security? Does the current system help or hurt French workers? Does it help or hurt recent college graduates?
6. Does the French government’s focus on job security help or
hinder its economy? Should the government be so heavily involved in employment matters?
7. 2.6 Environmentalism

2.6 Environmentalism

Learning Objectives

1. Identify threats to the natural environment, and explain how businesses are addressing them.
2. Define sustainability and understand why companies are now focusing on environmental and socially responsibility issues.

Today, virtually everyone agrees that companies must figure out how to produce products without compromising the right of future generations to meet their own needs. Clearly, protecting natural resources is the right thing to do, but it also has become a business necessity. Companies’ customers demand that they respect the environment. Let's identify some key environmental issues and highlight the ways in which the business community has addressed them.

Land Pollution

The land we live on has been polluted by the dumping of waste and increasing reliance on agricultural chemicals. It’s pockmarked by landfills stuffed with the excess of a throwaway society. It's been strip-mined and deforested, and urban sprawl on every continent has squeezed out wetlands and farmlands and destroyed wildlife habitats.

Protecting the land from further damage, then, means disposing
of waste in responsible ways (or, better yet, reducing the amount of waste). At both national and global levels, we must resolve the conflicts of interest between those who benefit economically from logging and mining and those who argue that protecting the environment is an urgent matter. Probably municipalities must step in to save open spaces and wetlands.


Air Pollution

It’s amazing what we can do to something as large as the atmosphere. Over time, we’ve managed to pollute the air with emissions of toxic gases and particles from factories, power plants, office buildings, cars, trucks, and even farms. In addition, our
preferred method of deforestation is burning, a major source of air pollution. In some places, polluted air causes respiratory problems, particularly for the young and elderly. Factory emissions, including sulfur and other gases, mix with air and rain to produce acid rain, which returns to the earth to pollute forests, lakes, and streams. Perhaps most importantly, many experts—scientists, government officials, and businesspeople—are convinced that the heavy emission of carbon dioxide is altering the earth’s climate. Predictions of the effect of unchecked global warming include extreme weather conditions, flooding, oceanic disruptions, shifting storm patterns, droughts, reduced farm output, and even animal extinctions.


Curbing global warming will require international cooperation. More than 190 nations (though not the United States) have stated their support for this initiative by endorsing the Kyoto Protocol, an agreement to slow global warming by reducing worldwide carbon-dioxide emissions.

What can business do? They can reduce greenhouse emissions by making vehicles, factories, and other facilities more energy efficient. In response to a government ban on chlorofluorocarbons, which damage the ozone layer, DuPont has cut its own greenhouse emissions by 72 percent over the last twenty years through improvements in manufacturing processes and a commitment to increased energy efficiency.


Water Pollution

Water makes up more than 70 percent of the earth’s surface, and it’s no secret that without it we wouldn’t be here. Unfortunately, that knowledge doesn’t stop us from polluting our oceans, rivers, and lakes and generally making our water unfit for use. Massive pollution occurs when such substances as oil and chemicals are dumped into bodies of water. The damage to the water, to the marine ecosystem, and to coastal wildlife from the accidental spilling of oil from supertankers and offshore drilling operations can be disastrous, and the cleanup can cost billions. Most contaminants, however, come from agricultural fertilizers, pesticides, wastewater, raw sewage, and silt that make their way into water systems over time. David Krantz and Brad Kifferstein, “Water Pollution and Society,” University of Michigan, http://www.umich.edu/~gs265/society/waterpollution.htm (accessed April 24, 2006). In some parts of the world—including certain areas in this country—water supplies are dwindling, partly because of diminishing rainfall and partly because of increased consumption.

The Environmental Protection Agency (EPA) has been a major force in cleaning up U.S. waters. Companies are now held to stricter standards in the discharge of wastes into water treatment systems. In some places, particularly where water supplies are dangerously low, such as the Southwest, local governments have instituted conservation programs. In Arizona (which suffers a severe shortage), Home Depot works with governmental and nongovernmental agencies on a $1.8 million water-conservation campaign. From its forty stores, the company runs weekend workshops to educate consumers on conservation basics, including drought-resistant...
Did you ever read (or have read to you) *The Lorax*, a well-known children’s book, written by Dr. Seuss in 1971? *The Lorax* was written by Dr. Seuss. It was first published in 1971 by Random House, New York. The copyright was renewed in 1999. It tells the story of how a business owners’ greed destroyed an ecosystem. To manufacture and sell a product that the owner argued everyone needed, he cut down the trees in the forest, polluted the river, and fouled the air. These actions destroyed the habitat for the bears that lived on the fruit that fell from the trees, the fish that swam in the streams and the birds that flew high up in the sky. In 1971, these actions were not viewed negatively; business owners believed that the purpose of business was to make a profit without regard for the effect on the environment.

This book was written for young people, but it sends an important message to today’s business executives. When it was written in 1971, few business people listened to its message. But, they seem to be listening now. Over the past ten to fifteen years, most of our large corporations have adopted measures that would have pleased environmentalists. These initiatives fall under the umbrella called “sustainability.” But what does sustainability mean? There are, of course, many definitions, but here is one that should work for us: sustainability—the principle of providing products today that don’t compromise the ability of future generations to meet their needs. For an excellent overview of sustainability, watch a short animated movie explaining sustainability at www.youtube.com/watch?v=B5NiTN0chj02 min – April 9, 2010 – Uploaded by RealEyesvideo and created by RealEyes by Igloo Animations.

Companies that undertake sustainability initiatives
believe that meeting business needs and protecting the environment are not mutually exclusive. They must do both.

How would you like a job in the sustainability field? Well twenty-six-year-old Robyn Beavers has one. As Google’s Chief Sustainability Officer she runs the company’s “Green Biz Ops” [Green Business Operations] and is responsible for reducing Google’s impact on the environment. Bob Keefe, Meet Google’s Chief Sustainability Officer (What a Cool Job!), Divine Caroline: Life in your words, at http://www.divinecaroline.com/22277/44799-meet-google-s-chief-sustainability-officer#ixzz1VWmTFINK (accessed August 17, 2011).

The 9,200 solar panels that were recently installed at the company’s corporate headquarters (the world’s biggest solar power system) will certainly reduce the company’s use of electricity supplied from fossil fuels. When she’s not finding ways to reduce Google’s footprint on the world, she keeps busy making sure Google’s offices are green—energy efficient, built with cradle-to-cradle products, and healthy. She gets to pick out carpeting that can be returned to the manufacturer when it’s worn out so it can be ground up and used to make other rugs, rather than sit in a landfill decaying. She OKs window shades and other textiles used in the cubicles only after she is assured they are toxin-free. And she makes sure there is plenty of filtered water for everyone and 90 percent fresh air coming into the building during the day. Although she has a lot of leeway in making decisions, each project has to be reviewed to be sure it adds value and makes financial sense.

Google, like many other companies who are proactive in environmental and social responsibility issues often have a “triple bottom line” focus. They believe that the current reporting model of one bottom line—profit—does not capture all the dimensions of performance. They argue instead that companies should measure performance using three separate bottom lines: profit, people, and planet (or the 3Ps). In addition to reporting profit through their income statement, companies should also report their progress in being socially responsible to other people (stakeholders, including

Key Takeaways

• Companies bear a responsibility to produce products without compromising the right of future generations to meet their needs.
• Customers demand that companies respect the environment. Our land, air, and water all face environmental threats.
• Land is polluted by the dumping of waste and an increasing reliance on agricultural chemicals. It’s pockmarked by landfills, shredded by strip mining, and laid bare by deforestation.
• Urban sprawl has squeezed out wetlands and farmlands and destroyed wildlife habitats.
• To protect the land from further damage, we must dispose of waste in responsible ways, control strip mining and logging, and save open spaces and wetlands.
• Emissions of toxic gases and particles from factories, power plants, office buildings, cars, trucks, and even farms pollute the air, which is also harmed by the burning associated with deforestation.
• Many experts believe that the heavy emission of carbon dioxide by factories and vehicles is altering the earth’s climate: carbon dioxide and other gases, they argue, act as a “greenhouse” over the earth, producing global warming—a heating of the earth that could have dire consequences. Many companies have taken actions to reduce air pollution.
• Water is polluted by such substances as oil and chemicals. Most of the contaminants come from agricultural fertilizers,
pesticides, wastewater, raw sewage, and silt.

• Also of concern is the dwindling supply of water in some parts of the world brought about by diminishing rainfall and increased consumption.

• The Environmental Protection Agency has been a major force in cleaning up U.S. waters.

• Many companies have joined with governmental and nongovernmental agencies alike in efforts to help people protect and conserve water.

• Sustainability can be defined as the principle of providing products today that don’t compromise the ability of future generations to meet their needs.

• Companies that undertake sustainability initiatives believe that meeting business needs and protecting the environment are not mutually exclusive. They must do both.

• Those who support a “triple bottom line” approach to corporate performance evaluation believe that the current reporting model of one bottom line—profit—does not capture all the dimensions of performance. They argue instead that companies should measure performance using three separate bottom lines: profit, people, and planet (or the 3Ps).

Exercise

(AACSB) Analysis

It’s very popular today for company spokespersons to brag about the great things their companies are doing to help the environment. Condé Nast, a worldwide magazine publishing company, questioned whether many of these vocal companies have earned bragging rights or whether they’re merely engaging in self-serving marketing stunts. After extensive research, Condé Nast created two lists: the “Green 11 roster of good guys” and the “Toxic 10” list of offenders that could be doing more to help the environment. Review Condé
Nast’s findings in its article “The Toxic Ten” (available here: Dirt Digger’s Digest – The Toxic Ten). Select one of the companies spotlighted. Go to that company’s Web site and read about its environmental efforts. Then answer the following questions:

- Based on the information provided in the Condé Nast article and on your selected company’s Web site, how would you rate the company’s environmental initiatives?
- Do the statements on the company’s Web site mesh with the criticism voiced by Condé Nast?
- In your opinion, does the company deserve to be on Condé Nast’s “Toxic 10” list? Why, or why not?
- Why does the company promote its environmental efforts? Is this promotion effective?
Learning on the Web (AACSB)

**Lessons in Community Living**

Executives consider it an honor to have their company named one of *Business Ethics* magazine’s “100 Best Corporate Citizens.” Companies are chosen from a group of one thousand, according to how well they serve their stakeholders—owners, employees, customers, and the communities with which they share the social and natural environment. Being in the top one hundred for five years in a row is cause for celebration. Two of the twenty-nine companies that enjoy this distinction are Timberland and the New York Times Company.

The two companies are in very different industries. Timberland designs and manufactures boots and other footwear, apparel, and accessories; the New York Times Company is a media giant, with nineteen newspapers (including the *New York Times* and the *Boston Globe*), eight television stations, and more than forty Web sites. Link to the Timberland Web site (http://www.timberland.com/corp/index.jsp?page=csroverview) and the New York Times Company Web site (http://www.nytco.com/social-responsibility/environmental-stewardship/) to learn how each, in its own way, supports the communities with which it shares the social and natural environment. Look specifically for information that will help you answer the following questions:

1. How does each company assist its community? To what organizations does each donate money? How do employees
volunteer their time? What social causes does each support?

2. How does each company work to protect the natural environment?

3. Are the community-support efforts of the two companies similar or dissimilar? In what ways do these activities reflect the purposes of each organization?

4. In your opinion, why do these companies support their communities? What benefits do they derive from being good corporate citizens?

Career Opportunities

Is “WorldCom Ethics Officer” an Oxymoron?

As you found out in this chapter, WorldCom's massive accounting scandal cost investors billions and threw the company into bankruptcy. More than one hundred employees who either participated in the fraud or passively looked the other way were indicted or fired, including accountant Betty Vinson, CFO Scott Sullivan, and CEO Bernard Ebbers. With the name “WorldCom” indelibly tarnished, the company reclaimed its previous name, “MCI.” It was put on court-imposed probation and ordered to follow the directives of the court. One of those directives called for setting up an ethics office. Nancy Higgins, a corporate attorney and onetime vice president for ethics at Lockheed Martin, was brought in with the title of chief ethics officer.

Higgins's primary responsibility is to ensure that MCI lives up to new CEO Michael Capellas's assertion that the company is dedicated to integrity and its employees are committed to high ethical standards. Her tasks are the same as those of most people with the same job title, but she's under more pressure because MCI can't afford any more ethical lapses. She oversees the company's ethics initiatives, including training programs and an ethics hotline.
She spends a lot of her time with employees, listening to their concerns and promoting company values.

Higgins is a member of the senior executive team and reports to the CEO and board of directors. She attends all board meetings and provides members with periodic updates on the company's newly instituted ethics program (including information gleaned from the new ethics hotline).

Answer the following questions:

1. Would you be comfortable in Higgins's job? Does the job of ethics officer appeal to you? Why, or why not?
2. Would you find it worthwhile to work in an ethics office for a few years at some point in your career? Why, or why not?
3. What qualities would you look for if you were hiring an ethics officer?
4. What factors will help (or hinder) Higgins's ability to carry out her mandate to bolster integrity and foster ethical standards?
5. Would the accounting scandals have occurred at WorldCom if Higgins had been on the job back when Vinson, Sullivan, and Ebbers were still there? Explain your opinion.

Team-Building Skills (AACSB)

What Are the Stakes When You Play with Wal-Mart?

In resolving an ethical dilemma, you have to choose between two or more opposing alternatives, both of which, while acceptable, are important to different groups. Both alternatives may be ethically legitimate, but you can act in the interest of only one group.

This project is designed to help you learn how to analyze and resolve ethical dilemmas in a business context. You'll work in teams to address three ethical dilemmas involving Wal-Mart, the world's largest company. Before meeting as a group, every team member should go to the BusinessWeek Web site.
(http://www.businessweek.com/magazine/content/03_40/b3852001_mz001.htm) and read “Is Wal-Mart Too Powerful?” The article discusses Wal-Mart’s industry dominance and advances arguments for why the company is both admired and criticized.

Your team should then get together to analyze the three dilemmas that follow. Start by reading the overview of the dilemma and any assigned material. Then debate the issues, working to reach a resolution through the five-step process summarized in Figure 2.2 “How to Face an Ethical Dilemma”:

1. Define the problem and collect the relevant facts.
2. Identify feasible options.
3. Assess the effect of each option on stakeholders.
4. Establish criteria for determining the most appropriate action.
5. Select the best option based on the established criteria.

Finally, prepare a report on your deliberations over each dilemma, making sure that each report contains all the following items:

- The team’s recommendation for resolving the dilemma
- An explanation of the team’s recommendation
- A summary of the information collected for, and the decisions made at, each step of the dilemma-resolution process

Three Ethical Dilemmas

**Ethical Dilemma 1: Should Wal-Mart Close a Store because It Unionizes?**

**Scenario:**

In February 2005, Wal-Mart closed a store in Quebec, Canada, after its workers voted to form a union. The decision has ramifications for various stakeholders, including employees, customers, and stockholders. In analyzing and arriving at a
resolution to this dilemma, assume that you’re the CEO of Wal-Mart, but ignore the decision already made by the real CEO. Arrive at your own recommendation, which may or may not be the same as that reached by your real-life counterpart.

Before analyzing this dilemma, go to the Washington Post Web site (http://www.washingtonpost.com/wp-dyn/articles/A15832-2005Feb10.html) and read the article “Wal-Mart Chief Defends Closing Unionized Store.”

 Ethical Dilemma 2: Should Levi Strauss Go into Business with Wal-Mart?

 Scenario:

For years, the words jeans and Levi’s were synonymous. Levi Strauss, the founder of the company that carries his name, invented blue jeans in 1850 for sale to prospectors in the gold fields of California. Company sales peaked at $7 billion in 1996 but then plummeted to $4 billion by 2003. Management has admitted that the company must reverse this downward trend if it hopes to retain the support of its twelve thousand employees, operate its remaining U.S. factories, and continue its tradition of corporate-responsibility initiatives. At this point, Wal-Mart made an attractive offer: Levi Strauss could develop a low-cost brand of jeans for sale at Wal-Mart. The decision, however, isn’t as simple as it may seem: Wal-Mart’s relentless pressure to offer “everyday low prices” can have wide-ranging ramifications for its suppliers’ stakeholders—in this case, Levi Strauss’s shareholders, employees, and customers, as well as the beneficiaries of its various social-responsibility programs. Assume that, as the CEO of Levi Strauss, you have to decide whether to accept Wal-Mart’s offer. Again, ignore any decision already made by your real-life counterpart, and instead work toward an independent recommendation.

Before you analyze this dilemma, go to the Fast Company Web site (http://www.fastcompany.com/magazine/77/walmart.html) and read the article “The Wal-Mart You Don’t Know.”

 Ethical Dilemma 3: Should You Welcome Wal-Mart into Your Neighborhood?
Scenario:

In 2002, Wal-Mart announced plans to build forty “supercenters” in California—a section of the country that has traditionally resisted Wal-Mart’s attempts to dot the landscape with big-box stores. Skirmishes soon broke out in California communities between those in favor of welcoming Wal-Mart and those determined to fend off mammoth retail outlets.

You’re a member of the local council of a California city, and you’ll be voting next week on whether to allow Wal-Mart to build in your community. The council’s decision will affect Wal-Mart, as well as many local stakeholders, including residents, small business owners, and employees of community supermarkets and other retail establishments. As usual, ignore any decisions already made by your real-life counterparts.

Before working on this dilemma, go to the USA Today Web site (http://www.usatoday.com/money/industries/retail/2004-03-02-wal-mart_x.htm) and read the article “California Tries to Slam Lid on Big-Boxed Wal-Mart.”

The Global View (AACSB)

Was Nike Responsible for Compensating Honduran Factory Workers?

Honduras is an impoverished country in which 70% of its residents live in poverty. Jobs are scarce, particularly those that pay decent wages along with benefits, such as health care. It is not surprising then that workers at two Honduran factories making products for U.S. companies, including Nike, were extremely upset when their factories closed down and they lost their jobs. Even worse, the owners of the factories refused to pay the 1,800 workers $2 million in severance pay and other benefits due to them by law. Although the factory owners had been paid in full by Nike for the apparel they produced, the workers argued that Nike should be
responsible for paying the $2 million in severance that the factory owners had not received.

Nike's original response was to sympathize with the workers but refuse to pay the workers the severance pay they had not received from the factory owners. This stance did not settle well with student groups around the country who rallied in support of the unpaid workers. In the end Nike gave into pressure from the students and paid $1.5 million to a relief fund for the employees. In addition, the company said it would provide vocational training and health coverage for the unemployed workers.

To learn more about this case, read the following:

- Working in These Times: Honduran Workers Speak Out Against Nike's Labor Violations (April 21, 2010) http://inthesetimes.org/working/entry/5895/honduran_workers_speak_out_against_nikes_labor_violations/
- Time Magazine: Just Pay It: Nike Creates Fund for Honduran Workers (July 27, 2010) http://www.time.com/time/printout/0,8816,2006646,00.html

Answer the following questions:

1. Do you think Nike was responsible for compensating the workers in Honduras? Why did it change its stance?
2. Did the students, universities, and workers themselves have all
of the information they needed before becoming involved in the protest? Are their facts accurate?

3. Should students be activists? Do companies such as Nike ignore them at their own peril?
3.7 Cases and Problems

Learning on the Web (AACSB)

Keeping Current About Currency

On a day-to-day basis, you probably don’t think about what the U.S. dollar (US$) is worth relative to other currencies. But there will likely be times when ups and downs in exchange rates will seem extremely important to you in your business career. The following are some hypothetical scenarios that illustrate what these times may be. (Note: To respond to the questions raised in each scenario, search Google for a currency converter.)

Scenario 1: Your Swiss Vacation

Your family came from Switzerland, and you and your parents visited relatives there back in 2007. Now that you’re in college, you want to make the trip on your own during spring break. While you’re there, you also plan to travel around and see a little more of the country. You remember that in 2007, US$1 bought 1.22 Swiss francs (FrS). You estimate that, at this rate, you can finance your trip (excluding airfare) with the $1,200 that you earned this summer. You’ve heard, however, that the exchange rate has changed. Given the current exchange rate, about how much do you think your trip would cost you? As a U.S. traveler going abroad, how are you helped by a shift in exchange rates? How are you hurt?

Scenario 2: Your British Friends

A few years ago, you met some British students who were visiting
the United States. This year, you're encouraging them to visit again so that you can show them around New York City. When you and your friends first talked about the cost of the trip back in 2007, the British pound (£) could be converted into US$1.90. You estimated that each of your British friends would need to save up about £600 to make the trip (again, excluding plane fare). Given today's exchange rate, how much will each person need to make the trip? Have your plans been helped or hindered by the change in exchange rates? Was the shift a plus for the U.S. travel industry? What sort of exchange-rate shift hurts the industry?

**Scenario 3: Your German Soccer Boots**

Your father rarely throws anything away, and while cleaning out the attic a few years ago, he came across a pair of vintage Adidas soccer boots made in 1955. Realizing that they'd be extremely valuable to collectors in Adidas's home country of Germany, he hoped to sell them for US $5,000 and, to account for the exchange rate at the time, planned to price them at $7,200 in euros. Somehow, he never got around to selling the boots and has asked if you could sell them for him on eBay. If he still wants to end up with US $5,000, what price in euros will you now have to set? Would an American company that exports goods to the European Union view the current rate more favorably or less favorably than it did back in 2007?

**Career Opportunities (AACSB)**

**Broadening Your Business Horizons**

At some point in your life, you'll probably meet and work with people from various countries and cultures. Participating in a college study-abroad program can help you prepare to work in the global business environment, and now is as good a time as any to start exploring this option. Here's one way to go about it:
• Select a study-abroad program that interests you. To do this, you need to decide what country you want to study in and your academic field of interest. Unless you speak the language of your preferred country, you should pick a program offered in English.
  ◦ If your school offers study-abroad programs, choose one that has been approved by your institution.
  ◦ If your school doesn't offer study-abroad programs, locate one through a Web search.
• Describe the program, the school that's offering it, and the country to which it will take you.
• Indicate why you've selected this particular program, and explain how it will help you prepare for your future business career.

Ethics Angle (AACSB)

**The Right, Wrong, and Wisdom of Dumping and Subsidizing**

When companies sell exported goods below the price they'd charge in their home markets (and often below the cost of producing the goods), they're engaging in *dumping*. When governments guarantee farmers certain prices for crops regardless of market prices, the beneficiaries are being *subsidized*. What do you think about these practices? Is dumping an unfair business practice? Why, or why not? Does subsidizing farmers make economic sense for the United States? What are the effects of farm subsidies on the world economy? Are the ethical issues raised by the two practices comparable? Why, or why not?
Team-Building Skills (AACSB)

Three Little Words: The China Price

According to business journalists Pete Engardio and Dexter Roberts, the scariest three words that a U.S. manufacturer can hear these days are the China price. To understand why, go to the Business Week Web site (http://www.businessweek.com/magazine/content/04_49/b3911401.htm) and read its article “The China Price,” which discusses the benefits and costs of China’s business expansion for U.S. companies, workers, and consumers. Once you’ve read the article, each member of the team should be able to explain the paradoxical effect of U.S.–Chinese business relationships—namely, that they can hurt American companies and workers while helping American companies and consumers.

Next, your team should get together and draw up two lists: a list of the top five positive outcomes and a list of the top five negative outcomes of recent Chinese business expansion for U.S. businesses, workers, and consumers. Then, the team should debate the pros and cons of China’s emergence as a global business competitor and, finally, write a group report that answers the following questions:

1. Considered on balance, has China’s business expansion helped or harmed U.S. companies, workers, and consumers? Justify your answers.
2. What will happen to U.S. companies, workers, and consumers in the future if China continues to grow as a global business competitor?
3. How should U.S. companies respond to the threats posed by Chinese competitors in their markets?
4. What can you do as a student to prepare yourself to compete in an ever-changing global business environment?

When you hand in your report, be sure to attach all the following items:
• Members’ individually prepared lists of ways in which business relationships with China both hurt and help U.S. businesses, workers, and consumers
• Your group-prepared list of the top five positive and negative effects of Chinese business expansion on U.S. businesses, workers, and consumers

The Global View (AACSB)

Go East, Young Job Seeker

How brave are you when it comes to employment? Are you bold enough to go halfway around the world to find work? Instead of complaining about U.S. jobs going overseas, you could take the bull by the horns and grab one job back. It’s not that tough to do, and it could be a life-changing experience. U.S. college graduates with business or technical backgrounds are highly sought after by companies that operate in India. If you qualify (and if you’re willing to relocate), you could find yourself working in Bangalore or New Delhi for some multinational company like Intel, Citibank, or GlaxoSmithKline (a pharmaceutical company). In addition, learning how to live and work in a foreign country can build self-confidence and make you more attractive to future employers. To get a glimpse of what it would be like to live and work in India, go to the Web sites of American Way magazine (http://www.americanwaymag.com/jeffrey-vanderwerf-high-tech-outsourcing-boom-bangalore-leela-palace) and CNN and Money (http://money.cnn.com/2004/03/09/pf/workers_to_india), and check out the posted articles: “Passage to India,” and “Needs Job, Moves to India.” Then, go to the Monster Work Abroad Web site (http://jobsearch.monsterindia.com/return2origin/index.html) and find a job in India that you’d like to have, either right after graduation or about five years into your career. (When selecting the job, ignore its actual location and proceed as if it’s in Bangalore.)
After you've pondered the possibility of living and working in India, answer the following questions:

1. What would your job entail?
2. What would living and working in Bangalore be like? What aspects would you enjoy? Which would you dislike?
3. What challenges would you face as an expatriate (a person who lives outside his or her native country)? What opportunities would you have?
4. How would the experience of working in India help your future career?
5. Would you be willing to take a job in India for a year or two? Why, or why not?
Would You Like to Own a Sub Shop?

How would you like to own your own sandwich shop? You could start one on your own or buy one that's already in business, but an easier way might be buying a franchise from SUBWAY, the largest fast-food franchise in the world (even bigger than McDonald's). SUBWAY began in 1965 when seventeen-year-old Fred DeLuca opened a tiny sandwich shop in Bridgeport, Connecticut, hoping to put himself through college. As it turns out, his venture paid off in more ways than one. By 1974, DeLuca was franchising his business concept, and today, there are more than fifteen thousand SUBWAY franchisees in some seventy-five countries.

Go to http://www.subway.com to link to the SUBWAY Web site and learn more about franchise opportunities with the company. After reviewing the information provided on the company's Web site, answer the following questions:

1. What do you have to do to get a SUBWAY franchise?
2. How much would it cost to open a SUBWAY shop?
3. What training and support would you receive from SUBWAY?
4. What advantages do you see in buying a SUBWAY franchise rather than starting a business from scratch? What disadvantages do you see?
Career Opportunities

Do You Want to Be an Entrepreneur?

Want to learn what it’s like to be an entrepreneur? To help you decide whether life as an entrepreneur might be for you, go to http://entrepreneurs.about.com/od/interviews/null.htm; then link to the “Interview with Entrepreneurs” section of the About.com Web site and review the entrepreneur interviews. Select two entrepreneurs who interest you, and for each, do the following:

1. Describe the company that he or she founded.
2. Explain the reasons why he or she became an entrepreneur.
3. Explain what qualities, background, or both, prepared the individual to start a business.

After reading the interviews with these two entrepreneurs, answer the following questions:

1. What aspects of being an entrepreneur are particularly rewarding?
2. What's the downside of being an entrepreneur?
3. What challenges do entrepreneurs face?
4. Is entrepreneurship for you? Why, or why not?

Ethics Angle (AACSB)

Term Papers for Sale

You and some fellow classmates are sitting around over pizza one night when someone comes up with an idea for a business. All of you have old term papers and essays lying around, and a couple of you know how to set up a Web page. What if you combine these two assets and start a business selling term papers over the Internet? Over time, you could collect or buy additional inventory from other
students, and since some of you are good at research and others are good writers, you could even offer “student clients” the option of customized papers researched and written just for them. You figure that you can charge $15 for an “off-the-rack” paper, and for customized jobs, $10 per double-spaced page seems reasonable.

You all agree that the idea is promising, and you and a partner volunteer to put together a business plan. You have no difficulty with the section describing your proposed business: you know what your business will do, what products it will offer, who your customers will be, how your products will be sold, and where you'll be located. So far, so good.

Let's pause at this point to consider the following questions:

1. Does selling term papers over the Internet make business sense? Is it a good business idea?
2. Could the venture be profitable?

Let’s continue and find out how the business plan proceeds.

Now you’re ready to write your section on industry analysis and the first question you need to answer is, who are the players in the industry? To get some answers, you go online, log on to Google, and enter the search term “term papers for sale.” Much to your surprise, up pop dozens of links to companies that have beaten you to market. The first company you investigate claims to have a quarter-million papers in stock, plus a team of graduate students on hand to write papers for anyone needing specialized work.

There’s also a statement that says something like this: “Our term papers and essays are intended to help students write their own papers. They should be used for research purposes only. Students using our term papers and essays should write their own papers and cite our work.”

You realize now that you're facing not only stiff competition but an issue that, so far, you and your partners have preferred to ignore: Is the business that you have in mind even ethical? It occurs to you that you could probably find the answer to this question in
at least one of the 8,484 term papers on ethics available on your competitor’s Web site, but you decide that it would be more efficient to give the question some thought on your own.

At this point, then, let’s pause again to identify a couple of questions that you need to ask yourself as you prepare a report of your findings for your partners:

1. Is the sole purpose of running a business to make a profit, or do you need to be concerned about what your products will be used for? Explain your reasoning.
2. Do you need to consider the ethics of what other people do with your product? Explain your reasoning.

When you report on the problem that you’ve uncovered, your would-be partners are pretty discouraged, some by the prospect of competition and some by the nagging ethical issue. Just as you’re about to dissolve the partnership, one person speaks up: “How about selling software that lets faculty search to see if students have plagiarized material on the Web?”

“Sorry,” says someone else. “It’s already out there. Two students at Berkeley have software that compares papers to a hundred million Web pages.”

Team-Building Skills (AACSB)

Knowing how to be an effective team member is a vital lifetime skill. It will help you in your academic career, in the business world, and in nonwork activities as well. It takes time and effort to learn how to work in a team. Part of the challenge is learning how to adjust your behavior to the needs of the group. Another part is learning how to motivate members of a group. A well-functioning team allows members to combine knowledge and skills, and this reliance on
diverse backgrounds and strengths often results in team decisions that are superior to those made by individuals working alone.

Are You a Team Player?

As a first step, you should do a self-assessment to evaluate whether you possess characteristics that will help you be a successful team member. You can do this by taking a “Team Player” quiz available at the Quintessential Careers Web site. Go to http://www.quintcareers.com/team_player_quiz.html to link to this quiz. You'll get feedback that helps you identify the characteristics you need to work on if you want to improve your teamwork skills.

Working Together as a Team

The best approach to specifying appropriate behavior for team members is for the team to come up with some ground rules. Get together with three other students selected by your instructor, and establish working guidelines for your team. Prepare a team report in which you identify the following:

1. Five things that team members can do to increase the likelihood of group success
2. Five things that team members can do to jeopardize group success

The Global View (AACSB)

Global Versions of MySpace

When Andrew Mason founded Groupon in November 2008, he had no idea that he was headed for an overnight success, but two years after he set out on his entrepreneurial adventure (which, admittedly, isn't actually overnight), Groupon had more than fifty million registered users and nine million customers who had purchased at least one “daily deal” (http://www.digital-dd.com/wp-content/uploads/2011/06/groupon-ipo-s-1.pdf).
What’s ahead for Groupon? Can its business model be exported to even more locations outside the United States? If you were in charge of global expansion for Groupon, what country would you enter next? What country would you avoid? To identify promising and not-so-promising foreign markets, go to the Groupon Wikipedia article (http://en.wikipedia.org/wiki/Groupon) and click on “Geographic Markets” to obtain a list of counties in which Groupon operates. Also go to http://news.bbc.co.uk/1/hi/country_profiles/default.stm to link to the Country Profiles Web site maintained by BBC News. Study the economic and political profiles of possible overseas locations, and answer the following questions:

1. Why do you think Groupon has been so successful in the United States? Cite some of the challenges that it still faces in this country.

2. If you were in charge of global expansion at Groupon, which country would you enter next? Why do you think the Groupon business concept will succeed in this country? What challenges will the company face there?

3. What country would you avoid? Why is it incompatible with the Groupon business concept?
Factors Contributing to Nike’s Success

This writing assignment solicits your opinion on factors contributing to Nike’s success. To complete it, you should go to https://en.wikipedia.org/wiki/Nike_timeline to learn about Nike’s history by reviewing the company’s time line.

Memo Format

Use the memo format described in the chapter for this assignment. Your memo should not exceed two pages. It should be single spaced (with an extra space between paragraphs and bulleted items).

Scenario

You're one of the fortunate college students selected to participate in Nike’s summer internship program. The program is quite competitive, and you still can't believe that you were chosen. You arrived in Beaverton, Oregon, yesterday morning and have been busy ever since. Last night, you attended a dinner for new interns where you were welcomed to Nike by CEO Mark Parker.

You were lucky to be sitting next to a personable, well-informed Nike veteran named Simon Pestridge. Pestridge joined Nike about twelve years ago. He was telling you about a past assignment he had as director of marketing for Australia. (You were impressed with his status at Nike, not just because he doesn't look much older than you, but also because you've always wanted to travel to Australia.) The dinner conversation turned to a discussion of the reasons for Nike's success. Others at the table were giving their opinions on the
subject when Pestridge turned to you and said, “As a new intern, give us an outsider’s point of view. Why do you think Nike’s been so successful?” You were about to venture an opinion when Pestridge was called away for a phone call. As he got up, however, he quickly said, “Send me a memo telling me what factors you think have contributed to Nike’s success. Keep it simple. Three factors are plenty.” Though you were relieved to have a little time to think about your answer, you were also a bit nervous about the prospect of writing your first official memo.

As everyone else headed for the Bo Jackson gym, you went back to your room to think about Pestridge’s question and to figure out how to go about writing your memo. You want to be sure to start by telling him that you enjoyed talking with him. You also need to remind him that you’re responding to his question about three factors in Nike’s success, and must be sure to explain why you believe they’re important. You’ll end by saying that you hope the information is helpful and that he can contact you if he has any further questions.

So far, so good, but you’re still faced with the toughest part of your task—identifying the three factors that you deem important to Nike’s success. Fortunately, even at Nike there’s always tomorrow to get something done, so you decide to sleep on it and write your memo in the morning.

Ethics Angle (AACSB)

The Goof-Off

You and three other students have been working on a group project all semester in your Introduction to Business class. One of the members of the team did very little work; he failed to attend almost all the meetings, took no responsibility for any of the tasks, didn’t attend the practice session before your presentation, and in general was a real goof-off. But he happens to be friends with two
of the team members. You and your other team members have been asked to complete the attached team member evaluation. You want to give the student what he deserves—almost no credit. But your other two team members don’t agree. They argue that it is “unsocial and mean” to tell the truth about this student’s lack of contribution. Instead, they want to report that everyone shared the work equally. The evaluation will be used in determining grades for each team member. Those who contributed more will get a higher grade than those who did not. Prepare an argument that you can advance to the other team members on the ethics of covering for this student. Assuming that your two teammates won’t change their minds, what would you do?

Attachment to Ethics Angle Problem

Introduction to Business

Team Member Evaluation

(To be given to your faculty member during the last week of class)

TEAM ___________________

You have a total of $100,000. You can use this to reward your team members (including yourself) for their contributions to the team project.

Fill in each team member’s name below (including your own), and show beside each name how much of the $100,000 you would give that member for his or her contributions to the preparation and presentation of the team project. Do not share your recommendations with your team members.

Your recommendations will be confidential.
Team-Building Skills (AACSB)

**Team Skills and Talents**

Team projects involve a number of tasks that are handled by individual team members. These tasks should be assigned to team members based on their particular skills and talents. The next time you work on a team project, you should use the following table to help your team organize its tasks and hold its members responsible for their completion.

Here is how you should use this document:

1. Identify all tasks to be completed.
2. Assign each task to a member (or members) of your team based on their skills, talents, and time available.
3. Determine a due date for each task.
4. As a task is completed, indicate its completion date and the team member (or members) who completed the task. If more than one team member works on the assignment, indicate the

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YOUR NAME

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74 | 8.7 Cases and Problems
percentage of time each devoted to the task. You can add tasks that surface as your team works its way through the project.

5. If the assigned person fails to complete the task, or submits poor quality work, add a note to the report explaining what happened and how the situation was corrected (for example, another team member had to redo the task).

6. Submit the completed form (with all columns completed) to your faculty member at the class after your team project is due. Include a cover sheet with your team’s name (or number) and the name of each team member.

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The Global View (AACSB)

**A Multicultural Virtual Team**

You work for Nike, a global company. You just learned that you were assigned to a virtual team whose mission is to assess the feasibility of Nike's making an inexpensive shoe that can be sold in
Brazil. The team consists of twelve members. Three of the members work in the United States (two in Beaverton, Oregon, and one in New York City). Two work in England, two in China, two in India, and three in Brazil. All are Nike employees and all were born in the country in which they work. All speak English, though some speak it better than others. What challenges do you anticipate the team will face because of its multicultural makeup?. How could these challenges be overcome?
The Economics of Online Annoyance

You've just accessed a Web page and begun searching for the information you want to retrieve. Suddenly the page is plastered from top to bottom with banner ads. Some pop up, some float across the screen, and in some, animated figures dance and prance to inane music. As a user of the Internet, feel free to be annoyed. As a student of business, however, you should stop and ask yourself a few questions: Where do banner ads come from? Who stands to profit from them?

To get a handle on these questions, go to the How Stuff Works Web site (http://computer.howstuffworks.com/web-advertising.htm) and read the article “How Web Advertising Works,” by Marshall Brain. When you've finished, answer the following questions from the viewpoint of a company advertising on the Web:

1. What are the advantages and disadvantages of banner ads? Why are they less popular with advertisers today than they were about ten years ago?
2. What alternative forms of Web advertising are more common today? (For each of these alternative forms, describe the type of ad, explain how it's more effective than banner advertising, and list any disadvantages.)
3. Why are there so many ads on the Web? Is it easy to make money selling ads on the Web? Why, or why not?
4. Assume that you're in charge of Web advertising for a company
that sells cell-phone ring tones. On which sites would you place your ads and what type of ads would you use? Why?

Career Opportunities

So Many Choices

How would you like to work for an advertising agency? How about promoting a new or top-selling brand? Want to try your hand at sales? Or does marketing research or logistics management sound more appealing? With a marketing degree, you can pursue any of these career options—and more. To learn more about these options, go to the WetFeet Web site (http://wetfeet.com/Careers–Industries.aspx). Scroll down to the “Careers” section and select **two** of the following career options that interest you: advertising, brand management, marketing, sales, or supply chain management. For each of the two selected, answer the following questions:

1. What would you do if you worked in this field?
2. Who does well?
3. What requirements are needed to be hired into this field?
4. Are job prospects in the field positive or negative?
5. What career track would you follow?

Finally, write a paragraph responding to these questions: Does a career in marketing appeal to you? Why, or why not? Which career option do you find most interesting? Why?

Ethics Angle (AACSB)

Pushing Cigarettes Overseas
A senior official of the United Nation's World Health Organization (WHO) claims that the marketing campaigns of international tobacco companies are targeting half a billion young people in the Asia Pacific region by linking cigarette smoking to glamorous and attractive lifestyles. WHO accuses tobacco companies of “falsely associating use of their products with desirable qualities such as glamour, energy and sex appeal, as well as exciting outdoor activities and adventure.” Agence France Presse, “WHO: Half a Billion Young Asians at Risk from Tobacco Addiction,” May 31, 2008, http://afp.google.com/article/ALeqM5hflqvMVfuC5AldasEdZ20BsmiDfQ (accessed January 22, 2012). WHO officials have expressed concern that young females are a major focus of these campaigns.

The organization called on policymakers to support a total ban on tobacco advertising saying that “the bombardment of messages through billboards, newspapers, magazines, radio and television ads, as well as sports and fashion sponsorships and other ploys, are meant to deceive young people into trying their first stick.” Associated Press, “WHO Criticizes Tobacco Industry Focus on Asian Young People,” May 30, 2008, http://www.iht.com/articles/ap/2008/05/30/news/Asia-Young-Smokers.php (accessed January 22, 2012). WHO stresses the need for a total ban on advertising as partial bans let tobacco companies switch from one marketing scheme to another.

WHO officials believe that extensive tobacco advertising gives young people the false impression that smoking is normal and diminishes their ability to comprehend that it can kill. Representatives of the organization assert that the tobacco industry is taking advantage of young people's vulnerability to advertising.

Instructions: Read the following articles and provide your opinion on the questions that follow:


• Were Blockbuster’s actions unethical?

Provide your opinion on the following:

• U.S. laws prohibit advertising by the tobacco companies. Should developing countries in which cigarette smoking is promoted by the international tobacco companies follow suit—should they also ban tobacco advertising?

• Are U.S. companies that engage in these advertising practices acting unethically? Why or why not?

• Should international policymakers support a total ban on tobacco advertising? Why or why not?

• If tobacco advertising was banned globally, what would be the response of the international tobacco companies?

Team-Building Skills (AACSB)

**Build a Better iPod and They Will Listen**

Right now, Apple is leading the pack of consumer-electronics manufacturers with its extremely successful iPod. But that doesn’t mean that Apple’s lead in the market can’t be surmounted. Perhaps some enterprising college students will come up with an idea for a better iPod and put together a plan for bringing it to market. After all, Apple founders (the late Steve Jobs and Stephen Wozniak) were college students (actually, college dropouts) who found entrepreneurship more rewarding than scholarship. Here’s your team assignment for this exercise:
1. Go to the BusinessWeek Web site (http://www.businessweek.com/technology/content/dec2004/tc2004127_7607_tc185.htm) and read the article “Could Apple Blow Its iPod Lead?”

2. Create a marketing strategy for your hypothetical iPod competitor. Be sure that you touch on all the following bases:

   ◦ Select a target market for your product.
   ◦ Develop your product so that it offers features that meet the needs of your target market.
   ◦ Describe the industry in which you’ll compete.
   ◦ Set a price for your product and explain your pricing strategy.
   ◦ Decide what distribution channels you’ll use to get your product to market.
   ◦ Develop a promotion mix to create demand for your product.

3. Write a report that details your marketing strategy.

The Global View (AACSB)

Made in China—Why Not Sell in China?

One of Wow Wee’s recent robots, Roboscooper, is manufactured in China. Why shouldn’t it sell the product in China? In fact, the company has introduced its popular robot to the Chinese market through a Toys “R” Us store in Hong Kong. Expanding into other parts of China, however, will require a well-crafted, well-executed marketing plan. You’re director of marketing for Wow Wee, and you’ve been asked to put together a plan to expand sales of Roboscooper in China. You can be introduced to Roboscooper by going to the product section of Wow Wee’s site: http://www.wowwee.com/en/products/toys/robots/robotics/
roboscooper. To get some background on selling toys in China, go to the Epoch Times Web site (http://en.epochtimes.com/news/4-12-23/25184.html) and read the article “China Could Soon Become Booming Toy Market.” Then, draw up a brief marketing plan for increasing sales in China, being sure to include all the following components:

- Profile of your target market (gender, age, income level, geographic location, interests, and so forth)
- Proposed changes to the company's current marketing mix: modifications to product design, pricing, distribution, and promotional strategies
- Estimated sales in units for each of the next five years, including a list of the factors that you considered in arriving at your projections
- Discussion of threats and opportunities posed by expansion in the Chinese market
10.9 Cases and Problems

Learning on the Web (AACSB)

Breaking Even on Burgers

You and your business partner plan to open a gourmet burger restaurant. Your partner estimated the new business will sell a hundred fifty thousand burgers during its first year and a half of operations. You want to determine the number of burgers you must sell to break even during this period.

Here are the figures you know so far:

• The variable cost for each burger is $0.97 each.
• The fixed cost of making burgers for eighteen months is $140,000 (this includes costs such as rent, utilities, insurance).
• You will sell your burgers for $1.99 each.
• At the $1.99 per-unit selling price, how many burgers will you have to sell to break even?

Part 1: Using the previous information, manually calculate the breakeven number of burgers. How close is the breakeven number of burgers to your partner’s sales estimate of one hundred fifty thousand burgers? How confident are you that your restaurant will be profitable?

Part 2: Now, recalculate the breakeven number of burgers using a higher selling price. Pretend that your likely customers are burger
fanatics and will pay $2.79 for a burger (rather than $1.99). Also pretend that the variable cost for each burger and your fixed costs won’t change (variable cost per burger is still $0.97 and fixed costs are still $140,000). Manually calculate the number of burgers you must sell to break even at this higher selling price. Are you now more confident that the business will succeed?

**Part 3:** Without recalculating breakeven, answer these two questions:

1. If the variable cost for each burger went down from $0.97 to $0.80 per burger (and your selling price stayed at $1.99), would you need to sell more or fewer burgers to break even?
2. If fixed costs went down from $140,000 to $100,000 (and your selling price stayed at $1.99 and variable cost per burger returned to $0.97), would you need to sell more or fewer burgers to break even?

**Career Opportunities**

**Being a “Big Idea” Person**

Imagine a career in which you design the products people use every day. If you’re a “big idea” person, have an active imagination, have artistic flair, and possess the ability to understand how products function, then a career in product design and development might be for you. To learn what opportunities are available in this field, go to the Job Bank section of the Product Development and Management Association’s Web site (http://www.pdma.org/job_bank.cfm) and click on “View Posted Jobs.” Explore the various job openings by clicking on a position (to highlight it); and then clicking on the “View Job Details” button at the bottom of the screen. Find a position that interests you and look for answers to these questions:
1. What's the job like?
2. What educational background, work experience, and skills are needed for the job?
3. What aspects of the job appeal to you? What aspects are unappealing?
4. Are you cut out for a career in product design and development? Why, or why not?

Ethics Angle (AACSB)

Who's Getting Fat from Fast Food?

Product liability laws cover the responsibility of manufacturers, sellers, and others for injuries caused by defective products. Under product liability laws, a toy manufacturer can be held liable if a child is harmed by a toy that's been marketed with a design flaw. The manufacturer can also be held liable for defects in marketing the toy, such as giving improper instructions on its use or failing to warn consumers about potential dangers. But what if the product isn't a toy, but rather a fast-food kid's meal? And what if the harm isn't immediately obvious but emerges over time?

These questions are being debated in the legal and health professions (and the media). Some people believe that fast-food restaurants should be held responsible (at least in part) for childhood obesity. They argue that fast-food products—such as kids' meals made up of high-calorie burgers, fried chicken fingers, French fries, and sugary soft drinks—are helping to make U.S. children overweight. They point out that while restaurant chains spend billions each year to advertise fast food to children, they don't do nearly enough to warn parents of the dangers posed by such foods. On the other side of the debate are restaurant owners, who argue that they're not the culprits. They say that their food can be a part of a child's diet—if it's eaten in moderation.

There's no disputing that 15 percent of American children are
obese and that fast-food consumption by children has increased by 500 percent since 1970. Most observers also accept the data furnished by the U.S. Surgeon General: that obesity in the United States claims some three hundred thousand lives a year and costs $117 billion in health care. The controversy centers on the following questions:

1. Who really is to blame for the increase in obesity among U.S. children?
2. Under current consumer-protection laws, is fast-food marketing aimed at children misleading?
3. Should fast-food restaurants be held legally liable for the health problems associated with their products?

What's your opinion? If you owned a fast-food restaurant, what action (if any) would you take in response to the charges leveled by critics of your industry?

Team-Building Skills (AACSB)

The Great Idea

Get together with members of your team and brainstorm ideas for a new-to-the-market product. Begin the brainstorming session by asking each person to write an idea on a sticky note. Post the idea and repeat the process four times. After the team has evaluated and discussed the ideas, all members should vote. Each gets ten votes, which can be placed on one idea or spread over many. Once the voting ends, add up the votes received by each idea and declare one idea the winner.

Write a group report that answers the following questions:

1. Product Idea
   - What is the idea?
How would the idea work?
Who would our customers be?
What unmet need does it fill?

2. Industry

What is the product's industry, segment, and niche?
Is the industry growing or contracting?
Who are our major competitors?
How does our product differ from those of our competitors?
What opportunities exist in the industry? What threats?

3. Product

What will the product look like?
What features will it have?
How will customers benefit from our product?
Why will customers buy the product from us?
Why will our product be financially successful?

The Global View (AACSB)

What to Do When the “False” Alarm Goes Off

If someone on the street tried to sell you a “Rolex” watch for $20, you'd probably suspect that it's a fake. But what about a pair of New Balance athletic shoes? How do you know they're authentic? How can you tell? Often you can't. Counterfeitors are getting so good at copying products that even experts have trouble telling a fake from the real thing. What if the counterfeit product in question was a prescription drug? Even worse, what if it had been counterfeited with unsterile equipment or contained no active ingredients?

How likely is it that you'll buy a counterfeit product in the next year? Unfortunately, it’s very likely. To learn a little more about
the global counterfeiting business, go to the BusinessWeek and Washington Post Web sites. Read the BusinessWeek article “Fakes!” (http://www.businessweek.com/magazine/content/05_06/b3919001_mz001.htm) and the Washington Post article “Counterfeit Goods That Trigger the ‘False’ Alarm” (http://www.highbeam.com/doc/1P2-4576.html). After you read these articles, answer the following questions:

1. How has the practice of counterfeiting changed over time? What factors have allowed it to escalate?
2. What types of products are commonly counterfeited, and why might they be unsafe? What counterfeit products are particularly dangerous?
3. How do the counterfeiters get goods onto the market? How can you reduce your chances of buying fake goods?
4. Why is counterfeiting so profitable? How can counterfeiters compete on price with those making the authentic goods? How do counterfeiters harm U.S. businesses?
5. What efforts are international companies and governments (including China) making to stop counterfeiters?
6. If you know that a product is fake, is it ethical to buy it?
11.8 Cases and Problems

Learning on the Web (AACSB)

How to Build a BMW

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

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

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

Next, click on “Production” to open a drop-down list that looks like this:
Fascination Production
Press Shop
Body Shop
Paint Shop
Engine Assembly
Assembly

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

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

Career Opportunities

Wanted: Problem Solvers and Creative Thinkers

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

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

Ethics Angle (AACSB)

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

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

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

Team-Building Skills (AACSB)

Growing Accustomed to Your Fit

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

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

The Global View (AACSB)

What's the State of Homeland Job Security?

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

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

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

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

Learning on the Web (AACSB)

Discounting Retailers

There was a time when Kmart was America’s number-one discount retailer and Sears, Roebuck & Co. was the seventh largest corporation in the world. Things have changed since Wal-Mart came on the scene. In the fifty years since Sam Walton opened the first Wal-Mart store in Rogers, Arkansas, the company has propelled itself to the number-one spot in discount retailing, and (even more impressive) has higher sales than any other company in the world. Over this same fifty-year period, Target emerged as a major player in the retail industry. The fifty-year period wasn’t kind to Kmart and Sears, and both stores watched their dominance in the retail market slip away. In an effort to reverse the downward spiral of both retailers, in November 2004, Sears and Kmart merged into a new company called Sears Holdings. To learn more about how Wal-Mart, Target, and Sears Holdings are doing today, go to the National Retail Federation’s Web site (http://www.stores.org/STORES%20Magazine%20July%202011/top-100-retailers) to access a report that ranks the 2010 top 100 retailers. After reading the introduction and reviewing the list of top retailers, prepare a report comparing the three retailers on the following:

- U.S. sales and percentage increase or decrease in sales
- Worldwide sales
- Number of stores and percentage increase or decrease in number of stores
Based on your analysis and reading of the introductory write-up, answer the following questions:

1. Do you believe that Target will be able to compete against Wal-Mart in the future? If so, how?
2. What about Sears Holdings? Will the company survive?
3. Some people criticize Wal-Mart for forcing other retailers out of business and for lowering the average wage for retail workers. Is this a legitimate criticism? In your opinion, has Wal-Mart helped the American people or hurt them?

Career Opportunities

Is a Career in Accounting for You?

Do you want to learn what opportunities are available for people graduating with degrees in accounting? Go to the Web site of the American Institute of Certified Public Accountants (http://www.startheregoplaces.com) and click on “Why Accounting?” (top, left). Then click on “Career Options” (left side bar). Select two areas of interest. Click on each interest area and select a job in that area that interests you. For each of two jobs selected (one from each interest area), answer the following questions:

• What is the job like?
• Why does the job seem interesting to you?

Ethics Angle (AACSB)

Counting Earnings before They Hatch

You recently ran into one of your former high school teachers.
You were surprised to learn that he'd left teaching, gone back to school, and, a little more than a year ago, started a business that creates Web sites for small companies. It so happens that he needs a loan to expand his business, and the bank wants financial statements. When he found out that you were studying accounting, he asked whether you'd look over a set of statements that he'd just prepared for his first year in business. Because you're anxious to show off your accounting aptitude, you agreed.

First, he showed you his income statement. It looked fine: revenues (from designing Web sites) were $94,000, expenses were $86,000, and net income was $8,000. When you observed how unusual it was that he'd earned a profit in his first year, he seemed a little uneasy.

“Well,” he confessed, “I fudged a little when I prepared the statements. Otherwise, I’d never get the loan.”

He admitted that $10,000 of the fees shown on the income statement was for work he'd recently started doing for a client (who happened to be in big trouble with the IRS). “It isn't like I won't be earning the money,” he explained. “I’m just counting it a little early. It was easy to do. I just added $10,000 to my revenues and recorded an accounts receivable for the same amount.”

You quickly did the math: without the $10,000 payment for the client in question, his profit of $8,000 would become a loss of $2,000 (revenues of $84,000 less expenses of $86,000).

As your former teacher turned to get his balance sheet, you realized that, as his accountant, you had to decide what you'd advise him to do. The decision is troublesome because you agree that if he changes the income statement to reflect the real situation, he won't get the bank loan.

1. What did you decide to do, and why?
2. Assuming that he doesn’t change the income statement, will his balance sheet be incorrect? How about his statement of cash flows? What will happen to next year’s income: will it be higher or lower than it should be?
3. What would happen to your former teacher if he gave the bank the fraudulent financial statements and the bank discovered the truth? How could the bank learn the truth?

Team-Building Skills (AACSB)

**Taking Stock of Ratios**

Your class has been told that each group of three students will receive a share of stock in one of three companies in the same industry. But there’s a catch: each group has to decide which of the companies it wants to own stock in. To reach this decision, your team will use ratio analysis to compare the three companies. Each team member will analyze one of the companies using the ratios presented in this chapter. Then, you’ll get together, compare your results, and choose a company. Here are the details of the project:

1. The team selects a group of three companies in the same industry. Here are just a few examples:
   - Auto manufacturers. Ford, General Motors, Toyota
   - Airlines. Southwest, United Airlines, American Airlines
   - Drug companies. GlaxoSmithKline, Eli Lilly & Co., Bristol-Myers Squibb
   - Specialty retailers. Bed Bath & Beyond, Pottery Barn, Pier 1 Imports
   - Computers. Hewlett Packard, Gateway, Apple Computer

2. Every team member gets a copy of one company’s most recent annual report (which includes its financial statements) from the company’s Web site (investor section).

3. Every member calculates the following ratios for the company for the last two years: gross profit margin, net profit margin, inventory turnover (if applicable), return on assets, current
ratio, debt-to-equity, and interest coverage.

4. Get together as a group and compare your results. Decide as a group which company you want to own stock in.

5. Write a report indicating the company that your team selected and explain your choice. Attach the following items to your team report:

   1. A brief explanation of each ratio (how to calculate it and what it means)
   2. Detailed calculations showing how each ratio was determined
   3. A chart comparing the ratios for the three companies

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**The Global View (AACSB)**

**Why Aren’t Shoes Made in the USA?**

Having just paid $70 for a pair of athletic shoes that were made in China, you wonder why they had to be made in that country. Why weren’t they made in the United States, where lots of people need good-paying jobs? You also figure that the shoe company must be making a huge profit on each pair it sells. Fortunately, you were able to get a breakdown of the costs for making a pair of $70 athletic shoes: From Tom Vanderbilt, *The Sneaker Book: Anatomy of an Industry and an Icon* (New York: The New Press, 1998), 111.
You’re surprised at a few of these items. First, out of the $70, the profit made by the manufacturer was only $6.25. Second, at $2.75, labor accounted for only about 4 percent of the price you paid. The advertising cost ($4.00) was higher than the labor cost. If labor isn’t a very big factor in the cost of the shoes, why are they made in China?

Deciding to look further into this puzzle, you discover that the $2.75 labor cost was for two hours of work. Moreover, that $2.75 includes not only the wages paid to the workers, but also labor-related costs, such as food, housing, and medical care.

That’s when you begin to wonder. How much would I have to pay for the same shoes if they were made in the United States? Or what if they were made in Mexico? How about Spain? To answer these questions, you need to know the hourly wage rates in these countries. Fortunately, you can get this information by going to the

To investigate this issue further, you should do the following:

1. Recalculate the cost of producing the shoes in the United States and two other countries of your choice. Because operating profit for the supplier, the shoe company, and the retailer will change as the cost to make the shoe changes, you have decided to determine this profit using the following percentage rates:
   - Supplier’s operating profit: 10 percent of its costs
   - Shoe company’s operating profit: 20 percent of its costs (including the cost paid to the supplier to make the shoes)
   - Retailer’s operating profit: 15 percent of its costs (including the cost paid to the shoe company)

2. Prepare a report that does the following:
   - Shows the selling price of the shoe for each manufacturing country (the United States and the other two countries you selected)
   - Lists any costs other than labor that might change if shoe production was moved to the United States
   - Identifies other factors that should be considered when selecting a manufacturing country
   - Indicates possible changes to production methods that would make production in the United States less costly

3. Finally, draw some conclusions: Do you, as a U.S. citizen, benefit from shoe production in foreign countries? Does the United States benefit overall? Does the world benefit? Should shoe production return to the United States?
How Much Should You Reveal in Playboy?

What can you do if you're sitting around your dorm room with nothing else to do (or at least nothing else you want to do)? How about starting a business? It worked for Michael Dell, who found assembling and selling computers more rewarding than attending classes at the University of Texas. It also worked for two Stanford graduate students, Sergey Brin and Larry Page. They came up with a novel (though fairly simple) idea for a search engine that ranked Web sites according to number of hits and online linkages. Because their goal was to organize massive amounts of electronic data, they wanted a name that connoted seemingly infinite volumes of information. They liked the word “googol” (a child’s coinage for a very big number—1 followed by a hundred zeros), but, unfortunately, someone already owned the domain name “Googol.” So Brin and Page did a little letter juggling and settled (as we all know by now) for “Google.”

By 2004, the company that they'd started in 1998 was the number-one search engine in the world. Their next step, like that of so many successful entrepreneurs before them, was to go public, and that's where our exercise starts. To learn more about this episode in the epic story of Google—and to find out what role Playboy magazine plays in it—read the article, “Google Sets $2.7 Billion IPO” (http://money.cnn.com/2004/04/29/technology/google), read Google's Playboy interview (http://kottke.org/plus/misc/google-playboy.html), and read the Business Week article, “Google Dodges

When you’ve finished reading the articles, answer the following questions:

1. What’s an IPO? Why did Brin and Page take their company public? What disadvantages did they incur by going public? Are they likely to lose control of their company?

2. How does a Playboy interview enter into the Google story? What did Brin and Page do wrong? (By the way, the interview appeared in the August 2004 issue of Playboy; because Google incorporated the text into its revised IPO filing, it’s now in the public domain and available online.)

3. Did the Google founders get off the hook? Was the punishment (or lack of it) appropriate? Quitting school to run Google paid off big for Brin and Page. Their combined net worth as a result of the IPO suddenly skyrocketed to $8 billion. But how about you? Could you have gotten rich if you’d jumped on the Google bandwagon just as it started to roll? Could you at least have earned enough to pay another year’s tuition? To respond to these questions, you need to know two things: (1) the IPO price of Google stock—$85—and (2) Google’s current stock price. To find the current price, go to http://finance.yahoo.com to link to the finance section of the Yahoo.com Web site. Enter Google’s stock symbol—GOOG—and click “Go.” When you find the current stock price, answer the following questions:

   1. If you’d bought Google stock on the IPO date and sold it today, how many shares of Google would you have had to buy in order to make enough to cover this year’s tuition?

   2. If you owned Google stock today, would you sell it or hold it? Explain your answer.
Career Opportunities

**Financial Futures**

One advantage of a finance major is that it prepares you for a wide range of careers. Some graduates head for Wall Street to make big bucks in investment banking. Others prefer the security of working in the corporate finance department of a large firm, while still others combine finance and selling in fields such as insurance or real estate. If you like working with other people's finances, you might end up in commercial banking or financial planning. To better acquaint yourself with the range of available finance careers, go to http://www.careers-in-finance.com/ to link to the Careers in Finance Web site. After reviewing the descriptions of each career option, select two areas that you find particularly interesting and two that you find unattractive. For each of your four selections, answer the following questions:

1. Why do you find a given area interesting (or unattractive)?
2. What experience and expertise are entailed by a career in a given area?

**Ethics Angle (AACSB)**

**The Inside Story**

You're the founder and CEO of a publicly traded biotech firm that recently came up with a promising cancer drug. Right now, life on Wall Street is good: investors are high on your company, and your stock price is rising. On top of everything else, your personal wealth is burgeoning because you own a lot of stock in the company. You're simply waiting to hear from the FDA, which is expected to approve the product. But when the call comes, the news is bad: the FDA has decided to delay approval because of insufficient data on the drug's effectiveness. You know that when investors hear the news, the
company's stock price will plummet. The family and friends that you encouraged to buy into your company will lose money, and you'll take a major hit.

Quickly, you place an order to sell about $5 million worth of your own stock. Then you start making phone calls. You tell your daughter to dump her stock, and you advise your friends to do the same thing. When you tell your stockbroker the news, he gets on the phone and gives a heads-up to his other clients. Unfortunately, he can't reach one client (who happens to be a good friend of yours), so he instructs his assistant to contact her and tell her what's happened. As a result, the client places an order to sell four thousand shares of stock at a market value of $225,000.

Let's pause at this point to answer a few questions:

1. Are you being a nice guy or doing something illegal?
2. Is your stockbroker doing something illegal?
3. Is the assistant doing something illegal or merely following orders?
4. Is the stockbroker's client acting illegally?

Fast-forward a few months. Federal investigators are interested in the sale of your stock and the sale of your daughter's stock. Because all signs point to the truth as being an invitation to trouble, you lie. When they talked with your friend about her sale, say investigators, she explained a standing agreement that instructed her broker to sell the stock when the market price went below a specified level. It sounds like a good explanation, so you go along with it.

Now, answer this question.

5. What have you done wrong? What has your client friend done wrong?

**The Reality Version of the Story**

At this point, let's stop protecting the not-so-innocent and name some names. The biotech company is ImClone, and its founder and
CEO is Dr. Samuel Waksal. The Merrill Lynch broker is named Peter Bacanovic and his assistant Douglas Faneuil. The client friend who dumped her stock is Martha Stewart.

Let’s focus on Stewart, who is the founder of Martha Stewart Living Omnimedia, a prosperous lifestyle empire. Her actions and their consequences are detailed in an article titled “Martha’s Fall,” which you can access by going to http://www.newsweek.com/id/53363 and linking to the MSNBC Web site. Read the article and then answer the following questions:

6. Do you believe Stewart’s story that she sold the stock because of a preexisting sell order and not because she learned that the cancer drug wouldn’t be approved? What did she do that was illegal? What was she actually convicted of doing?

7. Waksal got seven years in prison for insider trading (and a few other illegal schemes). Bacanovic (Stewart’s broker) got five months in jail and five months of home confinement for lying and obstructing the investigation into the sale of ImClone stock. In return for helping the prosecutors convict Stewart, Faneuil (the broker’s assistant) got a federal “get-out-of-jail” card but was fined $2,000 for accepting a payoff (namely, an extra week of vacation and a bump in his commission) to stonewall investigators. Stewart went to prison for five months and spent another five under house arrest. Was her punishment too lenient? Too harsh? If you’d been the judge, what sentence would you have given her?

8. How could Stewart have avoided prison? Did her celebrity status or reputation help or hurt her? Did she, as some people claim, become a poster CEO for corporate wrongdoing?

9. Why are government agencies, such as the SEC, concerned about insider trading? Who’s hurt by it? Who’s helped by government enforcement of insider-trading laws?
Looking for a High-Flying Stock

Congratulations! Your team has just been awarded $100,000 in hypothetical capital. There is, however, a catch: you have to spend the money on airline stocks. Rather than fly by the seat of your pants, you'll want to research a number of stocks. To familiarize yourself with the airline industry, go to http://www.airlines.org/Economics/ReviewOutlook/Pages/2010AirlineIndustryEconomic.aspx to link to and read the article: “2010 Airline Industry Economic Perspective.”

Each team member is responsible for researching and writing a brief report on a different company. Don’t duplicate your research. Be sure to include low-cost airlines as well as larger carriers. To cover the industry, pick airlines from the following list. The URLs bring you to each airline’s information page on Yahoo! Finance. If any of the links listed below do not work, you can get to that airline’s page by doing the following: Go to http://beta.finance.yahoo.com/; under “Investing” on the top bar, select “Industries” from the dropdown list. Then click on “Complete Industry List” on left sidebar. Under “Services” click on “Major Airlines” and then “Company Index” to find the first four airlines listed below (AMR/American, Delta, U.S. Airways, and Spirit); click on “Regional Airlines” to find the remaining two airlines (Jet Blue and Southwest).

- Delta Air Lines (http://biz.yahoo.com/ic/10/10448.html)
- Southwest Airlines (http://biz.yahoo.com/ic/11/11377.html)

Each member should prepare a report detailing the following information about his or her chosen company:
• A description of the airline
• The percentage change in revenue over the last fiscal year
• The percentage change in net income over the last fiscal year
• A chart comparing the movement in the company’s stock price over the past year with the movement of the DJIA
• Current earnings per share (EPS): net income divided by number of common shareholders
• Current PE ratio
• Current stock price

Here are some hints for finding this information on the Yahoo! page devoted to a given company:

• The company will be described in a “Company Profile” appearing toward the top of the page.
• You can get the remaining information by going to the bottom of the page and clicking on the following:
  • “Financials” for changes in revenues and net income
  • “Chart” for trends in stock prices
  • “Quote” for EPS, PE ratio, and current stock price
  • When reviewing financial statements to calculate percentage changes in revenues and net income, be sure you click on “Annual Data” to get information for the entire year rather than for just the quarter.

Team Report

Once each member has researched one airline, the team should get together and decide how to invest its $100,000. Announce your decision in a final report that includes the following items:

1. An overall description and assessment of the airline industry, including a report on opportunities, threats, and future outlook
2. A decision on how you’ll invest your $100,000, including the names of the stock or stocks that you plan to purchase,
current market prices, and numbers of shares
3. An explanation of the team’s investment decision
4. Individual member reports on each researched company

Follow-Up
A few weeks later, you might want to check on the stock prices of your picks to see how you’d have done if you’d actually invested $100,000.

The Global View (AACSB)

Where’s the Energy in the Chinese Stock Market?
Warren Buffett is the third-richest man in the world (behind Bill Gates). As CEO of Berkshire Hathaway, a holding company with large stakes in a broad portfolio of investments, Buffett spends a lot of his time looking for companies with promising futures. His time has been quite well spent: the market price of a share in Berkshire Hathaway now tops $115,000—up from $16 a share in 1964.

In 2002 and 2003, Berkshire Hathaway paid $488 million for two million shares in PetroChina, an energy firm 90 percent owned by the Chinese government. In 2007, he sold the stock for $4 billion, realizing an incredible more than 700 percent gain. To evaluate Buffett’s thinking in buying and then selling stock in PetroChina, you’ll need to do some research.

First, find out something about the company by going to http://www.petrochina.com.cn/ptr and linking to the English version of the PetroChina Web site. Explore the sections “About PetroChina” and “Investor Relations.” Look for answers to the following questions:
What does the company do? What products and services does it provide? How does it distribute its products?
On which stock exchanges are its shares sold?

Next, to learn about the company’s financial performance, go
to http://finance.yahoo.com to link to the Finance section of the Yahoo.com Web site. Enter the company's stock symbol—PTR—and review the information provided on the site. To see what analysts think of the stock, for example, click on “Analyst Opinion.” To gain insight into why Buffett sold his stock and whether it was a good or a bad move, read these articles: “Should We Buy the PetroChina Stock Warren Buffett Sold?” (http://www.peridotcapitalist.com/2008/03/should-we-buy-petrochina-stock-warren.html) and “Buffett's PetroChina Sale: Fiscal or Social Move,” (http://investorsagainstgenocide.net/page1001126)

Now, answer the following questions:

What do analysts think of the stock?

Should Buffett have bought the stock in PetroChina? Was it a good decision at the time? Why or why not?

Should Buffett have sold his stock in the company? Why do you think he sold the stock? Was it a good decision at the time? Why or why not?

If you personally had $50,000 to invest, how likely is it that you'd buy stock in PetroChina? What factors would you consider in making your decision?

To learn more about the pros and cons of buying stock in Chinese companies, go to http://www.newsweek.com/id/54174 to link to the MSNBC Web site and read the article “Nice Place to Visit.” Then answer these final questions:

What are the advantages of investing in the stock of Chinese companies? What are the disadvantages?

In your opinion, should the average investor put money in Chinese stock? Why, or why not?
17. 14.5 Cases and Problems

14.5 Cases and Problems

Learning on the Web (AACSB)

Go to https://www.quizzle.com and request a free copy of your credit report. Review the report. If you identify any errors, get them fixed. Write a brief report explaining the value of good credit.

Ethics Angle (AACSB)

Go online and read this article at Forbes.com: “Most Common Resume Lies,” by Kate DuBose Tomassi at http://www.forbes.com/workspecial/2006/05/20/resume-lies-work_cx_kdt_06work_0523lies.html. View the slide show of common résumé lies. Answer these questions: What are the most common lies made in résumés? Why is it a bad idea to lie on such a document? What are the potential consequences of misstating facts on your résumé?

Team-Building Skills (AACSB)

It’s becoming more difficult for individuals to buy homes. This has meant that many people who would have bought a home have remained in apartments. In big cities, such as New York, sharing
an apartment with roommates is a good way to save money. Yet it has some disadvantages. Get together as a team and identify the pros and cons of sharing housing. Pretend that each member of the group has agreed to share one apartment. Create a document that details each member’s rights and responsibilities. Decide as a group whether the lease should be in one person’s name or in all your names. Explain the pros and cons of both approaches.

The Global View (AACSB)

You’re looking forward to taking a month-long vacation to Australia when you graduate from college in two years. Create a budget for this trip after researching likely costs. Determine how much you’ll need for the trip and calculate how much you’d have to save each month to afford the trip.
Learning on the Web

Taking Care of Your Cyber Health

It seems that some people have nothing better to do than wreak havoc by spreading computer viruses, and as a computer user, you should know how to protect yourself from malicious tampering. One place to start is by reading the article “How Computer Viruses Work,” by Marshall Brain, which you can access by going to the How Stuff Works Web site (http://computer.howstuffworks.com/virus.htm). After reading the article, answer the following questions:

1. Why do people create viruses?
2. What can you do to protect yourself against viruses?

Career Opportunities

Could You Manage a Job in IT or IS?

Do you have an aptitude for dealing with IT? Would you enjoy analyzing the information needs of an organization? Are you interested in directing a company’s Internet operations or overseeing network security? If you answered yes to any of these questions, then a career in IT and IS might be for you. Go to the U.S. Department of Labor Web site (http://www.bls.gov/oco/ocos258.htm) and learn more about the nature of the work, qualifications, and job outlook in IT and IS management. Bearing
in mind that many people who enter the IT field attain middle-management positions, look for answers to the following questions:

1. What kinds of jobs do IT managers perform?
2. What educational background, work experience, and skills are needed for positions in IT management?
3. What's the current job outlook for IS and IT managers? What factors drive employment opportunities?
4. What's the median annual income of a mid-level IT manager?

Ethics Angle (AACSB)

Campus Commando or Common Criminal?

Do you want to be popular (or at least more prominent) on campus? You could set up a Web site that lets fellow students share music files over the campus network. All you have to do is seed the site with some of your own downloaded music and let the swapping begin. That's exactly what Daniel Peng did when he was a sophomore at Princeton. It was a good idea, except for one small hitch: it was illegal, and he got caught. Unimpressed with Peng's technological ingenuity, the Recording Industry Association of America (RIAA) sued him, and he was forced to settle for $15,000. Instead of delivering music, Peng's Web site now asks visitors to send money to help defray the $15,000 and another $8,000 in legal costs.

To learn more about the case, read these articles from the Daily Princetonian: “Peng, RIAA Settle Infringement Case” (http://www.dailyprincetonian.com/2003/05/02/8154/), and “Peng ’05 Sued by Recording Industry for ‘Wake’ Site” (http://www.dailyprincetonian.com/2003/04/04/7791).

After researching the topic, answer the following questions:

1. The practice of sharing commercial music files is illegal. Do
you think that it’s also unethical? Why, or why not?

2. What steps to curb the practice are being taken by the music industry? By college administrators? By the government? Do you approve of these steps? Have they been effective?

3. What, ultimately, do you see as the solution to the problem?


Team-Building Skills (AACSB)

CampusCupid.com

It’s no secret that college can be fun. For one thing, you get to hang around with a bunch of people your own age. Occasionally, you want to spend time with just one special someone, but finding that special person on a busy campus can take some of the fun out of matriculating. Fortunately, you're in the same love boat with a lot of other people, so one possible solution—one that meshes nicely with your desire to go into business—is to start an online dating service that caters to your school. Inasmuch as online dating is nothing new, you can do some preliminary research. For example, go to the Internetnews Web site (http://www.internetnews.com/ec-news/article.php/2228891/Online+Personals+Big+Profits+Intense+Competition.htm) and read the article “Online Personals: Big Profits, Intense Competition.”

Next, you and several of your classmates should work as a team to create a business model for an online dating service at your school. After working out the details, submit a group report that covers the following issues:
1. **Services.** How will you earn revenues? What services will you offer? How will you price these services? What forms of payment will you accept? Will you sell ads? If so, what kinds?

2. **Appearance.** What will your site look like? Will it have graphics? Sound? Video? What will your domain name be? What information will you collect from customers? What information will you provide to visitors?

3. **Operations.** What criteria will you use to match customers? How will your customers interface with the Web site? How will they connect with each other? Will you design your own software or buy or lease it from vendors? Before you answer, go to these vendors’ Web sites and check out their dating software:

   - WebDate (http://www.webscribble.com/products/webdate/index.shtml)
   - PG Dating (http://www.datingpro.com/dating)

4. **Attracting Customers.** How will you attract customers to the site? How will you monitor and analyze site activity?

5. **Security.** How will you guarantee confidentiality? How will you ensure that your site is secure? How will you limit access to students at your school?

6. **Opportunities and Challenges.** What opportunities do e-businesses offer? What challenges do they create? How would your business model change if you decided to run it as a traditional business rather than as an e-business?

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The Global View (AACSB)

“Hong Kong—Traditional Chinese”

Hewlett-Packard (HP) provides technology solutions to individuals, businesses, and institutions around the world. It
generates annual revenues of $80 billion from the sale of IT products, including computers, printers, copiers, digital photography, and software. Anyone in the United States who wants to buy an HP product, get technical support, download software, learn about the company, or apply for a job can simply go to the HP Web site. But what if you live in Hong Kong? How would you get answers to your questions? You'd do the same thing as people in this country do—go to HP’s Web site.

Try to imagine, however, the complex process of developing and maintaining a Web site that serves the needs of customers in more than seventy countries. To get a better idea, go to the HP Web site (http://www.hp.com). Start by looking at HP’s line of notebooks and checking its prices. Then, review the company information (click on “About HP” in the bottom right) that’s posted on the site, and, finally, look for a job—it’s good practice (click on “Jobs” in the bottom right).

Now pretend that you live in Hong Kong and repeat the process. Start by going to the same HP Web site (http://www.hp.com). Click on the United States (next to U.S. flag in the bottom left) and then Asia and Oceania. If you can read Chinese, click on “Hong Kong—Traditional Chinese.” Otherwise, click on “Hong Kong—English.” Then, answer the following questions:

1. How easy was it to navigate the site and to switch back and forth between the U.S. and Hong Kong sections of the site?
2. Identify at least five differences between the two sections.
3. Does HP’s Web site meet the needs of customers in both the United States and Hong Kong? Why, or why not? How could it be improved?
19. I Need Help

Need more information about this course? Have questions about faculty resources? Can't find what you're looking for? Experiencing technical difficulties?

We're here to help! Take advantage of the following Lumen customer-support resources:

- Check out one of Lumen's Faculty User Guides here.
- Submit a support ticket here and tell us what you need.
- Talk and screen-share with a live human during Lumen’s OER office hours. See available times here.
PART II

MODULE 1: ROLE OF BUSINESS
20. Why It Matters: Role of Business

Why discuss the role of business in society, the primary functions within a business, and external forces that affect business activities?

As you embark on your study of business, you may be thinking that you aren’t really going “into business,” so much of what you will learn about isn’t applicable to your career or your future. Here is a challenge that may change your mind.

Stop what you are doing and take a minute to look around you. What do you see? Perhaps you see your living room where you are sitting at your desk doing your homework. You might be at a local coffee shop, hanging out with some friends who are going to help you study. In fact, you might even be sitting on the beach, reading this on your tablet or phone while you listen to the sounds of the ocean and children playing in the sand.

Now, look around again but this time consider everything within
your view and ask yourself what do all of these things have in common? If you said that they are all the product of business then you are correct! How can that be, you ask? Business is everywhere, in everything we touch, we eat, we see, we smell and we feel. Oh, not always directly but in one way or another business is there. It is like the air that we breathe—sometimes invisible, but always present.

The next part of the challenge is this: As you work through this first outcome, keep trying to think of something, anything that you can say with certainty has no relationship to business. We will check back at the end of this outcome and see what you came up with!

Learning Outcomes

• Define the concept of business
• Distinguish between for-profit and non-profit organizations
• List the four factors of production required to sustain a business
• Identify the primary functional areas within a business and describe their contribution to the organization.
• Identify business stakeholders and describe their relationship with business organizations
• Identify the external forces that shape the business environment

What you’ll learn to do: define the concept of business

What do you think of when you hear the word business? Hold that thought as you complete this course to the end. Then see if your initial idea of business has changed.

Business can refer to a particular organization such as WalMart or to an entire market sector—for example, “the music business.” Compound forms such as agribusiness represent subsets of the word’s broader meaning, which encompasses all activity by suppliers of goods and services in the agricultural industry.

Business can also refer to an individual who earns his or her income by working from home selling items through an online auction site like eBay. The concept of business has enough definitions and applications that we could almost say that everything is business. Throughout this course we will explore the various functions, roles, and characteristics of business while keeping in mind that business is like the air we breathe—everywhere!

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Getting Down to Business
- Self Check: What is Business?
Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Now is an interesting time to study business. Advances in technology are bringing rapid changes in the ways we produce and deliver goods and services. The Internet and other improvements in communication (such as smartphones, video conferencing, and social networking) have had a huge effect on the way we do business. Companies are expanding international operations, and the workforce is more diverse than ever. Corporations are being held responsible for the behavior of their executives, and more people share the opinion that companies should be good corporate citizens. Plus—and this is a big plus—businesses today are facing the lingering effects of what many economists believe is the worst financial crisis since the Great Depression.

The economic turmoil began in the housing and mortgage industries as a result of troubled subprime mortgages and quickly spread to the rest of the economy. In 2008, credit markets froze up and banks stopped making loans. Lawmakers tried to get money flowing again by passing a $700 billion Wall Street bailout, yet businesses and individuals were still denied access to needed credit. Without money or credit, consumer confidence in the economy dropped and consumers cut back their spending. Businesses responded by producing fewer products, and their sales and profits dropped. Unemployment rose as troubled companies shed the most jobs in five years, and 760,000 Americans marched to the unemployment lines. The stock market reacted to the financial crisis and its stock prices dropped by 44 percent while millions of Americans watched in shock as their savings and retirement...
accounts took a nose dive. Things have turned around for some businesses, but not all companies or individuals are doing so well. The economy is still struggling, unemployment is high (particularly for those ages 16 to 24), and home prices remain low. These conditions make it all the more important that we understand business and the challenges and opportunities it affords.

Defining Business

So, what is this thing we call “business”? We can apply a broad approach that defines a business is any activity that provides goods or services to consumers for the purpose of making a profit. When Steve Jobs and Steve Wozniak created Apple Computer in Jobs’s family garage, they started a business. The product was the Apple I, and the company’s founders hoped to sell their computers to customers for more than it cost to make and market them. If they were successful (which they were), they'd make a profit. Later in this outcome we will add another type of organization to our definition of business: a nonprofit business, which provides goods or services to consumers but whose primary goal is not profit.

Before we go on, let’s make a couple of important distinctions concerning the terms in our definitions. Whereas Apple produces and sells goods (iPhone, iPod, Mac), many businesses provide services. Your bank is a service company, as is your Internet provider. Airlines, law firms, movie theaters, and hospitals are also service companies. Many companies provide both goods and services. For example, your local car dealership sells goods (cars) and also provides services (automobile repairs).

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

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered above. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here: https://library.achievingthedream.org/baycollegeintrobusiness/?p=42
23. Outcome: For-Profit vs. Non-Profit

What you’ll learn to do: distinguish between for-profit and non-profit organizations

We defined business earlier as an organization that provides goods, service, or both to their customers, clients, or consumers in order to make a profit. That definition, although accurate, does not account for those organizations and businesses that are not driven by the “bottom line” or profitability. Instead, some organizations provide their goods and services in order to generate revenues (income) that can be used to further its purpose or mission. It is highly likely that you have been involved with a non-profit organization and although it may not have seemed like it at the time— you were actually working with a business! In this section we will dig a little deeper into this idea of profit versus non-profit business.

LEARNING ACTIVITIES

The learning activities for this section include the following:

• Reading: Making a Profit
• Self Check: For-Profit vs. Non-Profit

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
For-Profit Businesses

An organization that aims to earn profit through its operations and is concerned with its own interests and not those of the public (non-profit) is known as a for-profit corporation.

Structure

A for-profit cooperation is usually an organization operating in the private sector that sets goals which eventually help the organization itself. This kind of a company often makes shares of ownership available to the general public. The purchasers of those shares then become the company’s shareholders; shareholders have bought a portion of ownership of the corporation by giving away a certain amount of money (differentiating from company to company) or assets of a particular value. Such organizations are usually not aided by the government, as they are working for private financial gains, unlike a non-profit organization, which exists to serve a mission. The nature of a for-profit corporation is such that it is required to pay applicable taxes and register with the state. Any donation they receive will also be subject to the tax policies of the concerned country. As these organizations are all corporations and have a separate identity from their owners the owners are not in their personal capacity required to satisfy any debts which the company might owe to anyone.
Aims

Unlike non-profit organizations, the policies of these organizations are usually profit oriented. Managers (corporate employees) here have a profit-oriented mindset and aim at maximizing the revenue of the firm, which in turn contributes to the profits of the shareholders/owners. Their aim can be accompanied by a goal of serving the society; however, that usually happens only in cases of specific corporations (B-corporations, which we’ll learn about later).

Non-Profit Businesses

Some organizations are not established solely for the purpose of making and retaining profit; however, they function in much the same way as a business. They establish goals and work to meet them in an effective, efficient manner. Thus, most of the business principles introduced in this text also apply to non-profits. Let’s take a look at some of the characteristics of the non-profit organization.

A non-profit business, often referred to as an NPO (non-profit organization), is an organization that uses its surplus revenues to further achieve its purpose or mission, rather than distributing its surplus income to the organization’s directors (or equivalents) as profit or dividends. This is known as the distribution constraint. The decision to adopt a non-profit legal structure is one that will often have taxation implications, particularly where the non-profit seeks income tax exemption, charitable status and so on.
Types of NPOs

The non-profit landscape is highly varied, although many people have come to associate NPOs with charitable organizations. Although charities do comprise an often high profile or visible aspect of the sector, there are many other types of non-profits. Overall, they tend to be either member-serving or community-serving. Member-serving organizations include mutual societies, cooperatives, trade unions, credit unions, industry associations, sports clubs, retired serviceman’s clubs and peak bodies—organizations that benefit a particular group of people—the members of the organization. Typically, community-serving organizations are focused on providing services to the community in general, either globally or locally: organizations delivering human services programs or projects, aid and development programs, medical research, education and health services, and so on. It could be argued many non-profits sit across both camps, at least in terms of the impact they make. For example, the grassroots support group that provides a lifeline to those with a particular condition or disease could be deemed to be serving both its members (by directly supporting them) and the broader community (through the provision of a helping service for fellow citizens).

Although NPOs are permitted to generate surplus revenues, they must be retained by the organization for its self-preservation, expansion, or plans. NPOs have controlling members or a board of directors. Many have paid staff including management, whereas others employ unpaid volunteers and even executives who work with or without compensation (occasionally nominal). In some countries, where there is a token fee, in general it is used to meet legal requirements for establishing a contract between the executive and the organization.

Designation as a non-profit does not mean that the organization does not intend to make a profit, but rather that the organization has no “owners” and that the funds realized in the operation of the
organization will not be used to benefit any owners. The extent to which an NPO can generate surplus revenues may be constrained or use of surplus revenues may be restricted.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=44
25. Outcome: Factors of Production

What you’ll learn to do: list the four factors of production required to sustain a business

Consider baking a cake for a friend’s birthday. Pretty straightforward, right? You combine your labor with the ingredients from the store to produce a cake. Well, this is what we see in business when they use resources to produce things but in business we call these **factors of production**. Land and natural resources provide the needed raw materials or even the location from which the business operates. Labor transforms raw materials into goods and services. Capital (equipment, buildings, vehicles, cash, and so forth) are needed for the production process. Entrepreneurship provides the skill and creativity needed to bring the other resources together to capitalize on an idea. In this section we will take a deeper look at not only these factors of production but how they actually cycle from your home to business and back.

**LEARNING ACTIVITIES**

The learning activities for this section include the following:

- Reading: Factors of Production: Inputs and Outputs
- Reading: The Flow of Inputs and Outputs
- Self Check: Factors of Production
Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Factors of Production: Inputs and Outputs

All businesses, both for-profit and non-profit, require fundamental resources in order to operate. In other words, resources are the inputs used to produce outputs. These factors or resources include the following:

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

Goods and services are produced using the factors of production available to the economy.

Land and Natural Resources

There are two essential characteristics of natural resources. The first is that they are found in nature—that no human effort has been used to make or alter them. The second is that they can be used for the production of goods and services. That requires knowledge; we must know how to use the things we find in nature before they become resources.

Consider oil. Oil in the ground is a natural resource because it
is found (not manufactured) and can be used to produce goods and services. However, 250 years ago oil was a nuisance, not a natural resource. Pennsylvania farmers in the eighteenth century who found oil oozing up through their soil were dismayed, not delighted. No one knew what could be done with the oil. It was not until the mid-nineteenth century that a method was found for refining oil into kerosene that could be used to generate energy, transforming oil into a natural resource. Oil is now used to make all sorts of things, including clothing, drugs, gasoline, and plastic. It became a natural resource because people discovered and implemented a way to use it.

Defining something as a natural resource only if it can be used to produce goods and services does not mean that a tree has value only for its wood or that a mountain has value only for its minerals. If people gain utility from the existence of a beautiful wilderness area, then that wilderness provides a service. The wilderness is thus a natural resource.

The natural resources available to us can be expanded in three ways. One is the discovery of new natural resources, such as the discovery of a deposit of ore containing titanium. The second is the discovery of new uses for resources, as happened when new techniques allowed oil to be put to productive use or sand to be used in manufacturing computer chips. The third is the discovery of new ways to extract natural resources in order to use them. New methods of discovering and mapping oil deposits have increased the world's supply of this important natural resource.

Labor

Labor is human effort that can be applied to production. People who work to repair tires, pilot airplanes, teach children, or enforce laws are all part of the economy's labor. People who would like to
work but have not found employment—who are unemployed—are also considered part of the labor available to the economy.

In some contexts, it is useful to distinguish two forms of labor. The first is the human equivalent of a natural resource. It is the natural ability an untrained, uneducated person brings to a particular production process. But most workers bring far more. The skills a worker has as a result of education, training, or experience that can be used in production are called human capital. Students who are attending a college or university are acquiring human capital. Workers who are gaining skills through experience or through training are acquiring human capital. Children who are learning to read are acquiring human capital.

The amount of labor available to an economy can be increased in two ways. One is to increase the total quantity of labor, either by increasing the number of people available to work or by increasing the average number of hours of work per week. The other is to increase the amount of human capital possessed by workers.

Capital

Long ago, when the first human beings walked the earth, they produced food by picking leaves or fruit off a plant or by catching an animal and eating it. We know that very early on, however, they began shaping stones into tools, apparently for use in butchering animals. Those tools were the first capital because they were produced for use in producing other goods—food and clothing.

Modern versions of the first stone tools include saws, meat cleavers, hooks, and grinders; all are used in butchering animals. Tools such as hammers, screwdrivers, and wrenches are also capital. Transportation equipment, such as cars and trucks, is capital. Facilities such as roads, bridges, ports, and airports are capital. Buildings, too, are capital; they help us to produce goods and services.
Capital does not consist solely of physical objects. The score for a new symphony is capital because it will be used to produce concerts. Computer software used by business firms or government agencies to produce goods and services is capital. Capital may thus include physical goods and intellectual discoveries. Any resource is capital if it satisfies the following two criteria:

- The resource must have been produced.
- The resource can be used to produce other goods and services.

One thing that is not considered capital is money. A firm cannot use money directly to produce other goods, so money does not satisfy the second criterion for capital. Firms can, however, use money to acquire capital. Money is a form of financial capital. Financial capital includes money and other “paper” assets (such as stocks and bonds) that represent claims on future payments. These financial assets are not capital, but they can be used directly or indirectly to purchase factors of production or goods and services.

The Entrepreneur

Two things play a crucial role in putting the other three factors of production to work. The first is technology, the knowledge that can be applied to the production of goods and services. The second is an individual who plays a key role in a market economy: the entrepreneur. An entrepreneur is a person who, operating within the context of an economy, seeks to earn profits by finding new ways to organize factors of production. The interplay of entrepreneurs and technology affects all our lives. Entrepreneurs put new technologies to work every day, changing the way factors of production are used. Farmers and factory workers, engineers and electricians, technicians and teachers all work differently than they did just a few years ago, using new technologies introduced
by entrepreneurs. The music you enjoy, the books you read, the athletic equipment with which you play are produced differently than they were five years ago. The text you are reading was written and manufactured using technologies that did not exist ten years ago. We can dispute whether all the changes have made our lives better. What we cannot dispute is that they have made our lives different.

Here is an example of the factors of production used to produce a shirt:

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

Looking deeper into how inputs and outputs interact to create the goods and services consumers demand allows us to begin to think of activities within business in terms of cycles. Consider how the factors of production (resources) flow from a business to your home.
The Flow of Inputs and Outputs

Many of the factors of production (or resources) are provided to businesses by households. For example, households provide businesses with labor (as workers), land and buildings (as landlords), and capital (as investors). In turn, businesses pay households for these resources by providing them with income, such as wages, rent, and interest. The resources obtained from households are then used by businesses to produce goods and services, which are sold to the same households that provide businesses with revenue. The revenue obtained by businesses is then used to buy additional resources, and the cycle continues. This circular flow is described below in Figure 1, which illustrates the dual roles of households and businesses:

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

Economists study the interactions between households and businesses and look at the ways in which the factors of production are combined to produce the goods and services that people need. Basically, economists try to answer the following three sets of questions:
1. What goods and services should be produced to meet consumers' needs? In what quantity? When should they be produced?

2. How should goods and services be produced? Who should produce them, and what resources, including technology, should be combined to produce them?

3. Who should receive the goods and services produced? How should they be allocated among consumers?

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=47
28. Outcome: Functional Areas

What you’ll learn to do: identify the primary functional areas within a business and describe their contribution to the organization

The decisions about how to use the factors of production to provide the goods or services of the business requires a team of people working in a variety of jobs. As businesses grow larger and their products and services become more complex, the number of functional areas within a business grows. Each functional area makes specific and valuable contributions to the organization as a whole. Think of a business like an engine where many parts are required to make it operate properly. In this section we will explore some of the most common functional areas in a business and how each contributes to the overall success of the business.

LEARNING ACTIVITIES

The learning activities for this section include the following:

- Reading: Functional Areas of Business
- Self Check: Functional Areas

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
29. Reading: Functional Areas of Business

Functional Areas of Business

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

Management

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

Operations

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

Marketing

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

Accounting

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

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

KEY TAKEAWAYS

- The main participants in a business are its owners, employees, and customers.
- Businesses are influenced by such external factors as the economy, government, consumer trends, and public pressure to act as good corporate citizens.
- The activities needed to run a business can be divided into five functional areas:
  - **Management** involves planning, organizing, staffing, directing, and controlling resources to achieve organizational goals.
  - **Operations** transforms resources (labor, materials, money, and so on) into products.
  - **Marketing** works to identify and satisfy customers' needs.
  - **Finance** involves planning for, obtaining, and managing company funds.
  - **Accounting** entails measuring, summarizing, and communicating financial and managerial information.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=49
What you’ll learn to do: identify business stakeholders and describe their relationship with business organizations

Just as it takes many parts to make a business run smoothly, there are many people, organizations, and entities that have a “stake” in the success of a business. Think again about the engine and the parts it takes to make it run smoothly. What relies upon the engine running? If the engine doesn’t run, the radio won’t play, the headlights won’t operate, and the passengers won’t get to where they want to go. Each of these seemingly unrelated “parts” has a stake in the engine running as intended. Let’s take a look at just some of the stakeholders in business.

LEARNING ACTIVITIES

The learning activities for this section include the following:

• Reading: Business Stakeholders
• Self Check: Stakeholders

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
What Is a Stakeholder?

A stakeholder is an individual or group that has a legitimate interest in a company. A corporate stakeholder is an individual or group who can affect or be affected by the actions of a business. The stakeholder concept was first used in a 1963 internal memorandum at the Stanford Research Institute. It defined stakeholders as “those groups without whose support the organization would cease to exist.”

In the last decades of the twentieth century, the word “stakeholder” has become more commonly used to refer to a person or group that has a legitimate interest in a project or entity. In discussing the decision-making process for institutions—including large business corporations, government agencies, and non-profit organizations—the concept has been broadened to include everyone with an interest (or “stake”) in what the entity does.

Internal Stakeholders

Internal stakeholders are groups within a business or people who work directly within the business, such as employees, owners, and investors. Employees want to earn high wages and keep their jobs. Owners are interested in maximizing the profit the business makes. Investors are concerned about earning income from their investment.
External Stakeholders

External stakeholders are groups outside a business or people who are not directly working within the business but are affected in some way from the decisions of the business, such as customers, suppliers, creditors, community, trade unions, and the government. The government wants the business to pay taxes, employ more people, follow laws, and truthfully report its financial conditions. Customers want the business to produce quality products at reasonable prices. Suppliers want the business to continue to buy their products. Creditors want to be repaid on time and in full. The community has a stake in the business as employers of local people.

KEY TAKEAWAYS

- A corporate stakeholder is a person or group who can affect or
be affected by the actions of a business.

- Internal stakeholders are groups within a business or people who work directly within the business, such as employees, owners, and investors.
- External stakeholders are groups outside a business or people who are not directly working within the business but are affected in some way from the decisions of the business, such as customers, suppliers, creditors, community, trade unions, and the government.

Glossary

corporate stakeholder:
A corporate stakeholder is that which can affect or be affected by the actions of the business as a whole.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
32. Outcome: External Forces

What you’ll learn to do: identify the external forces that shape the business environment

You have now looked at some of the internal parts that run this machine we are calling business—accounting, human resources, and management, just to name a few. You also identified stakeholders who have some personal or professional interest in the continued success or operation of the business. But, you also know that businesses do not operate outside of the external environment in a vacuum where they are immune to the forces that shape our everyday life. Just like people, businesses interact with their surroundings, and just like people, businesses react differently to their environment. In this section you’ll consider some of the external forces that have an impact on business operations and decisions.

LEARNING ACTIVITIES

The learning activities for this section include the following:

- Reading: External Forces
- Self Check: External Forces

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
External Forces That Influence Business Activities

Apple and other businesses don’t operate in a vacuum: they’re influenced by a number of external factors. These include the economy, government, consumer trends, and public pressure to act as good corporate citizens. The figure below sums up the relationship among the participants in a business, its functional areas, and the external forces that influence its activities.

Figure 1. Business and its environment

Participants in a business must respond to the conditions created...
by a variety of external forces. Economic factors include things like strong economic growth cycles or recessions, consumer confidence and other economic indicators, interest rates and the strength of financial markets. Government actions such as policies, regulation, tax code and legislation all impact businesses as well as their internal and external stakeholders. In order to serve customers effectively, it is essential to monitor consumer trends such as consumer spending, fads, fashions and buying behavior. Demonstrating strong corporate citizenship through ethical business practices helps ensure goodwill and a culture of trust among all stakeholders and society at large.

The fast food industry provides a great example of how all these factors come together to affect business. A strong economy means people have more money to eat out at places where food standards are monitored by a government agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by consumer trends (eating fried foods might be okay one year and out the next). Finally, a number of decisions made by the industry result from its desire to be a good corporate citizen. For example, several fast-food chains have responded to environmental concerns by eliminating Styrofoam containers.1 Addressing public health concerns about obesity in the U.S., many fast food restaurants have added healthier alternatives to their menus. As you move through this text, you'll learn more about these external influences on business.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=53
34. Putting It Together: Role of Business

Summary

This module covered the role of business. Below is a summary of the topics covered in this module.

What Is Business?

We defined business as any kind of organization or action that creates goods or provides services. While this is usually done with making a profit as the main goal, this isn’t always the case.

For-Profit vs. Non-Profit

For-profit businesses focus on earning a profit. They are concerned with the company’s well-being and success above all else. Non-profit organizations, on the other hand, are more goal-oriented. They are concerned with communities or members. Instead of focusing on earning money, NPOs focus on their customers and their needs (e.g., credit unions, sports clubs, human service programs, aid and development programs).
Factors of Production

In order to produce services or goods, a business needs four resources: land (or other natural resources), labor, capital, and entrepreneurship. Natural resources are defined as resources found in nature unaltered by man; these include oil, wind, trees, and so on. Labor can be divided into two general categories: physical labor and mental labor. Both kinds of work are necessary for success. Capital includes things created by human beings that are used to make other goods: power tools, computers, and even art (which can be used to create museums or art shows). Money is not considered to be capital. An entrepreneur is the person who starts the company or business—without him or her, the business would not exist to begin with.

Functional Areas

Businesses are made up of functional areas—different activities that need to be done to maintain the business. These include management, operations, marketing, accounting, and finance. Management ensures employees are on task and that each employee is being leveraged in the way that makes the business most efficient. Operations watches over production and ensures quality of product. Marketing brings in customers, both by making the business look appealing to customer and by taking customer feedback and improving the business. Accounting keeps track of the money currently coming in and the money currently being spent. Finance plans for future expenses and income.
Stakeholders

There are two kinds of stakeholders (individuals who have a vested interest in a company): internal stakeholder and external stakeholders. Internal stakeholders include employees, managers, and owners. These individuals are vested in the company because they directly depend on it for income. External stakeholders include customers, shareholders, creditors, suppliers, and others. These people are have a legitimate interest in the company for various reasons but can all be affected by actions the business takes.

External Forces

A business is not just influenced by itself—everything in the world around it can impact a business. A business may create a fun new toy, but if the economy is suffering and consumers aren’t buying a lot of things they do not need, the business most likely won’t succeed. Business can be affected by the economy, consumer trends, government regulations, and many other things.

Synthesis

Now that you have been exposed to some of the terms and definitions we use in business, have you been able to find something that doesn’t have a link back to business? Let’s go back to where we started.
If you were in your living room, then everything in your surroundings was most likely manufactured by a business for your use—chairs, television, computer, pens, pencils.

What if you had been at the coffee shop? Well, this one is easy because you were doing your studying in a business, surrounded by people working for a business who were serving the customers of the business.

The last possibility we suggested was the beach. Well, the ocean doesn't have anything to do with business, does it? Remember in the module we talked about nonprofit organizations as business entities. Aren't there organizations that use their profits to support clean water and preservation of the coastline? What about the lifeguards at the beach who are paid by a business to keep swimmers safe? Where did the children get the shovels and pails they were using to play in the sand?

By this time you should begin to see that even though you may not think of business as you go about your daily routine, it is always there, like the air we breathe. Throughout this text you will learn about how businesses operate, why they engage in the activities they do, and numerous other components that go into this thing we call “business.”

In the meantime, don’t stop looking for something that qualifies as “non-business related”—you might find something after all.
PART III
MODULE 2: ECONOMIC ENVIRONMENT
Why explain fundamental economic principles and describe how they shape the business environment?

Economics is about choices: namely, how we choose to allocate scarce resources and how our choices impact others. Beyond that, it's about the choices made by businesses, government, and other countries. Let's begin with ice cream—something familiar and tasty to most people—and use it as a framework for thinking about economics.

Let's say you live in Boise, Idaho, and decide to go out for ice cream with your friend Charlie, who has been reading about ice cream flavored with Persian saffron. That's the kind he wants, but none of the five ice-cream shops you visit has it. Why not? Why can't they meet his demand? Because Charlie is the only person in Boise who has ever asked for it, and none of the shops has decided to carry something so expensive (the saffron costs nearly $1,000 per ounce) and, frankly, strange. They have chosen to offer ice cream that is low-cost, high-demand, and easy to manufacture.

The next day, Charlie is still obsessed with saffron ice cream, and he's discovered a shop in Dubai, where, for the mere price of

Why It Matters: Economic Environment | 165
$816 (per scoop, fancy toppings included), one can try this exotic treat. Now Charlie has some economic choices to make. Including the $1,800 airfare, plus the other travel expenses (hotel, cabs, etc.), the trip to Dubai will cost $2,600—at least. It will also cost Charlie time: the time it takes to plan the trip, the days off work, and travel time. Then, there's the opportunity cost. While he is planning, traveling, and eating his ice cream, Charlie’s giving up the opportunity to do other things with his time and money. And there are unforeseen choices and expenses: What if he gets to Dubai and they’ve run out of saffron ice cream? Does he hang around in Dubai, investing more resources and waiting for them to restock? What if he tries Persian saffron ice cream and says, “Yuck!”—and wishes he’d bought banana ice cream back in Boise?

This is an extreme, unlikely situation, of course. However, the choices that ice-cream manufacturers, ice-cream shops, and people like Charlie make every day are all examples of economic decisions: at every turn, a choice has to be made about the allocation of limited resources. What economic decisions do you make in your life?

The purpose of this module is to give you an understanding of the fundamental principles of economics, some of the factors that drive economies, and how economics shapes the business environment. You will likely learn more about economics as you continue your education, but this section should serve as an excellent introduction and give you some tools to think about the impact of economics on your daily life.

Learning Outcomes

- Define economics and explain the difference between macroeconomics and microeconomics
- Identify the forces that drive supply and demand within an economic system
- Illustrate the relationship between supply and demand using
supply and demand curves

- Compare and contrast different economic systems (capitalist, planned, and mixed)
- Describe the methods economists use to evaluate the health of an economy, such as GDP, unemployment rate, and CPI
- Explain the effect that the four stages of an economy (expansion, peak, contraction and trough) have on business operations
36. Outcome: What Is Economics?

What you’ll learn to do: define economics and explain the difference between macroeconomics and microeconomics

From the purchase of the latest iPhone to the sale of tickets to a popular concert or movie, economic forces are at work in even the simplest of personal and business transactions. In order to truly understand the science of economics, economists have to consider both the small picture (how individuals make decisions) and the big picture (how entire countries make decisions), which is why the first section of this module covers the two branches of economics: macroeconomics and microeconomics. Decisions made by governments impact the decisions made by business. Decisions made by business impact the decisions made by governments. When we put these two pieces together, you will be able to answer the question “What is economics?”

LEARNING ACTIVITIES

The learning activities for this section include:

- Video: What Is Economics?
- Reading: Economics and Scarcity
- Reading: The Division and Specialization of Labor
- Reading: Microeconomics and Macroeconomics
- Self Check: What is Economics?
Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
37. Video: What Is Economics?

What Is Economics?

As you watch the following video, think back to Charlie and his ice cream. Is his situation represented in this clip? Let's find out.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=58
Economics and Scarcity

Economics is the study of how humans make decisions in the face of scarcity. These can be individual decisions, family decisions, business decisions or societal decisions. If you look around carefully, you will see that scarcity is a fact of life. Scarcity means that human wants for goods, services and resources exceed what is available. Resources, such as labor, tools, land, and raw materials are necessary to produce the goods and services we want but they exist in limited supply. Of course, the ultimate scarce resource is time—everyone, rich or poor, has just twenty-four hours in the day to try to acquire the goods they want. At any point in time, there are only a finite number of resources available.

Think about it this way: In 2012 the labor force in the United States contained over 155.5 million workers, according to the U.S. Bureau of Labor Statistics. Similarly, the total area of the United States is 3,794,101 square miles. These are large numbers for such crucial resources, however, they are limited. Because these resources are limited, so are the numbers of goods and services we produce with them. Combine this with the fact that human wants seem to be virtually infinite, and you can see why scarcity is a problem.
Scarcity of Resources

Figure 1. Homeless people are a stark reminder that scarcity of resources is real. (Credit: “daveynin”/Flickr Creative Commons)

If you still do not believe that scarcity is a problem, consider the following: Does everyone need food to eat? Does everyone need a decent place to live? Does everyone have access to healthcare? In every country in the world, there are people who are hungry, homeless (for example, those who call park benches their beds, as shown in Figure 1), and in need of healthcare, just to focus on a few critical goods and services. Why is this the case? It is because of scarcity. Let's delve into the concept of scarcity a little deeper, because it is crucial to understanding economics.
The Problem of Scarcity

Think about all the things you consume: food, shelter, clothing, transportation, healthcare, and entertainment. How do you acquire those items? You do not produce them yourself. You buy them. How do you afford the things you buy? You work for pay. Or if you do not, someone else does on your behalf. Yet most of us never have enough to buy all the things we want. This is because of scarcity. So how do we solve it?

LINK IT UP

Visit this website to read about how the United States is dealing with scarcity in resources.

Every society, at every level, must make choices about how to use its resources. Families must decide whether to spend their money on a new car or a fancy vacation. Towns must choose whether to put more of the budget into police and fire protection or into the school system. Nations must decide whether to devote more funds to national defense or to protecting the environment. In most cases, there just isn’t enough money in the budget to do everything. So why do we not each just produce all of the things we consume? The simple

Figure 2. Adam Smith introduced the idea of dividing labor into discrete tasks. (Credit: Wikimedia Commons)
answer is most of us do not know how, but that is not the main reason. (When you study economics, you will discover that the obvious choice is not always the right answer—or at least the complete answer. Studying economics teaches you to think in a different way.)

Think back to pioneer days, when individuals knew how to do so much more than we do today, from building their homes, to growing their crops, to hunting for food, to repairing their equipment. Most of us do not know how to do all—or any—of those things. It is not because we could not learn. Rather, we do not have to. The reason why is something called the division and specialization of labor, a production innovation first put forth by Adam Smith (see Figure 2) in his book The Wealth of Nations.
The formal study of economics began when Adam Smith (1723–1790) published his famous book *The Wealth of Nations* in 1776. Many authors had written on economics in the centuries before Smith, but he was the first to address the subject in a comprehensive way. In the first chapter, Smith introduces the **division of labor**, which means that the way a good or service is produced is divided into a number of tasks that are performed by different workers, instead of all the tasks being done by the same person.

To illustrate the division of labor, Smith counted how many tasks went into making a pin: drawing out a piece of wire, cutting it to the right length, straightening it, putting a head on one end and a point on the other, and packaging pins for sale, to name just a few. Smith counted 18 distinct tasks that were often done by different people—all for a pin, believe it or not!
Modern businesses divide tasks as well. Even a relatively simple business like a restaurant divides up the task of serving meals into a range of jobs like top chef, sous chefs, less-skilled kitchen help, servers to wait on the tables, a greeter at the door, janitors to clean up, and a business manager to handle paychecks and bills—not to mention the economic connections a restaurant has with suppliers of food, furniture, kitchen equipment, and the building where it is located. A complex business, like a large manufacturing factory such as the shoe factory shown in Figure 3, or a hospital, can have hundreds of job classifications.

Why the Division of Labor Increases Production

When the tasks involved with producing a good or service are divided and subdivided, workers and businesses can produce a
greater quantity of output. In his observations of pin factories, Smith observed that one worker alone might make twenty pins in a day, but that a small business of ten workers (some of whom would need to do two or three of the eighteen tasks involved with pin-making), could make 48,000 pins in a day. How can a group of workers, each specializing in certain tasks, produce so much more than the same number of workers who try to produce the entire good or service by themselves? Smith offered three reasons.

First, specialization in a particular small job allows workers to focus on the parts of the production process where they have an advantage. People have different skills, talents, and interests, so they will be better at some jobs than at others. The particular advantages may be based on educational choices, which are in turn shaped by interests and talents. Only those with medical degrees qualify to become doctors, for instance. For some goods, specialization will be affected by geography—it is easier to be a wheat farmer in North Dakota than in Florida, but easier to run a tourist hotel in Florida than in North Dakota. If you live in or near a big city, it is easier to attract enough customers to operate a successful dry cleaning business or movie theater than if you live in a sparsely populated rural area. Whatever the reason, if people specialize in the production of what they do best, they will be more productive than if they produce a combination of things, some of which they are good at and some of which they are not.

Second, workers who specialize in certain tasks often learn to produce more quickly and with higher quality. This pattern holds true for many workers, including assembly line laborers who build cars, stylists who cut hair, and doctors who perform heart surgery. In fact, specialized workers often know their jobs well enough to suggest innovative ways to do their work faster and better.

A similar pattern often operates within businesses. In many cases, a business that focuses on one or a few products (sometimes called its “core competency“) is more successful than firms that try to make a wide range of products.

Third, specialization allows businesses to take advantage of
economies of scale, which means that for many goods, as the level of production increases, the average cost of producing each individual unit declines. For example, if a factory produces only 100 cars per year, each car will be quite expensive to make on average. However, if a factory produces 50,000 cars each year, then it can set up an assembly line with huge machines and workers performing specialized tasks, and the average cost of production per car will be lower. The ultimate result of workers who can focus on their preferences and talents, learn to do their specialized jobs better, and work in larger organizations is that society as a whole can produce and consume far more than if each person tried to produce all of their own goods and services. The division and specialization of labor has been a force against the problem of scarcity.

Trade and Markets

Specialization only makes sense, though, if workers can use the pay they receive for doing their jobs to purchase the other goods and services that they need. In short, specialization requires trade.

You do not have to know anything about electronics or sound systems to play music—you just buy an iPod or MP3 player, download the music and listen. You do not have to know anything about artificial fibers or the construction of sewing machines if you need a jacket—you just buy the jacket and wear it. You do not need to know anything about internal combustion engines to operate a car—you just get in and drive. Instead of trying to acquire all the knowledge and skills involved in producing all of the goods and services that you wish to consume, the market allows you to learn a specialized set of skills and then use the pay you receive to buy the goods and services you need or want. This is how our modern society has evolved into a strong economy.
Why Study Economics?

Now that we have gotten an overview on what economics studies, let’s quickly discuss why you are right to study it. Economics is not primarily a collection of facts to be memorized, though there are plenty of important concepts to be learned. Instead, economics is better thought of as a collection of questions to be answered or puzzles to be worked out. Most important, economics provides the tools to work out those puzzles. If you have yet to be been bitten by the economics “bug,” there are other reasons why you should study economics.

- Virtually every major problem facing the world today, from global warming, to world poverty, to the conflicts in Syria, Afghanistan, and Somalia, has an economic dimension. If you are going to be part of solving those problems, you need to be able to understand them. Economics is crucial.
- It is hard to overstate the importance of economics to good citizenship. You need to be able to vote intelligently on budgets, regulations, and laws in general. When the U.S. government came close to a standstill at the end of 2012 due to the “fiscal cliff,” what were the issues involved? Did you know?
- A basic understanding of economics makes you a well-rounded thinker. When you read articles about economic issues, you will understand and be able to evaluate the writer’s argument. When you hear classmates, co-workers, or political candidates talking about economics, you will be able to distinguish between common sense and nonsense. You will find new ways of thinking about current events and about personal and business decisions, as well as current events and politics.

The study of economics does not dictate the answers, but it can illuminate the different choices.
Key Concepts and Summary

Economics seeks to solve the problem of **scarcity**, which is when human wants for goods and services exceed the available supply. A modern economy displays a division of labor, in which people earn income by specializing in what they produce and then use that income to purchase the products they need or want. The **division of labor** allows individuals and firms to specialize and to produce more for several reasons: a) It allows the agents to focus on areas of advantage due to natural factors and skill levels; b) It encourages the agents to learn and invent; c) It allows agents to take advantage of economies of scale. Division and specialization of labor only work when individuals can purchase what they do not produce in markets. Learning about economics helps you understand the major problems facing the world today, prepares you to be a good citizen, and helps you become a well-rounded thinker.
Microeconomics and Macroeconomics

Economics is concerned with the well-being of all people, including those with jobs and those without jobs, as well as those with high incomes and those with low incomes. Economics acknowledges that production of useful goods and services can create problems of environmental pollution. It explores the question of how investing in education helps to develop workers’ skills. It probes questions like how to tell when big businesses or big labor unions are operating in a way that benefits society as a whole and when they are operating in a way that benefits their owners or members at the expense of others. It looks at how government spending, taxes, and regulations affect decisions about production and consumption.

It should be clear by now that economics covers a lot of ground. That ground can be divided into two parts: Microeconomics focuses on the actions of individual agents within the economy, like households, workers, and businesses; Macroeconomics looks at the economy as a whole. It focuses on broad issues such as growth of production, the number of unemployed people, the inflationary increase in prices, government deficits, and levels of exports and imports. Microeconomics and macroeconomics are not separate subjects, but rather complementary perspectives on the overall subject of the economy.

To understand why both microeconomic and macroeconomic perspectives are useful, consider the problem of studying a biological ecosystem like a lake. One person who sets out to study the lake might focus on specific topics: certain kinds of algae or plant life; the characteristics of particular fish or snails; or the trees
surrounding the lake. Another person might take an overall view and instead consider the entire ecosystem of the lake from top to bottom; what eats what, how the system stays in a rough balance, and what environmental stresses affect this balance. Both approaches are useful, and both examine the same lake, but the viewpoints are different. In a similar way, both microeconomics and macroeconomics study the same economy, but each has a different viewpoint.

Whether you are looking at lakes or economics, the micro and the macro insights should blend with each other. In studying a lake, the micro insights about particular plants and animals help to understand the overall food chain, while the macro insights about the overall food chain help to explain the environment in which individual plants and animals live.

In economics, the micro decisions of individual businesses are influenced by whether the macroeconomy is healthy; for example, firms will be more likely to hire workers if the overall economy is growing. In turn, the performance of the macroeconomy ultimately depends on the microeconomic decisions made by individual households and businesses.

**Microeconomics**

What determines how households and individuals spend their budgets? What combination of goods and services will best fit their needs and wants, given the budget they have to spend? How do people decide whether to work, and if so, whether to work full time or part time? How do people decide how much to save for the future, or whether they should borrow to spend beyond their current means?

What determines the products, and how many of each, a firm will produce and sell? What determines what prices a firm will charge? What determines how a firm will produce its products?
What determines how many workers it will hire? How will a firm finance its business? When will a firm decide to expand, downsize, or even close? In the microeconomic part of this book, we will learn about the theory of consumer behavior and the theory of the firm.

Macroeconomics

What determines the level of economic activity in a society? In other words, what determines how many goods and services a nation actually produces? What determines how many jobs are available in an economy? What determines a nation's standard of living? What causes the economy to speed up or slow down? What causes firms to hire more workers or to lay workers off? Finally, what causes the economy to grow over the long term?

An economy’s macroeconomic health can be defined by a number of goals: growth in the standard of living, low unemployment, and low inflation, to name the most important. How can macroeconomic policy be used to pursue these goals? Monetary policy, which involves policies that affect bank lending, interest rates, and financial capital markets, is conducted by a nation's central bank. For the United States, this is the Federal Reserve. Fiscal policy, which involves government spending and taxes, is determined by a nation's legislative body. For the United States, this is the Congress and the executive branch, which originates the federal budget. These are the main tools the government has to work with. Americans tend to expect that government can fix whatever economic problems we encounter, but to what extent is that expectation realistic? These are just some of the issues that will be explored in the macroeconomic chapters of this book.
KEY TAKEAWAYS

• Microeconomics and macroeconomics are two different perspectives on the economy.
  ◦ The microeconomic perspective focuses on parts of the economy: individuals, firms, and industries.
  ◦ The macroeconomic perspective looks at the economy as a whole, focusing on goals like growth in the standard of living, unemployment, and inflation.
• Macroeconomics has two types of policies for pursuing these goals:
  ◦ monetary policy
  ◦ fiscal policy

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=61
What you’ll learn to do: identify the forces that drive supply and demand within an economic system

How do supply and demand shift within an economic system? They are both “driven” to change by forces in the economic system. In this module you’ll learn about some of these forces, such as Adam Smith’s “invisible hand,” scarcity caused by natural disasters, and human intervention aimed at manipulation or control of the markets. Watch the following video, which provides an introduction and context for understanding changes in supply and demand.
LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Demand, Supply, and Equilibrium in Markets for Goods and Services
• Reading: Shifts in Demand
• Simulation: Demand for Food Trucks
• Reading: Shifts in Supply
• Simulation: Supply of Food Trucks
• Simulation: Food Trucks and Changes in Equilibrium
• Video: Indiana Jones (Demand, Supply, Equilibrium, Shifts)
• Self Check: Supply and Demand

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Demand for Goods and Services

First let’s first focus on what economists mean by demand, what they mean by supply, and then how demand and supply interact in a market.

Economists use the term demand to refer to the amount of some good or service consumers are willing and able to purchase at each price. Demand is based on needs and wants—a consumer may be able to differentiate between a need and a want, but from an economist’s perspective they are the same thing. Demand is also based on ability to pay. If you cannot pay for it, you have no effective demand.

What a buyer pays for a unit of the specific good or service is called price. The total number of units purchased at that price is called the quantity demanded. A rise in price of a good or service almost always decreases the quantity demanded of that good or service. Conversely, a fall in price will increase the quantity demanded. When the price of a gallon of gasoline goes up, for example, people look for ways to reduce their consumption by combining several errands, commuting by carpool or mass transit, or taking weekend or vacation trips closer to home. Economists call this inverse relationship between price and quantity demanded the law of demand. The law of demand assumes that all other variables that affect demand are held constant.

An example from the market for gasoline can be shown in the form of a table or a graph. A table that shows the quantity demanded...
at each price, such as the table below, is called a demand schedule. Price in this case is measured in dollars per gallon of gasoline. The quantity demanded is measured in millions of gallons over some time period (for example, per day or per year) and over some geographic area (like a state or a country). A demand curve shows the relationship between price and quantity demanded on a graph like Figure 1, with quantity on the horizontal axis and the price per gallon on the vertical axis. (Note that this is an exception to the normal rule in mathematics that the independent variable (x) goes on the horizontal axis and the dependent variable (y) goes on the vertical. Economics is not math.)

The demand schedule shown by the table below and the demand curve shown by the graph in Figure 1 are two ways of describing the same relationship between price and quantity demanded.

Figure 1. The demand schedule shows that as price rises, quantity demanded decreases, and vice versa. These points are then graphed, and the line connecting them is the demand curve (D). The downward slope of the demand curve again illustrates the law of demand—the inverse relationship between prices and quantity demanded.
<table>
<thead>
<tr>
<th>Price (per gallon)</th>
<th>Quantity Demanded (millions of gallons)</th>
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</thead>
<tbody>
<tr>
<td>$1.00</td>
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<td>$1.80</td>
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<td>$2.00</td>
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<tr>
<td>$2.20</td>
<td>420</td>
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</tbody>
</table>

Demand curves will appear somewhat different for each product. They may appear relatively steep or flat, or they may be straight or curved. Nearly all demand curves share the fundamental similarity that they slope down from left to right. So demand curves embody the law of demand: As the price increases, the quantity demanded decreases, and conversely, as the price decreases, the quantity demanded increases.

Confused about these different types of demand?

Is Demand the Same as Quantity Demanded?

In economic terminology, demand is not the same as quantity demanded. When economists talk about demand, they mean the relationship between a range of prices and the quantities demanded at those prices, as illustrated by a demand curve or a demand schedule. When economists talk about quantity demanded, they mean only a certain point on the demand curve, or one quantity on the demand schedule. In short, demand refers to the curve and quantity demanded refers to the (specific) point on the curve.
Supply of Goods and Services

When economists talk about supply, they mean the amount of some good or service a producer is willing to supply at each price. Price is what the producer receives for selling one unit of a good or service. A rise in price almost always leads to an increase in the quantity supplied of that good or service, while a fall in price will decrease the quantity supplied. When the price of gasoline rises, for example, it encourages profit-seeking firms to take several actions: expand exploration for oil reserves; drill for more oil; invest in more pipelines and oil tankers to bring the oil to plants where it can be refined into gasoline; build new oil refineries; purchase additional pipelines and trucks to ship the gasoline to gas stations; and open more gas stations or keep existing gas stations open longer hours. Economists call this positive relationship between price and quantity supplied—that a higher price leads to a higher quantity supplied and a lower price leads to a lower quantity supplied—the law of supply. The law of supply assumes that all other variables that affect supply are held constant.

Still unsure about the different types of supply?

Is Supply the Same as Quantity Supplied?

In economic terminology, supply is not the same as quantity supplied. When economists refer to supply, they mean the relationship between a range of prices and the quantities supplied at those prices, a relationship that can be illustrated with a supply curve or a supply schedule. When economists refer to quantity supplied, they mean only a certain point on the supply curve, or one quantity on the supply schedule. In short, supply refers to the curve and quantity supplied refers to the (specific) point on the curve.

Figure 2 illustrates the law of supply, again using the market for...
gasoline as an example. Like demand, supply can be illustrated using a table or a graph. A **supply schedule** is a table, like the table below, that shows the quantity supplied at a range of different prices. Again, price is measured in dollars per gallon of gasoline and quantity demanded is measured in millions of gallons. A **supply curve** is a graphic illustration of the relationship between price, shown on the vertical axis, and quantity, shown on the horizontal axis. The supply schedule and the supply curve are just two different ways of showing the same information. Notice that the horizontal and vertical axes on the graph for the supply curve are the same as for the demand curve.

**Figure 2.** The supply schedule is the table that shows quantity supplied of gasoline at each price. As price rises, quantity supplied also increases, and vice versa. The supply curve (S) is created by graphing the points from the supply schedule and then connecting them. The upward slope of the supply curve illustrates the law of supply—that a higher price leads to a higher quantity supplied, and vice versa.
<table>
<thead>
<tr>
<th>Price (per gallon)</th>
<th>Quantity Supplied (millions of gallons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1.00</td>
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<td>$1.20</td>
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<td>$2.00</td>
<td>700</td>
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<tr>
<td>$2.20</td>
<td>720</td>
</tr>
</tbody>
</table>

The shape of supply curves will vary somewhat according to the product: steeper, flatter, straighter, or curved. Nearly all supply curves, however, share a basic similarity: they slope up from left to right and illustrate the law of supply: as the price rises, say, from $1.00 per gallon to $2.20 per gallon, the quantity supplied increases from 500 gallons to 720 gallons. Conversely, as the price falls, the quantity supplied decreases.

**Equilibrium—Where Demand and Supply Meet**

Because the graphs for demand and supply curves both have price on the vertical axis and quantity on the horizontal axis, the demand curve and supply curve for a particular good or service can appear on the same graph. Together, demand and supply determine the price and the quantity that will be bought and sold in a market.

Figure 3 illustrates the interaction of demand and supply in the market for gasoline. The demand curve (D) is identical to Figure 1. The supply curve (S) is identical to Figure 2. The table below contains the same information in tabular form.
Figure 3. The demand curve (D) and the supply curve (S) intersect at the equilibrium point E, with a price of $1.40 and a quantity of 600. The equilibrium is the only price where quantity demanded is equal to quantity supplied. At a price above equilibrium like $1.80, quantity supplied exceeds the quantity demanded, so there is excess supply. At a price below equilibrium such as $1.20, quantity demanded exceeds quantity supplied, so there is excess demand.

<table>
<thead>
<tr>
<th>Price (per gallon)</th>
<th>Quantity demanded (millions of gallons)</th>
<th>Quantity supplied (millions of gallons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1.00</td>
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<td>700</td>
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<tr>
<td>$2.20</td>
<td>420</td>
<td>720</td>
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</tbody>
</table>
Remember this: When two lines on a diagram cross, this intersection usually means something. The point where the supply curve (S) and the demand curve (D) cross, designated by point E in Figure 3, is called the **equilibrium**. The **equilibrium price** is the only price where the plans of consumers and the plans of producers agree—that is, where the amount of the product consumers want to buy (quantity demanded) is equal to the amount producers want to sell (quantity supplied). This common quantity is called the **equilibrium quantity**. At any other price, the quantity demanded does not equal the quantity supplied, so the market is not in equilibrium at that price.

In Figure 3, the equilibrium price is $1.40 per gallon of gasoline and the equilibrium quantity is 600 million gallons. If you had only the demand and supply schedules, and not the graph, you could find the equilibrium by looking for the price level on the tables where the quantity demanded and the quantity supplied are equal.

The word “**equilibrium**” means “balance.” If a market is at its equilibrium price and quantity, then it has no reason to move away from that point. However, if a market is not at equilibrium, then economic pressures arise to move the market toward the equilibrium price and the equilibrium quantity.

Imagine, for example, that the price of a gallon of gasoline was above the equilibrium price—that is, instead of $1.40 per gallon, the price is $1.80 per gallon. This above-equilibrium price is illustrated by the dashed horizontal line at the price of $1.80 in Figure 3. At this higher price, the quantity demanded drops from 600 to 500. This decline in quantity reflects how consumers react to the higher price by finding ways to use less gasoline.

Moreover, at this higher price of $1.80, the quantity of gasoline supplied rises from the 600 to 680, as the higher price makes it more profitable for gasoline producers to expand their output. Now, consider how quantity demanded and quantity supplied are related at this above-equilibrium price. Quantity demanded has fallen to 500 gallons, while quantity supplied has risen to 680 gallons. In fact,
at any above-equilibrium price, the quantity supplied exceeds the quantity demanded. We call this an **excess supply** or a **surplus**.

With a surplus, gasoline accumulates at gas stations, in tanker trucks, in pipelines, and at oil refineries. This accumulation puts pressure on gasoline sellers. If a surplus remains unsold, those firms involved in making and selling gasoline are not receiving enough cash to pay their workers and to cover their expenses. In this situation, some producers and sellers will want to cut prices, because it is better to sell at a lower price than not to sell at all. Once some sellers start cutting prices, others will follow to avoid losing sales. These price reductions in turn will stimulate a higher quantity demanded. So, if the price is above the equilibrium level, incentives built into the structure of demand and supply will create pressures for the price to fall toward the equilibrium.

Now suppose that the price is below its equilibrium level at $1.20 per gallon, as the dashed horizontal line at this price in Figure 3 shows. At this lower price, the quantity demanded increases from 600 to 700 as drivers take longer trips, spend more minutes warming up the car in the driveway in wintertime, stop sharing rides to work, and buy larger cars that get fewer miles to the gallon. However, the below-equilibrium price reduces gasoline producers' incentives to produce and sell gasoline, and the quantity supplied falls from 600 to 550.

When the price is below equilibrium, there is **excess demand**, or a **shortage**—that is, at the given price the quantity demanded, which has been stimulated by the lower price, now exceeds the quantity supplied, which had been depressed by the lower price. In this situation, eager gasoline buyers mob the gas stations, only to find many stations running short of fuel. Oil companies and gas stations recognize that they have an opportunity to make higher profits by selling what gasoline they have at a higher price. As a result, the price rises toward the equilibrium level.
KEY TAKEAWAYS

A demand schedule is a table that shows the quantity demanded at different prices in the market. A demand curve shows the relationship between quantity demanded and price in a given market on a graph. The law of demand states that a higher price typically leads to a lower quantity demanded.

A supply schedule is a table that shows the quantity supplied at different prices in the market. A supply curve shows the relationship between quantity supplied and price on a graph. The law of supply says that a higher price typically leads to a higher quantity supplied.

The equilibrium price and equilibrium quantity occur where the supply and demand curves cross. The equilibrium occurs where the quantity demanded is equal to the quantity supplied. If the price is below the equilibrium level, then the quantity demanded will exceed the quantity supplied. Excess demand or a shortage will exist. If the price is above the equilibrium level, then the quantity supplied will exceed the quantity demanded. Excess supply or a surplus will exist. In either case, economic pressures will push the price toward the equilibrium level.
What Factors Affect Demand?

You may think that the only thing that affects the quantity demanded and the quantity supplied is price. Price, however, is not the only thing that influences demand. Nor is it the only thing that influences supply. For example, how is demand for vegetarian food affected if, say, health concerns cause more consumers to avoid eating meat? Or how is the supply of diamonds affected if diamond producers discover several new diamond mines? What are the major factors, in addition to the price, that influence demand or supply?

We defined demand as the amount of some product a consumer is willing and able to purchase at each price. That suggests at least two factors in addition to price that affect demand. Willingness to purchase suggests a desire, based on what economists call tastes and preferences. If you neither need nor want something, you will not buy it. Ability to purchase suggests that income is important. Professors are usually able to afford better housing and transportation than students, because they have more income. Prices of related goods can affect demand also. If you need a new car, the price of a Honda may affect your demand for a Ford. Finally, the size or composition of the population can affect demand. The more children a family has, the greater their demand for clothing. The more driving-age children a family has, the greater their demand for car insurance, and the less for diapers and baby formula.

These factors matter both for demand by an individual and demand by the market as a whole. Exactly how do these various factors affect demand, and how do we show the effects graphically? To answer those questions, we need the ceteris paribus assumption.
The *Ceteris Paribus* Assumption

A **demand curve** or a **supply curve** is a relationship between two, and only two, variables: quantity on the horizontal axis and price on the vertical axis. The assumption behind a demand curve or a supply curve is that no relevant economic factors, other than the product’s price, are changing. Economists call this assumption *ceteris paribus*, a Latin phrase meaning “other things being equal.” Any given demand or supply curve is based on the *ceteris paribus* assumption that all else is held equal. A demand curve or a supply curve is a relationship between two, and only two, variables when all other variables are kept constant. If all else is not held equal, then the laws of supply and demand will not necessarily hold, as the following section shows.

**When Does Ceteris Paribus Apply?**

*Ceteris paribus* is typically applied when we look at how changes in price affect demand or supply, but *ceteris paribus* can be applied more generally. In the real world, demand and supply depend on more factors than just price. For example, a consumer’s demand depends on income and a producer’s supply depends on the cost of producing the product. How can we analyze the effect on demand or supply if multiple factors are changing at the same time—say price rises and income falls? The answer is that we examine the changes one at a time, assuming the other factors are held constant.

For example, we can say that an increase in the price reduces the amount consumers will buy (assuming income, and anything else that affects demand, is unchanged). Additionally, a decrease in income reduces the amount consumers can afford to buy (assuming price, and anything else that affects demand, is unchanged). This is what the *ceteris paribus* assumption really means. In this particular
case, after we analyze each factor separately, we can combine the results. The amount consumers buy falls for two reasons: first because of the higher price and second because of the lower income.

**How Does Income Affect Demand?**

Let's use income as an example of how factors other than price affect demand. Figure 1 below shows the initial demand for automobiles as $D_0$. At point Q, for example, if the price is $20,000 per car, the quantity of cars demanded is 18 million. $D_0$ also shows how the quantity of cars demanded would change as a result of a higher or lower price. For example, if the price of a car rose to $22,000, the quantity demanded would decrease to 17 million, at point R.

The original demand curve $D_0$, like every demand curve, is based on the *ceteris paribus* assumption that no other economically relevant factors change. Now imagine that the economy expands in a way that raises the incomes of many people, making cars more affordable. How will this affect demand? How can we show this graphically?

Return to Figure 1. The price of cars is still $20,000, but with higher incomes, the quantity demanded has now increased to 20 million cars, shown at point S. As a result of the higher income levels, the demand curve shifts to the right to the new demand curve $D_1$, indicating an increase in demand. The table below shows clearly that this increased demand would occur at every price, not just the original one.
Increased demand means that at every given price, the quantity demanded is higher, so that the demand curve shifts to the right from D₀ to D₁. Decreased demand means that at every given price, the quantity demanded is lower, so that the demand curve shifts to the left from D₀ to D₂.

<table>
<thead>
<tr>
<th>Price</th>
<th>Decrease to D₂</th>
<th>Original Quantity Demanded D₀</th>
<th>Increase to D₁</th>
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<td>17.6 million</td>
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<td>$24,000</td>
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<tr>
<td>$26,000</td>
<td>12.8 million</td>
<td>16.0 million</td>
<td>18.0 million</td>
</tr>
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Now, imagine that the economy slows down so that many people lose their jobs or work fewer hours, reducing their incomes. In this case, the decrease in income would lead to a lower quantity of cars demanded at every given price, and the original demand curve D₀ would shift left to D₂. The shift from D₀ to D₂ represents...
such a decrease in demand: At any given price level, the quantity demanded is now lower. In this example, a price of $20,000 means 18 million cars sold along the original demand curve, but only 14.4 million sold after demand fell.

When a demand curve shifts, it does not mean that the quantity demanded by every individual buyer changes by the same amount. In this example, not everyone would have higher or lower income and not everyone would buy or not buy an additional car. Instead, a shift in a demand curve captures an pattern for the market as a whole.

In the previous section, we argued that higher income causes greater demand at every price. This is true for most goods and services. For some—luxury cars, vacations in Europe, and fine jewelry—the effect of a rise in income can be especially pronounced. A product whose demand rises when income rises, and vice versa, is called a normal good. A few exceptions to this pattern do exist. As incomes rise, many people will buy fewer generic brand groceries and more name brand groceries. They are less likely to buy used cars and more likely to buy new cars. They will be less likely to rent an apartment and more likely to own a home, and so on. A product whose demand falls when income rises, and vice versa, is called an inferior good. In other words, when income increases, the demand curve shifts to the left.

Other Factors That Shift Demand Curves

Income is not the only factor that causes a shift in demand. Other things that change demand include tastes and preferences, the composition or size of the population, the prices of related goods, and even expectations. A change in any one of the underlying factors that determine what quantity people are willing to buy at a given price will cause a shift in demand. Graphically, the new
demand curve lies either to the right (an increase) or to the left (a decrease) of the original demand curve. Let’s look at these factors.

Changing Tastes or Preferences

From 1980 to 2012, the per-person consumption of chicken by Americans rose from 33 pounds per year to 81 pounds per year, and consumption of beef fell from 77 pounds per year to 57 pounds per year, according to the U.S. Department of Agriculture (USDA). Changes like these are largely due to movements in taste, which change the quantity of a good demanded at every price: that is, they shift the demand curve for that good, rightward for chicken and leftward for beef.

Changes in the Composition of the Population

The proportion of elderly citizens in the United States population is rising. It rose from 9.8% in 1970 to 12.6% in 2000, and will be a projected (by the U.S. Census Bureau) 20% of the population by 2030. A society with relatively more children, like the United States in the 1960s, will have greater demand for goods and services like tricycles and day care facilities. A society with relatively more elderly persons, as the United States is projected to have by 2030, has a higher demand for nursing homes and hearing aids. Similarly, changes in the size of the population can affect the demand for housing and many other goods. Each of these changes in demand will be shown as a shift in the demand curve.

The demand for a product can also be affected by changes in the prices of related goods such as substitutes or complements. A substitute is a good or service that can be used in place of another good or service. As electronic books, like this one, become more
available, you would expect to see a decrease in demand for traditional printed books. A lower price for a substitute decreases demand for the other product. For example, in recent years as the price of tablet computers has fallen, the quantity demanded has increased (because of the law of demand). Since people are purchasing tablets, there has been a decrease in demand for laptops, which can be shown graphically as a leftward shift in the demand curve for laptops. A higher price for a substitute good has the reverse effect.

Other goods are complements for each other, meaning that the goods are often used together, because consumption of one good tends to enhance consumption of the other. Examples include breakfast cereal and milk; notebooks and pens or pencils, golf balls and golf clubs; gasoline and sport utility vehicles; and the five-way combination of bacon, lettuce, tomato, mayonnaise, and bread. If the price of golf clubs rises, since the quantity demanded of golf clubs falls (because of the law of demand), demand for a complement good like golf balls decreases, too. Similarly, a higher price for skis would shift the demand curve for a complement good like ski resort trips to the left, while a lower price for a complement has the reverse effect.

Changes in Expectations about Future Prices or Other Factors that Affect Demand

While it is clear that the price of a good affects the quantity demanded, it is also true that expectations about the future price (or expectations about tastes and preferences, income, and so on) can affect demand. For example, if people hear that a hurricane is coming, they may rush to the store to buy flashlight batteries and bottled water. If people learn that the price of a good like coffee is likely to rise in the future, they may head for the store to stock up on coffee now. These changes in demand are shown as shifts in
the curve. Therefore, a shift in demand happens when a change in some economic factor (other than price) causes a different quantity to be demanded at every price. The following Work It Out feature shows how this happens.

Shift in Demand

A shift in demand means that at any price (and at every price), the quantity demanded will be different than it was before. Following is an example of a shift in demand due to an income increase.

Step 1. Draw the graph of a demand curve for a normal good like pizza. Pick a price (like \( P_0 \)). Identify the corresponding \( Q_0 \). An example is shown in Figure 2.

![Demand Curve Graph](image)

Figure 2. The demand curve can be used to identify how much consumers would buy at any given price.

Step 2. Suppose income increases. As a result of the change, are consumers going to buy more or less pizza? The answer is more. Draw a dotted horizontal line from the chosen price, through the
original quantity demanded, to the new point with the new $Q_1$. Draw a dotted vertical line down to the horizontal axis and label the new $Q_1$. An example is provided in Figure 3.

![Figure 3](image)

Figure 3. With an increase in income, consumers will purchase larger quantities, pushing demand to the right.

Step 3. Now, shift the curve through the new point. You will see that an increase in income causes an upward (or rightward) shift in the demand curve, so that at any price the quantities demanded will be higher, as shown in Figure 4.
Figure 4. With an increase in income, consumers will purchase larger quantities, pushing demand to the right, and causing the demand curve to shift right.

**KEY TAKEAWAYS**

Six factors that can shift demand curves are summarized in Figure 5. The direction of the arrows indicates whether the demand curve shifts represent an increase in demand or a decrease in demand. Notice that a change in the price of the good or service itself is not listed among the factors that can shift a demand curve. A change in the price of a good or service causes a movement along a specific demand curve, and it typically leads to some change in the quantity demanded, but it does not shift the demand curve.
Figure 5. (a) A list of factors that can cause an increase in demand from D0 to D1. (b) The same factors, if their direction is reversed, can cause a decrease in demand from D0 to D1.

When a demand curve shifts, it will then intersect with a given supply curve at a different equilibrium price and quantity. We are, however, getting ahead of our story. Before discussing how changes in demand can affect equilibrium price and quantity, we first need to discuss shifts in supply curves.
44. Simulation: Demand for Food Trucks

Try It

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=65
45. Reading: Shifts in Supply

How Production Costs Affect Supply

A supply curve shows how quantity supplied will change as the price rises and falls, assuming *ceteris paribus* so that no other economically relevant factors are changing. If other factors relevant to supply do change, then the entire supply curve will shift. Just as a shift in demand is represented by a change in the quantity demanded at every price, a shift in supply means a change in the quantity supplied at every price.

In thinking about the factors that affect supply, remember what motivates firms: profits, which are the difference between revenues and costs. Goods and services are produced using combinations of labor, materials, and machinery, or what we call inputs or factors of production. If a firm faces lower costs of production, while the prices for the good or service the firm produces remain unchanged, a firm's profits go up. When a firm's profits increase, it is more motivated to produce output, since the more it produces the more profit it will earn. So, when costs of production fall, a firm will tend to supply a larger quantity at any given price for its output. This can be shown by the supply curve shifting to the right.

Take, for example, a messenger company that delivers packages around a city. The company may find that buying gasoline is one of its main costs. If the price of gasoline falls, then the company will find it can deliver messages more cheaply than before. Since lower costs correspond to higher profits, the messenger company may now supply more of its services at any given price. For example, given the lower gasoline prices, the company can now serve a greater area, and increase its supply.

Conversely, if a firm faces higher costs of production, then it will earn lower profits at any given selling price for its products. As a
result, a higher cost of production typically causes a firm to supply a smaller quantity at any given price. In this case, the supply curve shifts to the left.

Consider the supply for cars, shown by curve $S_0$ in Figure 6. Point $J$ indicates that if the price is $20,000, the quantity supplied will be 18 million cars. If the price rises to $22,000 per car, ceteris paribus, the quantity supplied will rise to 20 million cars, as point $K$ on the $S_0$ curve shows. The same information can be shown in table form, as in the table below.

![Figure 6. Decreased supply means that at every given price, the quantity supplied is lower, so that the supply curve shifts to the left, from $S_0$ to $S_1$. Increased supply means that at every given price, the quantity supplied is higher, so that the supply curve shifts to the right, from $S_0$ to $S_2$.](image)
Price and Shifts in Supply: A Car Example

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<tr>
<th>Price</th>
<th>Decrease to $S_1$</th>
<th>Original Quantity Supplied $S_0$</th>
<th>Increase to $S_2$</th>
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<tbody>
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<td>$16,000</td>
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<tr>
<td>$26,000</td>
<td>20.5 million</td>
<td>22.0 million</td>
<td>24.2 million</td>
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</tbody>
</table>

Now, imagine that the price of steel, an important ingredient in manufacturing cars, rises, so that producing a car has become more expensive. At any given price for selling cars, car manufacturers will react by supplying a lower quantity. This can be shown graphically as a leftward shift of supply, from $S_0$ to $S_1$, which indicates that at any given price, the quantity supplied decreases. In this example, at a price of $20,000, the quantity supplied decreases from 18 million on the original supply curve ($S_0$) to 16.5 million on the supply curve $S_1$, which is labeled as point L.

Conversely, if the price of steel decreases, producing a car becomes less expensive. At any given price for selling cars, car manufacturers can now expect to earn higher profits, so they will supply a higher quantity. The shift of supply to the right, from $S_0$ to $S_2$, means that at all prices, the quantity supplied has increased. In this example, at a price of $20,000, the quantity supplied increases from 18 million on the original supply curve ($S_0$) to 19.8 million on the supply curve $S_2$, which is labeled M.

Other Factors That Affect Supply

In the example above, we saw that changes in the prices of inputs in the production process will affect the cost of production and
thus the supply. Several other things affect the cost of production, too, such as changes in weather or other natural conditions, new technologies for production, and some government policies.

The cost of production for many agricultural products will be affected by changes in natural conditions. For example, the area of northern China which typically grows about 60% of the country’s wheat output experienced its worst drought in at least 50 years in the second half of 2009. A drought decreases the supply of agricultural products, which means that at any given price, a lower quantity will be supplied; conversely, especially good weather would shift the supply curve to the right.

When a firm discovers a new technology that allows the firm to produce at a lower cost, the supply curve will shift to the right, as well. For instance, in the 1960s a major scientific effort nicknamed the Green Revolution focused on breeding improved seeds for basic crops like wheat and rice. By the early 1990s, more than two-thirds of the wheat and rice in low-income countries around the world was grown with these Green Revolution seeds—and the harvest was twice as high per acre. A technological improvement that reduces costs of production will shift supply to the right, so that a greater quantity will be produced at any given price.

Government policies can affect the cost of production and the supply curve through taxes, regulations, and subsidies. For example, the U.S. government imposes a tax on alcoholic beverages that collects about $8 billion per year from producers. Taxes are treated as costs by businesses. Higher costs decrease supply for the reasons discussed above. Other examples of policy that can affect cost are the wide array of government regulations that require firms to spend money to provide a cleaner environment or a safer workplace; complying with regulations increases costs.

A government subsidy, on the other hand, is the opposite of a tax. A subsidy occurs when the government pays a firm directly or reduces the firm’s taxes if the firm carries out certain actions. From the firm’s perspective, taxes or regulations are an additional cost of production that shifts supply to the left, leading the firm to produce
a lower quantity at every given price. Government subsidies reduce the cost of production and increase supply at every given price, shifting supply to the right. The following Work It Out feature shows how this shift happens.

Shift in Supply

We know that a supply curve shows the minimum price a firm will accept to produce a given quantity of output. What happens to the supply curve when the cost of production goes up? Following is an example of a shift in supply due to a production cost increase.

Step 1. Draw a graph of a supply curve for pizza. Pick a quantity (like \( Q_0 \)). If you draw a vertical line up from \( Q_0 \) to the supply curve, you will see the price the firm chooses. An example is shown in Figure 7.

![Figure 7. The supply curve can be used to show the minimum price a firm will accept to produce a given quantity of output.](image)

Step 2. Why did the firm choose that price and not some other?
One way to think about this is that the price is composed of two parts. The first part is the average cost of production, in this case, the cost of the pizza ingredients (dough, sauce, cheese, pepperoni, and so on), the cost of the pizza oven, the rent on the shop, and the wages of the workers. The second part is the firm's desired profit, which is determined, among other factors, by the profit margins in that particular business. If you add these two parts together, you get the price the firm wishes to charge. The quantity $Q_0$ and associated price $P_0$ give you one point on the firm's supply curve, as shown in Figure 8.

![Figure 8. The cost of production and the desired profit equal the price a firm will set for a product.](image)

Step 3. Now, suppose that the cost of production goes up. Perhaps cheese has become more expensive by $0.75 per pizza. If that is true, the firm will want to raise its price by the amount of the increase in cost ($0.75). Draw this point on the supply curve directly above the initial point on the curve, but $0.75 higher, as shown in Figure 9.
Figure 9. Because the cost of production and the desired profit equal the price a firm will set for a product, if the cost of production increases, the price for the product will also need to increase.

Step 4. Shift the supply curve through this point. You will see that an increase in cost causes an upward (or a leftward) shift of the supply curve so that at any price, the quantities supplied will be smaller, as shown in Figure 10.
Figure 10. When the cost of production increases, the supply curve shifts upwardly to a new price level.

KEY TAKEAWAYS

Changes in the cost of inputs, natural disasters, new technologies, and the impact of government decisions all affect the cost of production. In turn, these factors affect how much firms are willing to supply at any given price.

Figure 11 summarizes factors that change the supply of goods and services. Notice that a change in the price of the product itself is not among the factors that shift the supply curve. Although a change in price of a good or service typically causes a change in quantity supplied or a movement along the supply curve for that specific good or service, it does not cause the supply curve itself to shift.
Because demand and supply curves appear on a two-dimensional diagram with only price and quantity on the axes, an unwary visitor to the land of economics might be fooled into believing that economics is about only four topics: demand, supply, price, and quantity. However, demand and supply are really “umbrella” concepts: demand covers all the factors that affect demand, and supply covers all the factors that affect supply. Factors other than price that affect demand and supply are included by using shifts in the demand or the supply curve. In this way, the two-dimensional demand and supply model becomes a powerful tool for analyzing a wide range of economic circumstances.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=66
46. Simulation: Supply of Food Trucks

Try It

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=67
47. Simulation: Food Trucks and Changes in Equilibrium

Try It

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=68
48. Video: Indiana Jones (Demand, Supply, Equilibrium, Shifts)

Indiana Jones (Demand, Supply, Equilibrium, Shifts)

Watch the following video that provides an overview of demand, supply, equilibrium, and shifting the curves.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=69
KEY TAKEAWAYS

• Economists often use the *ceteris paribus* or “other things being equal” assumption: while examining the economic impact of one event, all other factors remain unchanged for the purpose of the analysis.

• Factors that can shift the demand curve for goods and services, causing a different quantity to be demanded at any given price, include changes in tastes, population, income, prices of substitute or complement goods, and expectations about future conditions and prices.

• Factors that can shift the supply curve for goods and services, causing a different quantity to be supplied at any given price, include input prices, natural conditions, changes in technology, and government taxes, regulations, or subsidies.
49. Outcome: Economic Systems

What you’ll learn to do: compare and contrast different economic systems (capitalist, planned, and mixed)

If you were born and raised in the United States, then the only economic system you have lived within is a capitalist or free market system. However, just as there are differences in culture, politics, religions, and languages around the world, economic systems vary from place to place. Which economic system a country adopts is the result of complex historical, political, and social factors that play out over time. Each system has its supporters and its critics, but as a student of economics it’s important for you to have a basic understanding of the three most common types: capitalist or free market economies, planned (sometimes called “command”) economies, and mixed economies, which have the characteristics of two or more types.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: How Economies Can Be Organized
- Reading: Control of Economic Decisions
- Self Check: Economic Systems
Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
50. Reading: How Economies Can Be Organized

Organizing Economies

Think about what a complex system a modern economy is. It includes all production of goods and services, all buying and selling, all employment. The economic life of every individual is interrelated, at least to a small extent, with the economic lives of thousands or even millions of other individuals. Who organizes and coordinates this system? Who ensures that, for example, the number of televisions a society provides is the same as the amount it needs and wants? Who ensures that the right number of employees work in the electronics industry? Who ensures that televisions are produced in the best way possible? How does it all get done?

There are at least three ways societies have found to organize an economy. The first is the traditional economy, which is the oldest economic system and can be found in parts of Asia, Africa, and South America. Traditional economies organize their economic affairs the way they have always done (i.e., tradition). Occupations stay in the family. Most families are farmers who grow the crops they have always grown using traditional methods. What you produce is what you get to consume. Because things are driven by tradition, there is little economic progress or development.
Command Economies

Command economies are very different. In a command economy, economic effort is devoted to goals passed down from a ruler or ruling class. Ancient Egypt was a good example: a large part of economic life was devoted to building pyramids, like those shown in Figure 1, for the pharaohs. Medieval manor life is another example: the lord provided the land for growing crops and protection in the event of war. In return, vassals provided labor and soldiers to do the lord’s bidding. In the last century, there were two primary examples of command economies: socialism and communism.
Under communism, the government decides what goods and services will be produced and what prices will be charged for them. The government decides what methods of production will be used and how much workers will be paid. Many necessities like healthcare and education are provided for free. Currently, Cuba and North Korea have communist economies.

Another type of command economy is socialism. Under socialism, industries that provide essential services, such as utilities, banking, and health care, may be government owned. Other businesses are owned privately. Central planning allocates the goods and services produced by government-run industries and tries to ensure that the resulting wealth is distributed equally. In contrast, privately owned companies are operated for the purpose of making a profit for their owners. In general, workers in
socialist economies work fewer hours, have longer vacations, and receive more health, education, and child-care benefits than do workers in capitalist economies. To offset the high cost of public services, taxes are generally steep. Examples of socialist countries include Sweden and France.
Market Economies

Unlike command economies, market economies have a very decentralized structure. A market is an institution that brings together buyers and sellers of goods or services, who may be either individuals or businesses. The New York Stock Exchange, shown in Figure 2, is a prime example of a market in which buyers and sellers are brought together. In a market economy, decision-making is decentralized. Market economies are based on private enterprise: the means of production (resources and businesses) are owned and operated by private individuals or groups of private individuals. Businesses supply goods and services based on demand. (In a command economy, by contrast, resources and businesses are owned by the government.) A person’s income is based on his or her ability to convert resources (especially labor) into something that society values. The more society values the person’s output, the higher the income (think Lady Gaga or LeBron James). In this scenario, economic decisions are determined by market forces, not governments.

Mixed Market Economies

Though it’s possible to have a pure communist system, or a pure capitalist (free market) system, in reality many economic systems are mixed. A mixed market economy relies on both markets and
the government to allocate resources. We’ve already seen that this is what happens in socialist economies in which the government controls selected major industries, such as transportation and health care, while allowing individual ownership of other industries. Even previously communist economies, such as those of Eastern Europe and China, are becoming more mixed as they adopt capitalistic characteristics and convert businesses previously owned by the government to private ownership through a process called privatization.

How Economic Systems Compare

In comparing economic systems, it’s helpful to think of a continuum with communism at one end and pure capitalism at the other, as in Figure 3. As you move from left to right, the amount of government control over business diminishes. So, too, does the level of social services, such as health care, child-care services, social security, and unemployment benefits. Most economies in the real world are mixed; they combine elements of command and market (and even traditional) systems. The U.S. economy is positioned toward the market-oriented end of the spectrum. Many countries in Europe and Latin America, while primarily market-oriented, have a greater degree of government involvement in economic decisions than does the U.S. economy. China and Russia, while they are closer to having a market-oriented system now than several decades ago, remain closer to the command economy end of the spectrum.
Figure 3. The Spectrum of Economic Systems
Who is in control of economic decisions? Are people free to do what they want and to work where they want? Are businesses free to produce when they want and what they choose, and to hire and fire as they wish? Are banks free to choose who will receive loans? Or does the government control these kinds of choices? Each year, researchers at the Heritage Foundation and the Wall Street Journal look at 50 different categories of economic freedom for countries around the world. They give each nation a score based on the extent of economic freedom in each category.

The 2013 Heritage Foundation’s Index of Economic Freedom report ranked 177 countries around the world: some examples of the most free and the least free countries are listed in the table below. Several countries were not ranked because of extreme instability that made judgments about economic freedom impossible. These countries include Afghanistan, Iraq, Syria, and Somalia.

The assigned rankings are inevitably based on estimates, yet even these rough measures can be useful for discerning trends. In 2013, 91 of the 177 included countries shifted toward greater economic freedom, although 78 of the countries shifted toward less economic freedom. In recent decades, the overall trend has been a higher level of economic freedom around the world.
### Economic Freedoms, 2013

<table>
<thead>
<tr>
<th>Most Economic Freedom</th>
<th>Least Economic Freedom</th>
</tr>
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<tbody>
<tr>
<td>1. Hong Kong</td>
<td>168. Iran</td>
</tr>
<tr>
<td>2. Singapore</td>
<td>169. Turkmenistan</td>
</tr>
<tr>
<td>3. Australia</td>
<td>170. Equatorial Guinea</td>
</tr>
<tr>
<td>4. New Zealand</td>
<td>171. Democratic Republic of Congo</td>
</tr>
<tr>
<td>5. Switzerland</td>
<td>172. Burma</td>
</tr>
<tr>
<td>6. Canada</td>
<td>173. Eritrea</td>
</tr>
<tr>
<td>7. Chile</td>
<td>174. Venezuela</td>
</tr>
<tr>
<td>8. Mauritius</td>
<td>175. Zimbabwe</td>
</tr>
<tr>
<td>9. Denmark</td>
<td>176. Cuba</td>
</tr>
<tr>
<td>10. United States</td>
<td>177. North Korea</td>
</tr>
</tbody>
</table>


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### Regulations: The Rules of the Game

Markets and government regulations are always entangled. There is no such thing as an absolutely free market. Regulations always define the “rules of the game” in the economy. Economies that are primarily market-oriented have fewer regulations—ideally just enough to maintain an even playing field for participants. At a minimum, these laws govern matters like safeguarding private property against theft, protecting people from violence, enforcing legal contracts, preventing fraud, and collecting taxes. Conversely, even the most command-oriented economies operate using markets. How else would buying and selling occur? But the decisions of what will be produced and what prices will be charged are heavily regulated. Heavily regulated economies often have **underground economies**, which are markets where the buyers and sellers make transactions without the government’s approval.

The question of how to organize economic institutions is
typically not a black-or-white choice between all market or all government, but instead involves a balancing act over the appropriate combination of market freedom and government rules.

The Rise of Globalization

Recent decades have seen a trend toward globalization, which is the expanding cultural, political, and economic connections between people around the world. One measure of this is the increased buying and selling of goods, services, and assets across national borders—in other words, international trade and financial capital flows.

Globalization has occurred for a number of reasons. Improvements in shipping, as illustrated by the container ship shown in Figure 4, and air cargo have driven down transportation costs. Innovations in computing and telecommunications have made it easier and cheaper to manage long-distance economic connections of production and sales. Many valuable products and services in the modern economy can take the form of information—for example: computer software; financial advice; travel planning; music, books and movies; and blueprints for designing a building. These products and many others can be transported over telephones and computer networks at ever-lower costs. Finally, international agreements and treaties between countries have encouraged greater trade.

The table below presents one measure of globalization. It shows the percentage of domestic economic production that was
exported for a selection of countries from 1970 to 2010, according to an entity known as The World Bank. **Exports** are the goods and services that are produced domestically and sold abroad. **Imports** are the goods and services that are produced abroad and then sold domestically. The size of total production in an economy is measured by the **gross domestic product (GDP)**. Thus, the ratio of exports divided by GDP measures what share of a country’s total economic production is sold in other countries.
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<tbody>
<tr>
<td><strong>Some High Income Countries</strong></td>
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<tr>
<td>United States</td>
<td>6%</td>
<td>10%</td>
<td>10%</td>
<td>11%</td>
<td>13%</td>
</tr>
<tr>
<td>Belgium</td>
<td>52%</td>
<td>58%</td>
<td>71%</td>
<td>86%</td>
<td>80%</td>
</tr>
<tr>
<td>Canada</td>
<td>23%</td>
<td>28%</td>
<td>26%</td>
<td>46%</td>
<td>29%</td>
</tr>
<tr>
<td>France</td>
<td>16%</td>
<td>21%</td>
<td>21%</td>
<td>29%</td>
<td>26%</td>
</tr>
<tr>
<td>Italy</td>
<td>16%</td>
<td>22%</td>
<td>20%</td>
<td>29%</td>
<td>27%</td>
</tr>
<tr>
<td>Japan</td>
<td>11%</td>
<td>14%</td>
<td>10%</td>
<td>11%</td>
<td>15%</td>
</tr>
<tr>
<td>Sweden</td>
<td>24%</td>
<td>29%</td>
<td>30%</td>
<td>46%</td>
<td>49%</td>
</tr>
<tr>
<td><strong>Some Middle Income Countries</strong></td>
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<td></td>
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<td></td>
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<tr>
<td>Brazil</td>
<td>7%</td>
<td>9%</td>
<td>8%</td>
<td>11%</td>
<td>11%</td>
</tr>
<tr>
<td>Mexico</td>
<td>8%</td>
<td>11%</td>
<td>19%</td>
<td>31%</td>
<td>30%</td>
</tr>
<tr>
<td>South Korea</td>
<td>14%</td>
<td>32%</td>
<td>28%</td>
<td>41%</td>
<td>52%</td>
</tr>
<tr>
<td><strong>Some Low Income Countries</strong></td>
<td></td>
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<td></td>
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<tr>
<td>Chad</td>
<td>16%</td>
<td>17%</td>
<td>13%</td>
<td>17%</td>
<td>41%</td>
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<tr>
<td>China</td>
<td>3%</td>
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<td>19%</td>
<td>23%</td>
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<tr>
<td>India</td>
<td>4%</td>
<td>6%</td>
<td>7%</td>
<td>6%</td>
<td>22%</td>
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<tr>
<td>Nigeria</td>
<td>8%</td>
<td>29%</td>
<td>43%</td>
<td>53%</td>
<td>35%</td>
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In recent decades, the export/GDP ratio has generally risen, both worldwide and for the U.S. economy. Interestingly, the share of U.S. exports in proportion to the U.S. economy is well below the global average, in part because large economies like the United States can contain more of the division of labor inside their national borders. However, smaller economies like Belgium, Korea, and Canada need to trade across their borders with other countries to take full advantage of division of labor, specialization, and economies of scale. In this sense, the enormous U.S. economy is less affected by globalization than most other countries.

The table above also shows that many medium and low income countries around the world, like Mexico and China, have also experienced a surge of globalization in recent decades. If an astronaut in orbit could put on special glasses that make all
economic transactions visible as brightly colored lines and look down at Earth, the astronaut would see the planet covered with connections.

KEY TAKEAWAYS

• Economies address these three questions: (1) What goods and services should be produced to meet consumer needs? (2) How should they be produced, and who should produce them? (3) Who should receive goods and services?
• The answers to these questions depend on a country's economic system. The primary economic systems that exist today are command (planned) and free market systems.
• In a planned system, such as communism and socialism, the government exerts control over the production and distribution of all or some goods and services.
• In a free market system, also known as capitalism, business is conducted with only limited government involvement. Competition determines what goods and services are produced, how they are produced, and for whom.
• More countries' economies are evolving into a mixed-economy which has characteristics of more than one system.
• The last few decades have seen globalization evolve as a result of growth in commercial and financial networks that cross national borders, making businesses and workers from different economies increasingly interdependent.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=72
52. Outcome: Health of the Economy

What you’ll learn to do: describe the methods economists use to evaluate the health of an economy, such as GDP, unemployment rate, and CPI

How many times have we had our temperature taken? Probably too many to count! Why do we (and doctors) reach for a thermometer when someone says, “I don’t feel good.” Because we’re looking for a symptom of an underlying problem or illness. If you have a fever, it could be a sign of the flu, an ear infection, or strep throat—or something else that requires treatment or action.

Similarly, economists have ways of taking the temperature of the economy to determine whether something serious is going on. Some of the “ills” they look for are recession, inflation, deflation, and stagnation. In this section you’ll learn about the key economic indicators used to measure the health of the economy: GDP, unemployment, and the CPI.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Measuring the Health of the Economy
- Self Check: Health of the Economy

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Every day, we're bombarded with economic news. We're told that the economy is struggling, unemployment is high, home prices are low, and consumer confidence is down. As a student learning about business, and later, as a business manager, you need to understand the nature of the U.S. economy and the terminology used to describe it. It's important to have some idea of where the economy is heading and know something about the government's role in influencing its direction.

Economic Indicators

An economic indicator is a statistic that provides valuable information about the economy. The majority of economic indicators are collected and released by government and/or non-profit groups. In the U.S., Department of Commerce and the Department of Labor track and publish key indicators such as the unemployment rate and GDP. There is no shortage of economic indicators, and trying to follow them all would be an overwhelming task. Thus, economists and businesspeople typically track only a select few that are most pertinent to their professional, financial and economic interests.
Economic Goals

All the world’s economies share the following three main goals:

1. Growth
2. High employment
3. Price stability

Economic indicators provide information about how an economy is performing relative to these goals. Let’s take a closer look at each of these goals, both to find out what they mean and to show how we determine whether they’re being met.

Growth

One purpose of an economy is to provide people with goods and services—cars, computers, video games, houses, rock concerts, fast food, amusement parks. One way in which economists measure the performance of an economy is by looking at a widely used measure of total output called gross domestic product (GDP). GDP is defined as the market value of all goods and services produced by the economy in a given year. In the United States, it’s calculated by the Department of Commerce. GDP includes only those goods and services produced domestically; goods produced outside the country are excluded. GDP also includes only those goods and services that are produced for the final user; intermediate products are excluded. For example, the silicon chip that goes into a computer (an intermediate product) would not count, even though the finished computer would.

By itself, GDP doesn’t necessarily tell us much about the state of the economy. But change in GDP does. If GDP (after adjusting for inflation) goes up, the economy is growing. If it goes down, the economy is contracting.
High Employment

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

The Unemployment Rate

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

Figure 1 below traces the U.S. unemployment rate between 1970 and 2010. If you want to know the current unemployment rate, go to CNNMoney, click on “Economy,” and then on “Job Growth.”
Price Stability

A third major goal of all economies is maintaining price stability. Price stability occurs when the average of the prices for goods and services either doesn’t change or changes very little. Rising prices are troublesome for both individuals and businesses. For individuals, rising prices mean you have to pay more for the things you need. For businesses, rising prices mean higher costs, and, at least in the short run, businesses might have trouble passing on higher costs to consumers. When the overall price level goes up, we have inflation. Figure 2 below shows inflationary trends in the U.S. economy since 1960. When the price level goes down (which rarely happens), we have deflation.
The Consumer Price Index

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

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

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<tr>
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<td>24.1</td>
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<td>38.8</td>
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<td>130.7</td>
<td>172.2</td>
<td>177.1</td>
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<tr>
<td>CPI</td>
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<td>215.3</td>
<td>214.15</td>
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</tbody>
</table>

## LINK IT UP

You can find out the current CPI by going to CNNMoney. Click on “Economy” and then on “Inflation (CPI).”

## Consumer Confidence Index

A private research firm called the Conference Board publishes a consumer confidence index based on results of a monthly survey of five thousand U.S. households. The survey gathers consumers' opinions on the health of the economy and their plans for future purchases. It's often a good indicator of consumers' future buying intent. When consumers are confident, they tend to spend more money and increase economic activity. When consumers are less confident, they typically spend less money and economic activity declines.

## LINK IT UP

For information on current consumer confidence, go to the Conference Board and click on “consumer confidence.”
Economic Forecasting

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

Lagging and Leading Indicators

Statistics that report the status of the economy a few months in the past are called lagging economic indicators. One such indicator is average length of unemployment. If unemployed workers have remained out of work for a long time, we may infer that the economy has been slow. Indicators that predict the status of the economy three to twelve months in the future are called leading economic indicators. If such an indicator rises, the economy is likely to expand in the coming year. If it falls, the economy is likely to contract.

To predict where the economy is headed, we obviously must examine several leading indicators. It’s also helpful to look at indicators from various sectors of the economy—labor, manufacturing, and housing. One useful indicator of the outlook for future jobs is the number of new claims for unemployment insurance. This measure tells us how many people recently lost their jobs. If it's rising, it signals trouble ahead because unemployed consumers can’t buy as many goods and services as they could if they had paychecks.

To gauge the level of goods to be produced in the future (which
will translate into future sales), economists look at a statistic called *average weekly manufacturing hours*. This measure tells us the average number of hours worked per week by production workers in manufacturing industries. If it’s on the rise, the economy will probably improve. For assessing the strength of the housing market, *building permits* is often a good indicator. An increase in this statistic—which tells us how many new housing units are being built—indicates that the economy is improving. Why? Because increased building brings money into the economy not only through new home sales but also through sales of furniture and appliances to furnish them.

Finally, if you want a measure that combines all these economic indicators, as well as others, the Conference Board publishes a U.S. *leading index*. To get an idea of what leading economic indicators are telling us about the state of the economy today, go to the Conference Board and click on “U.S. Indicators” and then “leading economic index.”

**KEY TAKEAWAYS**

- All economies share three goals: growth, high employment, and price stability.
- To get a sense of where the economy is headed in the future, we use statistics called *economic indicators*.
- Growth. An economy provides people with goods and services, and economists measure its performance by studying the *gross domestic product (GDP)*—the market value of all goods and services produced by the economy in a given year.
- If GDP goes up, the economy is growing; if it goes down, the economy is contracting.
- High employment. Because most people earn their money by working, a goal of all economies is making jobs available to everyone who wants one.
• The U.S. government reports an **unemployment rate**—the percentage of the labor force that’s unemployed and actively seeking work.
• The unemployment rate goes up during periods when the economy is in decline and down when the economy is expanding.
• Price stability. When the average prices of products either don’t change or change very little, **price stability occurs**.
• When overall prices go up, we have **inflation**; when they go down, we have **deflation**.
• The **consumer price index (CPI)** measures inflation by determining the change in prices of a hypothetical basket of goods bought by a typical household.
• Indicators that, like average length of unemployment, report the status of the economy a few months in the past are **lagging economic indicators**.
• Those, like new claims for unemployment insurance, that predict the status of the economy three to twelve months in the future are **leading economic indicators**.

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
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54. Outcome: Stages of an Economy

What you’ll learn to do: explain the effect that the four stages of an economy (expansion, peak, contraction, trough) have on business operations.

Spring, summer, fall and winter: the four seasons of the year. Expansion, peak, contraction, trough: the four seasons of an economy. In this next section you’ll learn about the cyclical nature of economies and how each of these “seasons” affects business operations.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Business Cycle: Definition and Phases
• Self Check: Stages of an Economy

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
The Business Cycle

The term “business cycle” (or economic cycle or boom-bust cycle) refers to economy-wide fluctuations in production, trade, and general economic activity. From a conceptual perspective, the business cycle is the upward and downward movements of levels of GDP (gross domestic product) and refers to the period of expansions and contractions in the level of economic activities (business fluctuations) around a long-term growth trend.

Figure 1. Business Cycles: The phases of a business cycle follow a wave-like pattern over time with regard to GDP, with expansion leading to a peak and then followed by contraction.
Business Cycle Phases

Business cycles are identified as having four distinct phases: expansion, peak, contraction, and trough.

An **expansion** is characterized by increasing employment, economic growth, and upward pressure on prices. A **peak** is the highest point of the business cycle, when the economy is producing at maximum allowable output, employment is at or above full employment, and inflationary pressures on prices are evident. Following a peak, the economy typically enters into a correction which is characterized by a **contraction** where growth slows, employment declines (unemployment increases), and pricing pressures subside. The slowing ceases at the **trough** and at this point the economy has hit a bottom from which the next phase of expansion and contraction will emerge.

Business Cycle Fluctuations

Business cycle fluctuations occur around a long-term growth trend and are usually measured in terms of the growth rate of real gross domestic product.

In the United States, it is generally accepted that the National Bureau of Economic Research (NBER) is the final arbiter of the dates of the peaks and troughs of the business cycle. An **expansion** is the period from a trough to a peak, and a **recession** as the period from a peak to a trough. The NBER identifies a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production. ” This is significantly different from the commonly cited definition of a recession being signaled by two consecutive quarters of decline in real GDP. If the
economy does not begin to expand again then the economy may be considered to be in a state of depression.

**Impact on Business Operations**

How the business cycle affects business operations may be best explained by looking at how one business responds to these cycles. Normal Maintenance is a small business that provides a variety of construction services to homeowners. They specialize in roofing, deck installations, siding, and general home maintenance. They employ three full-time workers, who typically work forty hours per week for an average of twelve dollars per hour. The company has been in business in the same town for than twenty years and has a solid reputation for quality work and reliability.

**Expansion**

Normal Maintenance is busy and has recently had to turn down jobs because it lacks the capacity to do all the work offered. Homeowners now want to make home repairs and improvements which they had had to put off during the sour economy. With the economy improving, others are fixing up their homes to sell. Faced with so much demand, the owner of Normal Maintenance must decide whether to pay his existing workers overtime (which will increase the costs for each job and reduce profits) or hire additional workers. The competition for qualified construction labor is steep, and he is concerned that he will have to pay more than his usual rate of twelve dollars per hour or possibly get workers who are not as qualified as his current crew. He is, however, able to charge higher prices for his work because homeowners are experiencing long waits and delays getting bids and jobs completed.
The owner purchases a new truck and invests in additional tools in order to keep up with the demand for services. Customers are willing to pay more than usual so they can get the work done. Business is expanding to such an extent that Normal Maintenance and its suppliers are starting to have trouble obtaining materials such as shingles and siding because the manufacturers have not kept pace with the economic expansion. In general, business is great for Normal Maintenance, but the expansion brings challenges.

Peak

At the peak of the business cycle, the economy can be said to be “overheated.” Despite hiring additional workers, the owner and crews of Normal Maintenance are working seven days a week and are still unable to keep up with demand. They can't work any harder or faster. As a result, the crews are exhausted and the quality of their work is beginning to decline. Customers leave messages requesting work and services, but the owner is so busy he doesn't return phone calls. Jobs are getting started and completed late as the crews struggle to cover multiple job sites. As a result, customer complaints are on the rise, and the owner is worried about the long-term reputation of the business. Neither the business nor the economy can sustain this level of activity, and despite the fact that Normal Maintenance is making great money, everyone is ready for things to let up a little.

Contraction

As the economy begins to contract, business begins to slow down for Normal Maintenance. They find that they are caught up on work and they aren't getting so many phone calls. The owner is
able to reduce his labor costs by cutting back on overtime and eliminate working on the weekends. When the phone does ring, homeowners are asking for bids on work—not just placing work orders. Normal Maintenance loses out on several jobs because their bids are too high. The company begins to look for new suppliers who can provide them with materials at a cheaper price so they can be more competitive. The building material companies start offering “deals” and specials to contractors in order to generate sales. In general, competition for work has increased and some of the businesses that popped up during the expansion are no longer in the market. In the short term the owner is confident that he has enough work to keep his crew busy, but he’s concerned that if things don’t pick up, he might have to lay off some of the less experienced workers.

**Trough**

On Monday morning, the crew of Normal Maintenance show up to work and the owner has to send them home: there’s no work for them. During the week before, they worked only three days, and the owner is down to his original crew of three employees. Several months ago he laid off the workers hired during the expansion. Although that was a difficult decision, the owner knows from hard experience that sometimes businesses fail not because their owners make bad decisions, but because they run out of money during recessions when there isn’t enough customer demand to sustain them. Without enough working capital to keep the doors open, some are forced to close down.

Representatives from supply companies are stopping by the office hoping to get an order for even the smallest quantity of materials. The new truck and tools that the owner purchased during the boom now sit idle and represent additional debt and costs. The company’s remaining work comes from people who have decided to fix up
their existing homes because the economy isn't good enough for them to buy new ones. The owner increases his advertising budget, hoping to capture any business that might be had. He is optimistic that Normal Maintenance will weather this economic storm—they've done it before—but he's worried about his employees paying their bills over the winter.

The owner of Normal Maintenance has been in business for a long time, so he's had some experience with the economic cycle. Though each stage has its stressors, he has learned to plan for them. One thing he knows is that the economy will eventually begin to expand again and run through the cycle all over again.

KEY TAKEAWAYS

- Business cycles are identified as having four distinct phases: peak, trough, contraction, and expansion.
- Business cycle fluctuations occur around a long-term growth trend and are usually measured by considering the growth rate of real gross domestic product.
- In the United States, it is generally accepted that the National Bureau of Economic Research (NBER) is the final arbiter of the dates of the peaks and troughs of the business cycle.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.
Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=76
Summary

In this module you learned about the fundamental principles of economics and how they shape the business environment. Below is a summary of the key points covered.

What Is Economics?

Economics focuses on the ways in which people, businesses, and governments make decisions when faced with scarce resources. Economists study the economy at either the microeconomic level (focus on individuals) or the macroeconomic level (focus on systems).

Forces Behind Supply and Demand

Supply

Supply is the amount of a good or service that a business is willing to produce at a given price. Quantity supplied refers to a specific quantity that will be supplied at a single point (price) on the supply curve.
Demand

Demand is the amount that consumers are willing and able to purchase of a good or service at a given price. Quantity demanded is a specific quantity that will be supplied at a single point (price) on the demand curve.

Equilibrium

Equilibrium is said to exist at the point where quantity supplied equals the quantity demanded, and therefore there is no excess or shortage in the market. The market is “in balance.” The equilibrium price is the price where the amount that consumers want to purchase is equal to the quantity that the producers are willing to supply. The equilibrium quantity is the quantity supplied and demanded at the equilibrium price.

Ceteris Paribus

The Latin phrase means “other things being equal,” and it refers to economists’ habit of comparing only two things at a time. For example, if the price of a product increases, the quantity demanded will decrease, assuming that all other factors that affect demand are held constant. In the real world, of course, many things change at the same time, but comparing them all at once makes it difficult to determine the effect of any one factor.

Economic Systems

Economic systems can be organized as traditional, planned, or
market economies. Traditional systems are hunter-gatherer economies in which people consume what they produce. In command economies such as communism and socialism, the government exercises a high degree of control over production and pricing. In market economies such as capitalism, free-market supply and demand drives what is produced and consumed. The increasing complexity of the world has led to mixed economic systems that have characteristics of both command and market economies.

Health of the Economy

Economists use several measures to evaluate the health of an economy. Among the most important are GDP (Gross Domestic Product), the unemployment rate, and the CPI (Consumer Price Index). These three key economic indicators are used to measure how well the economy is achieving the goals of growth, high employment, and price stability.

Stages of the Business Cycle

The business environment is cyclical, meaning it goes through a cycle of stages, each of which is characterized by a different set of economic conditions. The four stages of the business environment are expansion, peak, contraction, and trough.
In this module you learned about the fundamental economic principles that affect the environment in which businesses operate. Understanding the economy is like getting the weather forecast before you head out the door. Might you need to pack a sweater or an umbrella or grab some sunscreen? Perhaps, like Dorothy in the Wizard of Oz, head for the nearest cellar? If you ignore the forecast, you can find yourself unprepared and caught in a storm. Of course economic forecasts aren’t totally reliable—sometimes there’s a freak weather event that no one saw coming. Nonetheless, having a basic understanding of how supply and demand work, how different economic systems function, and how the business cycle connects to the economy can help you make informed decisions—and make the best out of a rainy day.
PART IV
MODULE 3: BUSINESS ETHICS
Why It Matters: Business Ethics

Why illustrate the importance of ethical behavior and corporate social responsibility in business?

Turning on the news often brings images and reports of unethical practices in business. Recently, General Motors’ mishandling of safety recalls landed the CEO in front of a U.S. House subcommittee to answer questions about decisions inside the company that resulted in dozens of deaths and millions of recalls. How is it possible that highly educated corporate executives can make such unethical and sometimes criminal decisions?

Business psychologists use this (GM) case as an example of how managers can become blind to the morality of some of their decisions. Cognitive biases can distort ethical thinking and result in a situation the author Professor Ann Tenbrunsel calls “ethical fading.” It’s a condition that arises when decision-makers fail to recognize the moral and ethical components of their decisions. Tenbrunsel and her colleagues have concluded that we as a species are not nearly as ethical as we think we are. Some people will say ethics and morals are not things that can be taught. On the contrary, ethical decision-making requires deliberate thought and discipline (“Where were GM’s Ethics?”).

As you begin your study of ethical behavior and corporate social responsibility, consider the outcome of one of the largest corporate scandals in U.S. history shown in the video below:
Learning Outcomes

- Differentiate moral, legal and ethical behaviors
- Explain how ethical behavior impacts business decisions
- Identify ethical issues faced by organizations
- Define the process organizations use to establish a code of ethics to encourage ethical behavior
- Identify how organizations demonstrate social responsibility
- Explain how stakeholders shape a business’s approach to corporate social responsibility
58. Outcome: Moral, Legal, and Ethical Behavior

What you’ll learn to do: differentiate moral, legal, and ethical behaviors

Defining business ethics is challenging because, unlike laws, which are written down and usually predictable in application, ethics are norms that have evolved from our religious and cultural heritage and, as such, can be much harder to pin down or follow consistently.

In an excellent article written for the *Harvard Business Review*, Sir Adrian Cadbury, former chairman of Cadbury Schweppes PLC, summarizes the difficulty this way:

> The possibility that ethical and commercial considerations will conflict has always faced those who run companies. There is no simple, universal formula for solving ethical problems. We have to choose from our own codes of conduct whichever rules are appropriate to the case in hand; the outcome of those choices makes us who we are (quoted in “Ethics in Business: Not Always an Easy Road, But Always the Right One”).

You will learn more about this from the reading below.

LEARNING ACTIVITIES

The learning activities for this section include:

- Simulation: Ethics
• Reading: Moral, Ethical, and Legal Perspectives
• Self Check: Moral, Ethical, and Legal Behavior

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
59. Simulation: Ethics

Try It

Play the simulation below multiple times to see how different choices influence the outcome. All simulations allow unlimited attempts so that you can gain experience applying the concepts.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=81
Dr. Jack Kevorkian was both famous and infamous for championing the patient’s “right to die” through physician-assisted suicide. During his career he claimed to have helped at least 130 patients end their lives, believing that physicians (and society) have a moral obligation to help end the pain and suffering of the terminally ill. His work sparked a national debate on patients’ right to end their own life; some in the media portrayed him as “Dr. Death,” while others treated him as a hero of medicine and the spokesman of the dying. He once famously said, “Dying is not a crime.”

Kevorkian’s case (described below) raises some interesting questions about the nature of moral, ethical, and legal behavior in our society, but it also offers us a way to think about some of the differences between these ideas and how the tensions between them play out in the real world. Sometimes, acting in ways that are moral, ethical, and legal are one and the same thing. Other times—as Dr. Kevorkian’s story reveals—they’re not.

As you read the definitions below, see if you can think of examples from your own or others’ experience.
Moral Behavior

Morals are concerned with, or come from, an unwritten code of behavior concerning what’s right or acceptable in a particular society. Traditionally, morals have been the special province of religion and cultural groups.

Ethical Behavior

Ethics are a set of standards that govern the conduct of a person, especially a member of a profession. In the medical profession, for instance, doctors take an ethical oath to “do no harm.”

Legal Behavior

Legal behavior follows the dictates of laws, which are written down and interpreted by the courts. Interpretations can change over time (through new legal precedents, for example) and laws can change, as well. These changes are negotiated within our political and legal systems.

Using these as working definitions, let’s return to Dr. Kevorkian and consider a brief chronology of the events in his case:

- Kevorkian was tried four times for assisting suicides between May 1994 to June 1997. He was acquitted three times; the fourth trial ended in a mistrial.
- On the November 22, 1998, broadcast of CBS News’ 60 Minutes, Kevorkian allowed the airing of a videotape he made on September 17, 1998, which depicted the voluntary euthanasia of Thomas Youk, 52, who was in the final stages of Lou Gehrig’s Disease. After Youk provided his fully informed consent,
Kevorkian himself gave Thomas Youk a lethal injection. This was highly significant, as all of his earlier clients had reportedly performed this procedure on their own. Youk’s family described the lethal injection as humane, not murder.

- On March 26, 1999, Kevorkian was charged with second-degree murder and the delivery of a controlled substance (administering the lethal injection to Thomas Youk).
- After a two-day trial, the Michigan jury found Kevorkian guilty of second-degree homicide. Judge Jessica Cooper sentenced Kevorkian to 10–25 years in prison.
- After serving eight years, Kevorkian was paroled on June 1, 2007, on the condition that he not help anyone else die and not provide care for anyone with a disability or over the age of 62. He was also prohibited from publicly commenting on assisted suicide.
- On June 3, 2011, Dr. Kevorkian died of natural causes—not assisted suicide.

Moral Considerations

Although simplified here, much of the opposition to Kevorkian’s behavior on “moral grounds” centered on religious and cultural beliefs:

In his March 19, 2002, article “Opposing Assisted Suicide: More Americans Don’t Want Doctors to Help People Kill Themselves” (which appeared on the ABC website), Gary Langer, director of polling at ABC News, wrote:

“When it’s posed in broad strokes, 48 percent of Americans oppose legalizing assisted suicide, while 40 percent support it . . . A variety of factors inform these views, and religious belief is central among them. Non-Christians and people who profess no religion don’t want doctors to help people kill themselves.”
overwhelmingly support assisted suicide. But it’s opposed by most Christians, who account for 8 in 10 Americans, and especially by evangelical Christians, who oppose assisted suicide by a 2-1 margin.\textsuperscript{1}

Ethical Considerations

Dr. Kevorkian was a licensed physician until his license was revoked in 1991. Bound by the obligation to do no harm, Kevorkian acted in ways that other doctors and health-care workers considered injurious to their profession:

The American Medical Association (AMA), in an October 10, 1995, letter by then AMA General Counsel Kirk Johnson to then Michigan Attorney General Frank Kelley, stated the following:

By invoking the physician-patient relationship to cloak his actions, Jack Kevorkian perverts the idea of the caring and committed physician, and weakens the public’s trust in the medical profession.

The AMA establishes the Code of Ethics for the medical profession. One of the fundamental principles of that code is that physicians must not act with the intent of causing the death of their patients. Physician-assisted suicide is simply incompatible with the physician’s role as healer. When faced with patients who are terminally ill and suffering, physicians must

Legal Considerations

Laws change over time, reflecting changes in society. By 2014, four states had passed laws legalizing physician-assisted suicide. Although there is no federal law specifically prohibiting it, assisted suicide falls under the jurisdiction of the laws against homicide. How the law changes—or doesn’t change—is summarized here by the court's position:

In Washington v. Glucksberg, the U.S. Supreme Court declared in its June 26, 1997 ruling (9-0):

The history of the law’s treatment of assisted suicide in this country has been and continues to be one of the rejection of nearly all efforts to permit it. That being the case, our decisions lead us to conclude that the asserted “right” to assistance in committing suicide is not a fundamental liberty interest protected by the Due Process Clause.  

That was in 1997, but in 2014 a New Mexico judge made the following ruling:

In Morris v. New Mexico the New Mexico Second Judicial District in a January 13, 2014, ruling by Judge Nan Nash stated:

2. ProCon.org. (2010, April 26). "Did Dr. Jack Kevorkian Ethically Serve the Best Interests of His Patients?"

This Court cannot envision a right more fundamental, more private or more integral to the liberty, safety and happiness of a New Mexican than the right of a competent, terminally ill patient to choose aid in dying. If decisions made in the shadow of one's imminent death regarding how they and their loved ones will face that death are not fundamental and at the core of these constitutional guarantees, than what decisions are? As recognized by the United States Supreme Court in Cruzan “[t]he choice between life and death is a deeply personal decision of obvious and overwhelming finality. . . .”

The Court therefore declares that the liberty, safety, and happiness interest of a competent, terminally ill patient to choose aid in dying is a fundamental right under our New Mexico Constitution.

As the Kevorkian example shows, people take positions and make choices within different frameworks, and those frameworks, while overlapping, are not always perfectly aligned. The legal framework establishes laws that govern behavior; ethical frameworks contain sets of standards and rules governing the behavior of individuals within groups or professions; and morals concern fundamental beliefs about right and wrong behavior. As you will see in the rest of this module, when businesses try to “do the right” thing—by the law, by their shareholders, by their employees, by their customers and other stakeholders (for example, environmental groups)—there is often a complex interplay of moral, ethical, and legal considerations.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
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61. Outcome: Ethical Behavior in Business

What you’ll learn to do: explain how ethical behavior impacts business decisions

Most people have a moral compass that guides their decision-making and behavior. Since businesses are composed of people, it follows that within any one organization there can be a range of “compasses” guiding people's relationships and work—because what one employee considers to be right or wrong might not be the same as what her coworker or boss thinks. For that reason, it’s important for businesses to establish a strong set of moral and ethical standards that it requires all of its employees to meet. Conducting business according to those standards can keep the company on the “straight and narrow” and out of the headlines. In this section you will learn more about the impact of ethical and unethical behavior on business.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Ethical and Unethical Business Decisions
- Self Check: Ethical Behavior in Business

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
At the very beginning of this module you watched a video that showed two young, powerful, and ultimately criminal corporate executives from WorldCom head to jail. For many of you this story is probably either ancient news or just another exposé on corporate malfeasance. But it's worth learning a little more about what happened behind the scenes in order to see how unethical decisions get made—and by whom. It's often the executives who star in the headlines when such scandals break, since they carry the most responsibility for the company’s actions, but employees all the way down can play their role, too—by joining in, by caving to pressure from the top, or by refusing to play along.

“The one question Betty Vinson would rather avoid is “Mommy, why do you have to go to jail?” Vinson graduated with an accounting degree from Mississippi State and married her college sweetheart. After a series of jobs at small banks, she landed a midlevel accounting job at WorldCom, at the time still a small long-distance provider. Sparked by the telecom boom, however, WorldCom soon became a darling of Wall Street, and its stock price soared. Now working for a wildly successful company, Vinson rounded out her life by reading legal thrillers and watching her twelve-year-old daughter play soccer.
Her moment of truth came in mid-2000, when company executives learned that profits had plummeted. They asked Vinson to make some accounting adjustments to boost income by $828 million. She knew that the scheme was unethical (at the very least) but gave in and made the adjustments. Almost immediately, she felt guilty and told her boss that she was quitting. When news of her decision came to the attention of CEO Bernard Ebbers and CFO Scott Sullivan, they hastened to assure Vinson that she’d never be asked to cook any more books. Sullivan explained it this way: “We have planes in the air. Let’s get the planes landed. Once they’ve landed, if you still want to leave, then leave. But not while the planes are in the air.” Besides, she’d done nothing illegal, and if anyone asked, he’d take full responsibility. So Vinson decided to stay. After all, Sullivan was one of the top CFOs in the country; at age thirty-seven, he was already making $19 million a year. Who was she to question his judgment?

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

By spring 2002, however, it was obvious that adjusting the books was business as usual at WorldCom. Vinson finally decided that it was time to move on, but, unfortunately, an internal auditor had already put two and two together and blown the whistle. The Securities and Exchange Commission charged WorldCom with fraud amounting to $11 billion—the largest in U.S. history. Seeing herself as a valuable witness, Vinson was eager to tell what she knew. The government, however, regarded her as more than a mere witness. When she was named a co-conspirator, she agreed to
cooperate fully and pleaded guilty to criminal conspiracy and securities fraud. And that’s why Betty Vinson spent five months in jail. But she wasn’t the only one doing time: Scott Sullivan—who claimed he was innocent—got sentenced to jail for five years, and Bernie Ebbers—who swore he was innocent also—got locked up for twenty-five years.

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

Misgoverning Corporations

The WorldCom situation is not an isolated incident.

- In fall 2001, executives at Enron, an energy supplier, admitted to accounting practices concocted to overstate the company’s income over a period of four years. In the wake of the company’s collapse, stock prices plummeted from $90 to $1 a share, inflicting massive financial losses on the investment community. Thousands of employees lost not only their jobs but their retirement funds, as well.
- Officials at Adelphia, the nation’s sixth-largest cable company, disclosed that founder and CEO John Rigas had treated the publicly owned firm as a personal piggy bank, siphoning off billions of dollars to support his family’s extravagant lifestyle and bankrupting the company in the process.
- CEO Dennis Koslowzki of conglomerate Tyco International...
was apparently confused about what was his and what belonged to the company. Besides treating himself to a $30 million estate in Florida and a $7 million Park Avenue apartment, Koslowzki indulged in a taste for expensive office accessories—such as a $15,000 umbrella stand, a $17,000 traveling toilette box, and a $2,200 wastebasket—that eventually drained $600 million from company coffers.

- Bernie Madoff, founder of Bernard L. Madoff Investment Securities, is alleged to have run a giant Ponzi scheme that cheated investors out of up to $65 billion. Madoff convinced investors to give him large sums of money. In return, he gave them an impressive 8 percent to 12 percent return a year. But Madoff never really invested their money. Instead, he kept it for himself. Thousands of investors, including many of his wealthy friends, not-so-rich retirees who trusted him with their life savings, and charitable foundations, were financially ruined. All those harmed by Madoff either directly or indirectly were pleased when he was sentenced to jail for 150 years.

Are these cases merely aberrations? Why do such incidents happen (and with such apparent regularity)? Who are the usual suspects? How long until the next corporate bankruptcy record is set? What action can be taken—by individuals, organizations, and the government—to discourage such behavior?

The Idea of Business Ethics

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

Let's begin this section by addressing one of the questions that
we posed previously: What can individuals, organizations, and government agencies do to foster an environment of ethical and socially responsible behavior in business? First, of course, we need to define two terms: business ethics and social responsibility. They're often used interchangeably, but they don't mean the same thing.

What Is Ethics?

You probably already know what it means to be ethical: to know right from wrong and to know when you’re practicing one instead of the other. At the risk of oversimplifying, then, we can say that business ethics is the application of ethical behavior in a business context. Acting ethically in business means more than simply obeying applicable laws and regulations: It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your company, its owners, and its workers. If you're in business you obviously need a strong sense of what's right and what's wrong (not always an easy task). You need the personal conviction to do what's right, even if it means doing something that's difficult or personally disadvantageous.

What Is Social Responsibility?

Corporate social responsibility deals with actions that affect a variety of parties in a company’s environment. A socially responsible company shows concern for its stakeholders—anyone who, like owners, employees, customers, and the communities in which it does business, has a “stake” or interest in it. We'll discuss corporate responsibility later in this module. At this point, we'll focus on ethics.
How Can You Recognize an Ethical Organization?

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

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

Whether you work for a business or for a nonprofit organization, you probably have a sense of whether your employer is ethical or unethical. Employees at companies that consistently make Business Ethics magazine’s list of the “100 Best Corporate Citizens” regard the items on the previous list as business as usual in the workplace. Companies that routinely win good-citizenship awards include Procter & Gamble, Hewlett-Packard, Intel, Avon Products, Cisco Systems, and Merck.

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

• They consistently feel uneasy about the work they do.
• They object to the way they’re treated.
• They’re uncomfortable about the way coworkers are treated.
• They question the appropriateness of management directives and policies.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

63. Outcome: Identifying Ethical Issues

What you’ll learn to do: identify ethical issues faced by organizations

Each day organizations and the individuals who work there make hundreds of decisions ranging from small (Do you call in sick in order to spend the day at the beach?) to large (Can we overstate our income for this quarter to raise our stock price?). Each decision has an ethical implication because the decisions we make impact not only ourselves but those around us. The result of an unethical decision even at the very lowest level in the organization is like tossing a stone into a pond—it creates a ripple effect. In this section, you will learn about some of the most common ethical issues faced by organizations and their employees.

LEARNING ACTIVITIES

The learning activities for this section include:
- Reading: Identifying Ethical Issues
- Self Check: Identifying Ethical Issues

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
64. Reading: Identifying Ethical Issues

Identifying Ethical Issues

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

- Is it OK to accept a pair of sports tickets from a supplier?
- Can I buy office supplies from my brother-in-law?
- Is it appropriate to donate company funds to my local community center?
- If I find out that a friend is about to be fired, can I warn her?
- Will I have to lie about the quality of the goods I'm selling?
- Can I take personal e-mails and phone calls at work?
- What do I do if I discover that a coworker is committing fraud?

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

Bribes vs. Gifts

It's not uncommon in business to give and receive small gifts of appreciation. But when is a gift unacceptable? When is it really a
bribe? If it’s OK to give a bottle of wine to a corporate client during the holidays, is it OK to give a case of wine? If your company is trying to get a big contract, is it appropriate to send a gift to the key decision maker? If it’s all right to invite a business acquaintance to dinner or to a ball game, is it also all right to offer the same person a fully paid weekend getaway?

There's often a fine line between a gift and a bribe. The questions that we’ve just asked, however, may help in drawing it, because they raise key issues in determining how a gesture should be interpreted: the cost of the item, the timing of the gift, the type of gift, and the connection between the giver and the receiver. If you're on the receiving end, it's a good idea to refuse any item that's overly generous or given for the purpose of influencing a decision. But because accepting even small gifts may violate company rules, the best advice is to check on company policy.

JCPenney’s “Statement of Business Ethics,” for instance, states that employees can't accept any cash gifts or any noncash gifts except those that have a value below $50 and that are generally used by the giver for promotional purposes. Employees can attend paid-for business functions, but other forms of entertainment, such as sports events and golf outings, can be accepted only if it’s practical for the Penney’s employee to reciprocate. Trips of several days can't be accepted under any circumstances. (JCPenney Co. “Statement of Business Ethics for Associates and Officers: The ‘Spirit' of This Statement,” accessed April 24, 2006).

Conflicts of Interest

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

What should you do? You should probably disclose the connection to your boss, who can then arrange things so that your personal interests don’t conflict with the company’s. You may, for example, agree that if you’re assigned to order products like those that your uncle makes, you’re obligated to find another supplier. Or your boss may make sure that someone else orders bakery products.

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

## Conflicts of Loyalty

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

**Issues of Honesty and Integrity**

Master investor Warren Buffet once told a group of business students the following:

> I cannot tell you that honesty is the best policy. I can’t tell you that if you behave with perfect honesty and integrity somebody somewhere won’t behave the other way and make more money. But honesty is a good policy. You'll do fine, you'll sleep well at night, and you'll feel good about the example you are setting for your coworkers and the other people who care about you.

Quoted by Adrian Gostick and Dana Telford, *The Integrity Advantage* (Salt Lake City: Gibbs Smith, 2003), 103.

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

Think about this story:

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

Adapted from Adrian Gostick and Dana Telford, The Integrity Advantage (Salt Lake City: Gibbs Smith, 2003), 16.

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

KEY TAKEAWAYS

- When you enter the business world, you’ll find yourself in situations in which you’ll have to choose the appropriate behavior.
- You’ll need to know how to distinguish a bribe from an acceptable gift.
- You’ll encounter situations that give rise to a conflict of interest—situations in which you’ll have to choose between taking action that promotes your personal interest and action that favors the interest of others.
- Sometimes you’ll be required to choose between loyalty to your employer and loyalty to a friend or family member.
- In business, as in all aspects of your life, you should act with honesty and integrity.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count
toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=86
65. Outcome: Corporate Ethics

What you’ll learn to do: define the process organizations use to establish a code of ethics to encourage ethical behavior

Whether you work for a business or for a nonprofit organization, you probably have a sense of whether your employer is ethical or unethical. Employees at companies that consistently make Business Ethics magazine’s list of the “100 Best Corporate Citizens” regard the items on the previous list as business as usual in the workplace. Companies that routinely win good-citizenship awards include Procter & Gamble, Hewlett-Packard, Intel, Avon Products, Cisco Systems, and Merck. How these companies develop sound corporate ethics and an environment in which ethical behavior can flourish is the subject of this next section.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Organizational Approach to Ethics
- Self Check: Corporate Ethics

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
66. Reading: The Organizational Approach to Ethics

The Organizational Approach to Ethics

Ethics is more than a matter of individual behavior; it's also about organizational behavior. Employees' actions aren't based solely on personal values alone: They're influenced by other members of the organization, from top managers and supervisors to coworkers and subordinates. So how can ethical companies be created and sustained? In this section, we'll examine some of the most reasonable answers to this question.

How to Create and Sustain Ethical Companies

As an Employee

How, as an employee, can you maintain an ethical position? A few rules of thumb can guide you. We've summed them up in Figure 1, “How to Maintain Honesty and Integrity,” below:
Figure 1. How to Maintain Honesty and Integrity

Whistle-Blowing

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

As a result of Cooper’s actions, executives came clean about the company’s financial situation. The conspiracy of fraud was brought to an end, and though public disclosure of WorldCom’s problems resulted in massive stock-price declines and employee layoffs, investor and employee losses would have been greater without Cooper’s intervention. Even though Cooper did the right thing, the experience wasn’t exactly gratifying. A lot of people applauded her action, but many coworkers shunned her; some even blamed her for the company’s troubles. She’s never been thanked by any senior executive at WorldCom.

Refusing to Rationalize

Despite all the good arguments in favor of doing the right thing, why do many reasonable people act unethically (at least at times)? Why
do good people make bad choices? According to one study, there are four common rationalizations for justifying misconduct¹:

1. **My behavior isn’t really illegal or immoral.** Rationalizers try to convince themselves that an action is OK if it isn’t downright illegal or blatantly immoral. They tend to operate in a gray area where there’s no clear evidence that the action is wrong.

2. **My action is in everyone’s best interests.** Some rationalizers tell themselves: “I know I lied to make the deal, but it’ll bring in a lot of business and pay a lot of bills.” They convince themselves that they’re expected to act in a certain way, forgetting the classic parental parable about jumping off a cliff just because your friends are².

3. **No one will find out what I’ve done.** Here, the self-questioning comes down to “If I didn’t get caught, did I really do it?” The answer is yes. There’s a simple way to avoid succumbing to this rationalization: Always act as if you’re being watched.

4. **The company will condone my action and protect me.** This justification rests on a fallacy. Betty Vinson may honestly have believed that her actions were for the good of the company and that her boss would, therefore, accept full responsibility (as he promised). When she went to jail, however, she went on her own.

Here’s another rule of thumb: If you find yourself having to

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rationalize a decision, it’s probably a bad one. Over time, you’ll develop and hone your ethical decision-making skills.

So, how do organizations establish a culture of ethics from the “top down”?

**Ethical Leadership**

Organizations have unique cultures—ways of doing things that evolve through shared values and beliefs. An organization’s culture is strongly influenced by senior executives, who tell members of the organization what’s considered acceptable behavior and what happens if it’s violated. In theory, the tone set at the top of the organization promotes ethical behavior, but sometimes (as at Enron) it doesn’t.

Before its sudden demise, Enron fostered a growth-at-any-cost culture that was defined by the company’s top executives. Said one employee, “It was all about taking profits now and worrying about the details later. The Enron system was just ripe for corruption.” Coupled with the relentless pressure to generate revenue—or at least to look as if you were generating it—was a climate that discouraged employees from questioning the means by which they were supposed to do it. There may have been chances for people to speak up, but no one did. “I don’t think anyone started out with a plan to defraud the company,” reflects another ex-employee. “Everything at Enron seemed to start out right, but somewhere something slipped. People’s mentality switched from focusing on the future good of the company to ‘let’s just do it today.’”  

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Leaders should keep in constant touch with subordinates about ethical policies and expectations. They should be available to help employees identify and solve ethical problems, and should encourage them to come forward with concerns. They're responsible for minimizing opportunities for wrongdoing and for exerting the controls needed to enforce company policies. They should also think of themselves as role models. Subordinates look to their supervisors to communicate policies and practices regarding ethical behavior, and as a rule, actions speak more loudly than words: If managers behave ethically, subordinates will probably do the same.

This is exactly the message that senior management at Martin Marietta (now a part of Lockheed Martin) sent to members of their organization. A leading producer of construction components, the company at the time was engaged in a tough competitive battle over a major contract. Because both Martin Marietta and its main competitor were qualified to do the work, the job would go to the lower bid. A few days before bids were due, a package arrived at Martin Marietta containing a copy of the competitor’s bid sheet (probably from a disgruntled employee trying to sabotage his or her employer’s efforts). The bid price was lower than Martin Marietta’s. In a display of ethical backbone, executives immediately turned the envelope over to the government and informed the competitor. No, they didn't change their own bid in the meantime, and, no, they didn't get the job. All they got was an opportunity to send a clear message to the entire organization.  

By the same token, leaders must be willing to hold subordinates

accountable for their conduct and to take appropriate action. The response to unethical behavior should be prompt and decisive. One CEO of a large company discovered that some of his employees were “Dumpster diving” in the trash outside a competitor’s offices (which is to say, they were sifting around for information that would give them a competitive advantage). The manager running the espionage operation was a personal friend of the CEO’s, but he was immediately fired, as were his “operatives.” The CEO then informed his competitor about the venture and returned all the materials that had been gathered. Like the top managers at Martin Marietta, this executive sent a clear message to people in his organization: namely, that deviations from accepted behavior would not be tolerated.5

It’s always possible to send the wrong message. In August 2004, newspapers around the country carried a wire-service story titled “Convicted CEO Getting $2.5 Million Salary While He Serves Time.” Interested readers found that the board of directors of Fog Cutter Capital Group had agreed to pay CEO Andrew Wiederhorn (and give him a bonus) while he served an eighteen-month federal-prison term for bribery, filing false tax returns, and financially ruining his previous employer (from which he’d also borrowed $160 million). According to the board, they couldn’t afford to lose a man of Wiederhorn’s ability. The entire episode ended up on TheStreet.com’s list of “The Five Dumbest Things on Wall Street This Week.”6

Tightening the Rules

In response to the recent barrage of corporate scandals, more large companies have taken additional steps to encourage employees to behave according to specific standards and to report wrongdoing. Even companies with excellent reputations for integrity have stepped up their efforts.
Codes of Conduct

Like many firms, Hershey Foods now has a formal code of conduct: a document describing the principles and guidelines that all employees must follow in the course of all job-related activities. It’s available on the company intranet and in printed form and, to be sure that everyone understands it, the company offers a training program. The Hershey code covers such topics as the use of corporate funds and resources, conflict of interest, and the protection of proprietary information. It explains how the code will be enforced, emphasizing that violations won’t be tolerated. It encourages employees to report wrongdoing and provides instructions on reporting violations (which are displayed on posters and printed on wallet-size cards). Reports can be made through a Concern Line, by e-mail, or by regular mail; they can be anonymous; and retaliation is also a serious violation of company policy.7

KEY TAKEAWAYS

• At some point in your career, you might become aware of wrongdoing on the part of others and will have to decide whether to report the incident and become a whistle-blower—an individual who exposes illegal or unethical behavior in an organization.
• Despite all the good arguments in favor of doing the right thing, some businesspeople still act unethically (at least at times). Sometimes they use one of the following rationalizations to justify their conduct:

The behavior isn't really illegal or immoral.
The action is in everyone's best interests.
No one will find out what I've done.
The company will condone my action and protect me.

- Ethics is more than a matter of individual behavior; it's also about organizational behavior. Employees’ actions aren’t based solely on personal values; they’re also influenced by other members of the organization.
- Organizations have unique cultures—ways of doing things that evolve through shared values and beliefs.
- An organization’s culture is strongly influenced by top managers, who are responsible for letting members of the organization know what’s considered acceptable behavior and what happens if it’s violated.
- Subordinates look to their supervisors as role models of ethical behavior. If managers act ethically, subordinates will probably do the same.
- Those in positions of leadership should hold subordinates accountable for their conduct and take appropriate action.
- Many organizations have a formal code of conduct that describes the principles and guidelines that all members must follow in the course of job-related activities.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingtheprogram.org/
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What you’ll learn to do: identify how organizations demonstrate social responsibility

Corporate social responsibility (CSR) is a phrase and a concept that didn’t come into existence until the 1960s. CSR policy functions as a self-regulatory mechanism whereby a business monitors and ensures its active compliance with the spirit of the law, ethical standards, and international norms. With some models, a firm’s implementation of CSR goes beyond compliance and engages in “actions that appear to further some social good, beyond the interests of the firm and that which is required by law.”

CSR aims to embrace responsibility for corporate actions and to encourage a positive impact on the environment and stakeholders including consumers, employees, investors, communities, and others.

Before reading about CSR, let’s look at an example of a company

and its CEO that have become synonymous with corporate social responsibility.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=89

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Corporate Social Responsibility
- Self Check: Corporate Social Responsibility

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Corporate Social Responsibility

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

Figure 1 presents a model of corporate responsibility based on a company’s relationships with its stakeholders. In this model, the focus is on managers—not owners—as the principals involved in all these relationships. Here, owners are the stakeholders who invest risk capital in the firm in expectation of a financial return. Other stakeholders include employees, suppliers, and the communities in which the firm does business. Proponents of this model hold that customers, who provide the firm with revenue, have a special claim on managers’ attention. The arrows indicate the two-way nature of
corporation-stakeholder relationships: All stakeholders have some claim on the firm's resources and returns, and it's management's job to make decisions that balance these claims.

![Figure 1. The Corporate Citizen](image)

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

**Owners**

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

**Fiduciary Responsibilities**

Finally, managers have a fiduciary responsibility to owners: They’re responsible for safeguarding the company’s assets and handling its funds in a trustworthy manner. This is a responsibility that was ignored by top executives at both Adelphia and Tyco, whose associates and families virtually looted company assets. To enforce managers’ fiduciary responsibilities for a firm’s financial statements and accounting records, the Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to attest to their accuracy. The law also imposes penalties on corporate officers, auditors, board members, and any others who commit fraud.

**Employees**

Companies are responsible for providing employees with safe, healthy places to work—as well as environments that are free from sexual harassment and all types of discrimination. They should also offer appropriate wages and benefits. In the following sections, we’ll take a closer look at each of these areas of responsibility.
Though it seems obvious that companies should guard workers’ safety and health, a lot of them simply don’t. For over four decades, for example, executives at Johns Manville suppressed evidence that one of its products, asbestos, was responsible for the deadly lung disease developed by many of its workers. The company concealed chest X-rays from stricken workers, and executives decided that it was simply cheaper to pay workers’ compensation claims (or let workers die) than to create a safer work environment. A New Jersey court was quite blunt in its judgment: Johns Manville, it held, had made a deliberate, cold-blooded decision to do nothing to protect at-risk workers, in blatant disregard of their rights.

About four in one hundred thousand U.S. workers die in workplace “incidents” each year. The Department of Labor categorizes deaths caused by conditions like those at Johns Manville as “exposure to harmful substances or environments.” How prevalent is this condition as a cause of workplace deaths? See Figure 2, above, which breaks down workplace fatalities by cause. Some jobs are more dangerous than others. For a comparative

Figure 2. Workplace Deaths by Event or Exposure, 2010
For most people, fortunately, things are better than they were at Johns Manville. Procter & Gamble (P&G), for example, considers the safety and health of its employees paramount and promotes the attitude that “Nothing we do is worth getting hurt for.” With nearly one hundred thousand employees worldwide, P&G uses a measure of worker safety called “total incident rate per employee,” which records injuries resulting in loss of consciousness, time lost from work, medical transfer to another job, motion restriction, or medical treatment beyond first aid. The company attributes the low rate of such incidents—less than one incident per hundred employees—to a variety of programs to promote workplace safety.

**Freedom from Sexual Harassment**

What is sexual harassment? The law is quite precise:

- Sexual harassment occurs when an employee makes
“unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature” to another employee who doesn’t welcome the advances.

• It’s also sexual harassment when “submission to or rejection of this conduct explicitly or implicitly affects an individual's employment, unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment.”

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

**Equal Opportunity and Diversity**

People must be hired, evaluated, promoted, and rewarded on the basis of merit, not personal characteristics. This, too, is the law—namely, Title VII of the 1964 Civil Rights Act. Like most companies, P&G has a formal policy on hiring and promotion that forbids discrimination based on race, color, religion, gender, age, national origin, citizenship, sexual orientation, or disability. P&G expects all employees to support its commitment to equal
employment opportunity and warns that those who violate company policies will face strict disciplinary action, including termination of employment.

Equal Pay and the Wage Gap

The Equal Pay Act of 1963 requires equal pay for both men and women in jobs that entail equal skill, equal effort, equal responsibility, or similar working conditions. What has been the effect of the law after forty years? In 1963, women earned, on average, $0.589 for every $1 earned by men. By 2010, that difference—which we call the wage gap—has been closed to $0.812 to $1, or approximately 81 percent. Figure 4, below, provides some interesting numbers on the differences in annual earnings based not only on gender but on race, as well. Figure 5 throws further light on the wage and unemployment gap when education is taken into consideration.

![Figure 4. Median Annual Earnings by Gender and Race](image-url)
What accounts for the difference, despite the mandate of federal law? For one thing, the jobs typically held by women tend to pay less than those typically held by men. In addition, men often have better job opportunities. For example, a man newly hired at the same time as a woman will often get a higher-paying assignment at the entry level. Coupled with the fact that the same sort of discrimination applies when it comes to training and promotions, women are usually relegated to a lifetime of lower earnings.

Figure 5. Median Annual Earnings by Level of Education. Education pays in higher earnings and lower unemployment rates. Note: Data are 2010 annual averages for persons age 25 and over. Earnings are for full-time wage and salary workers. Source: Bureau of Labor Statistics, Current Population Survey.

Building Diverse Workforces

In addition to complying with equal employment opportunity laws, many companies make special efforts to recruit employees who are underrepresented in the workforce according to sex, race, or some other characteristic. In helping to build more diverse workforces, such initiatives contribute to competitive advantage for two reasons: (1) People from diverse backgrounds bring new talents and fresh perspectives to an organization, typically enhancing creativity
in the development of new products. (2) By reflecting more accurately the changing demographics of the marketplace, a diverse workforce improves a company’s ability to serve an ethnically diverse population.

### Wages and Benefits

At the very least, employers must obey laws governing minimum wage and overtime pay. A minimum wage is set by the federal government, though states can set their own rates. The current federal rate, for example, is $7.25, while the rate in the state of Washington is $8.67. When there’s a difference, the higher rate applies. By law, employers must also provide certain benefits—social security (which provides retirement benefits), unemployment insurance (which protects against loss of income in case of job loss), and workers’ compensation (which covers lost wages and medical costs in case of on-the-job injury). Most large companies pay most of their workers more than minimum wage and offer considerably broader benefits, including medical, dental, and vision care, as well as pension benefits.

### Customers

The purpose of any business is to satisfy customers, who reward businesses by buying their products. Sellers are also responsible—both ethically and legally—for treating customers fairly. The rights of consumers were first articulated by President John F. Kennedy in 1962 when he submitted to Congress a presidential message devoted to consumer issues. Kennedy identified four consumer rights:
1. **The right to safe products.** A company should sell no product that it suspects of being unsafe for buyers. Thus, producers have an obligation to safety-test products before releasing them for public consumption. The automobile industry, for example, conducts extensive safety testing before introducing new models (though recalls remain common).

2. **The right to be informed about a product.** Sellers should furnish consumers with the product information that they need to make an informed purchase decision. That’s why pillows have labels identifying the materials used to make them, for instance.

3. **The right to choose what to buy.** Consumers have a right to decide which products to purchase, and sellers should let them know what their options are. Pharmacists, for example, should tell patients when a prescription can be filled with a cheaper brand-name or generic drug. Telephone companies should explain alternative calling plans.

4. **The right to be heard.** Companies must tell customers how to contact them with complaints or concerns. They should also listen and respond.

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

**Communities**

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

Financial Contributions

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

Volunteerism

Many companies support employee efforts to help local communities. Patagonia, for example, a maker of outdoor gear and clothing, lets employees leave their jobs and work full-time for any environmental group for two months—with full salary and benefits; so far, more than 850 employees have taken advantage of the program.
Supporting Social Causes

Companies and executives often take active roles in initiatives to improve health and social welfare in the United States and elsewhere. Microsoft’s former CEO Bill Gates intends to distribute more than $3 billion through the Bill and Melinda Gates Foundation, which funds global health initiatives, particularly vaccine research aimed at preventing infectious diseases, such as polio, in undeveloped countries. Noting that children from low-income families have twice as many cavities and often miss school because of dental-related diseases, P&G invested $1 million a year to set up “cavity-free zones” for 3.3 million economically disadvantaged children at Boys and Girls Clubs nationwide. In addition to giving away toothbrushes and toothpaste, P&G provided educational programs on dental hygiene. At some locations, the company even maintained clinics providing affordable oral care to poor children and their families. Proctor & Gamble recently committed to provide more than two billion liters of clean drinking water to adults and children living in poverty in developing countries. The company believes that this initiative will save an estimated ten thousand lives.

KEY TAKEAWAYS

- **Corporate social responsibility** refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions.
- Companies are socially responsible to their various stakeholders—owners, employees, customers, and the communities in which they conduct business.
- Owners invest money in companies. In return, the people who manage companies have a responsibility to increase the value
of owners’ investments through profitable operations.

- Managers have a responsibility to provide owners and other stakeholders with accurate, reliable financial information.
- They also have a **fiduciary responsibility** to safeguard the company's assets and handle its funds in a trustworthy manner.
- Companies have a responsibility to guard workers’ safety and health and to provide them with a work environment that's free from sexual harassment.
- Businesses should pay appropriate wages and benefits, treat all workers fairly, and provide equal opportunities for all employees.
- Many companies have discovered the benefits of valuing diversity. People with diverse backgrounds bring new talents and fresh perspectives, and improve a company’s ability to serve an ethically diverse population.
- Sellers are responsible—both ethically and legally—for treating customers fairly. Consumers have certain rights: to use safe products, to be informed about products, to choose what to buy, and to be heard.
- Companies also have a responsibility to the communities in which they produce and sell their products. The economic impact of businesses on local communities is substantial.

Companies have the following functions:

- Provide jobs
- Pay taxes
- Support local education, health, and recreation activities
- Donate funds to community projects
- Encourage employees to volunteer their time
- Donate equipment and products for a variety of activities
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=90
69. Outcome: Stakeholders and Social Responsibility

What you’ll learn to do: explain how stakeholders shape a business’s approach to corporate social responsibility

As you’ll call from an earlier module, the list of business stakeholders ranges from consumers to governments. These groups have vested interests in the business that go beyond financial matters—stakeholders can also influence the organization’s role as a good corporate citizen. Many large companies have come under stakeholder scrutiny for “lapses in corporate social responsibility.” The issues that stakeholders raise range from the working conditions of employees to product safety. In some cases, stakeholders have called for businesses to be accountable for practices that, although legal, cross the line of ethical practice.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Demands for Corporate Social Responsibility
- Reading: Stakeholder Theory and Corporate Social Responsibility
- Self Check: Stakeholders and Social Responsibility

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
70. Reading: Demands for Corporate Social Responsibility

Stakeholder Pressure

Most of the pressure on businesses/corporations in the last twenty-five years has come from shareholders. More recently, however, a different source of pressure—the demand for corporate social responsibility (CSR)—has emerged, which is forcing directors into new governance territory occupied by stakeholders other than shareholders. While pressure on corporate executives to pay greater attention to stakeholder concerns and make CSR an integral part of corporate strategy has been mounting since the early 1990s, such pressure is only now beginning to filter through to the board of directors who are responsible for making decisions for the corporation.

The emergence of CSR as a more prominent item on a board's agenda reflects a shift in popular opinion about the role of business in society and the convergence of environmental forces, such as the following:

Globalization

There are now more than 60,000 multinational corporations estimated to be in the world (World Investment Report, 2004). Perceptions about the growing reach and influence of global companies have drawn attention to the impact of business on
society. This has led to heightened demands for corporations to take responsibility for the social, environmental, and economic effects of their actions. It has also spawned more aggressive demands for corporations to set their sights on limiting harm and actively seeking to improve social, economic, and environmental circumstances.

Loss of Trust

High-profile cases of corporate financial misdeeds (Enron, WorldCom, and others) and of social and environmental irresponsibility (e.g., Shell's alleged complicity in political repression in Nigeria; Exxon's oil spill in Prince William Sound in Alaska; Nike's and other apparel makers' links with “sweatshop” labor in developing countries; questions about Nestlé's practices in marketing baby formula in the developing world) have contributed to a broad-based decline in trust in corporations and corporate leaders. The public's growing reluctance to give corporations the benefit of the doubt has led to intensified scrutiny of corporate impact on society, the economy, and the environment, and a greater readiness to assume—rightly or wrongly—immoral corporate intent.

Civil Society Activism

The growing activity and sophistication of “civil society” organizations, many of which are oriented to social and environmental causes, have generated pressure on corporations to take CSR seriously. The International Chamber of Commerce, a global advocacy group for the private sector, observed in 2000 that “non-governmental organizations have gained an enormous
influence” over corporate decision making, as quoted in Barrington.\(^1\) Well-known international nongovernmental organizations (NGOs), such as Oxfam, Amnesty International, Greenpeace, the Rainforest Action Network, and the Fair Labor Association, have influenced corporate decision making in areas such as access to essential medicines, labor standards, environmental protection, and human rights. The advent of the Internet has increased the capacity of these organizations—as well as a plethora of national and local civic associations—to monitor corporate behavior and mobilize public opinion. “Civil society” is sometimes described as the part of society that exists between the state and the market. A more formal definition is “the voluntary association of citizens, promoting their values and interests in the public domain,” according to Saxby and Schacter.\(^2\) Kaldor, Anheier, and Glasius\(^3\) estimate that there are approximately 48,000 international nongovernmental organizations (NGOs) and that total membership in international NGOs grew by about 70% between 1990 and 2000.

**Institutional Investor Interest in CSR**

The growth in “socially responsible investing” has created institutional demand for equity in corporations that demonstrate a commitment to CSR. Recent growth in assets involved in socially responsible investing has outpaced growth in all professionally managed investment assets in the United States, even though the mainstream financial community has been slow to incorporate nonfinancial factors into its analyses of corporate value.\(^{“Big}

2. 2003, p. 4.
investors want SRI research: European institutions to allocate part of brokers’ fees to ‘nontraditional’ information.”

These trends indicate that there is both a growing perception that corporations must be more accountable to society for their actions and a growing willingness and capacity within society to make corporations accountable. These developments have profound implications for the future of corporate governance, suggesting that boards will have to deal with many of the following:

- a growing pressure to give stakeholders a role in corporate governance;
- a growing pressure on corporations to disclose more and better information about their management of social, environmental, and economic issues;
- an increasing level of regulatory compulsion related to elements of corporate activity that are currently regarded as voluntary forms of social responsibility;
- a growing interest by the mainstream financial community in the link between shareholder value and nonfinancial corporate performance.

The discussion about corporate accountability to stakeholders, therefore, while often couched in the vocabulary of CSR, is really a discussion about the changing definition of corporate governance, which is why it should receive a greater priority on the board's agenda.

Interestingly, whereas board agendas mostly focus on competition, cooperation may well become the preferred business strategy for addressing social and environmental issues. Increasingly, companies are joining forces not only with business competitors but also with human rights and environmental activists (formerly considered enemies), as well as socially responsible

investors, academics, and governmental organizations. At the World Economic Forum (WEF) gathering, for example, two such coalitions were announced to address the issue of global online freedom of expression, particularly in repressive regimes. One, facilitated by Business for Social Responsibility (BSR), consists of companies facing intense criticism over complicity with suppressing online free speech in China. This coalition includes big names, such as Google, Microsoft, and Yahoo. The others gathered together socially responsible investing firms and human rights advocates, such as Amnesty International, Human Rights Watch, and Reporters Without Borders.
Stakeholder Theory

Instead of starting with a business and looking out into the world to see what ethical obligations are there, stakeholder theory starts in the world. It lists and describes those individuals and groups who will be affected by (or affect) the company’s actions and asks, “What are their legitimate claims on the business?” “What rights do they have with respect to the company’s actions?” and “What kind of responsibilities and obligations can they justifiably impose on a particular business?” In a single sentence, stakeholder theory affirms that those whose lives are touched by a corporation hold a right and obligation to participate in directing it.

Corporate Social Responsibility

As a simple example, when a factory produces industrial waste, a CSR perspective attaches a responsibility directly to factory owners to dispose of the waste safely. By contrast, a stakeholder theorist begins with those living in the surrounding community whose environment might be poisoned and begins to talk about business ethics by insisting that they have a right to clean air and water. In other words the community members are stakeholders in the company and their voices must contribute to corporate decisions. It’s true that they may own no stock, but they have a moral claim
to being involved in the decision-making process. This is a very important point. At least in theoretical form, those affected by a company's actions actually become something like shareholders and owners. Because they're touched by a company's actions, they have a right to participate in managing it.

Who are the stakeholders surrounding companies? The answer depends on the particular business, but the list can be quite extensive. If the enterprise produces chemicals for industrial use and is located in a small Massachusetts town, the stakeholders include:

- Company owners, whether a private individual or shareholders
- Company workers
- Customers and potential customers of the company
- Suppliers and potential suppliers to the company
- Everyone living in the town who may be affected by contamination from workplace operations
- Creditors whose money or loaned goods are mixed into the company's actions
- Government entities involved in regulation and taxation
- Local businesses that cater to company employees (restaurants where workers have lunch, grocery stores where employee families shop, and similar)
- Other companies in the same line of work competing for market share
- Other companies that may find themselves subjected to new and potentially burdensome regulations because of contamination at that one Massachusetts plant

The first five on the list—shareholders, workers, customers, suppliers, and community—may be cited as the five cardinal stakeholders.

In an abstract sense, it's probably true that everyone in the world counts as a stakeholder of any sizable factory—we all breathe the same air, and because the global economy is so tightly linked,
decisions made in a boardroom in a small town on the East Coast can end up costing someone in India her job.

Once a discrete set of stakeholders surrounding an enterprise has been located, stakeholder ethics may begin. The purpose of the firm, underneath this theory, is to maximize profit on a collective bottom line, with profit defined not as money but as human welfare. The collective bottom line is the total effect of a company’s actions on all stakeholders. Company managers, that means, are primarily charged not with representing the interests of shareholders (the owners of the company) but with the more social task of coordinating the interests of all stakeholders, balancing them in the case of conflict, and maximizing the sum of benefits over the medium and long term. Corporate directors, in other words, spend part of the day just as directors always have: explaining to board members and shareholders how it is that the current plans will boost profits. They spend other parts of the day, however, talking with other stakeholders about their interests: they ask for input from local environmentalists about how pollution could be limited, they seek advice from consumers about how product safety could be improved, and so on. At every turn, stakeholders are treated (to some extent) like shareholders, as people whose interests need to be served and whose voices have real power.

In many cases transparency is an important value for those promoting stakeholder ethics. The reasoning is simple: if you’re going to let every stakeholder actively participate in a corporation’s decision making, then those stakeholders need to have a good idea about what’s going on.

What’s certain is that stakeholder theory obligates corporate directors to appeal to all sides and balance everyone’s interests and welfare in the name of maximizing benefits across the spectrum of those whose lives are touched by the business.

Consider the role concept of social responsibility had on Starbucks as you watch this video:
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=93
72. Putting It Together: Business Ethics

Summary

In this module you learned about the importance of ethical behavior and corporate social responsibility in business. Below is a summary of the key points that were covered.

Moral, Legal, and Ethical Behavior

Standards of moral, ethical and legal behavior are intertwined but are separate “codes” arising from different sources. Legality comes from legislation or case law that establishes standards of behaviors—illegal behavior may be punished by fines, imprisonment, or both. Morals are concerned with the principles of right and wrong, often from a religious standpoint. Ethics is a branch of philosophy that deals with the study of morals; it can also refer to standards of conduct for professional groups.

Ethical Behavior in Business

Businesses and organizations possess a set of ethical standards just like people. When we refer to “business ethics” we are referring to the culture, attitudes, or actions governing “right vs. wrong.”
Identifying Ethical Issues

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

Corporate Ethics

Corporate ethics is a set of standards and expectations for behavior by the organization and its employees. Most organizations have a formal code of ethics that guide the decisions and actions of the company.

Corporate Social Responsibility

Corporate social responsibility (CSR) refers to actions that businesses take or refrain from taking based on the impact of those actions on the external environment and community. Areas of CSR include environmental concerns (green business), poverty, human rights, and animal rights.

Stakeholders and Social Responsibility

Today, businesses are realizing the importance of CSR in attracting and maintaining employees and customers. Stakeholders are demanding that businesses give back to the larger community in which they operate. Examples of stakeholder and social
responsibility can be seen at companies such as Toms Shoes and Coca-Cola.

Synthesis

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

MODULE 4:
ENTREPRENEURSHIP
Why It Matters: Entrepreneurship

Why explain the concepts of entrepreneurship and entrepreneurial thinking as they apply to small business?

What do all of the following have in common?

They all represent the efforts of entrepreneurs! What if you couldn’t fly to DisneyWorld and see the lights from Cinderella’s Castle shining after sunset as you rode Space Mountain? For some of you this might not be a great loss, but think of all of the other things...
you use and rely on in your daily life that are the result of an entrepreneur's willingness to step up and take a risk. Are you using an iPhone or did you Google anything today? Have you eaten at Wendy’s lately, perhaps on your way to the Ford dealership after you stopped at WalMart to pick up a lightbulb for your desk lamp? In the same way that we are surrounded by the fruits of business labor, we are the beneficiaries of the hard work, dedication, and fearlessness of men and women across the centuries who have taken the plunge and become entrepreneurs. In this module, you'll learn about some of these individuals as well as some of the steps it takes to launch your own business venture. Are you ready to be inspired? Please read on!

Learning Outcomes

• Identify the role entrepreneurs (past and present) play in small businesses and economic growth
• Identify the characteristics of an entrepreneur and explain how these characteristics contribute to business success
• Identify the opportunities and challenges of starting a business
• Describe the steps necessary to start a business
• Identify and describe the essential components of a business plan
• Explain why entrepreneurial ventures fail
74. Outcome: The Role of Entrepreneurs

What you’ll learn to do: identify the role entrepreneurs (past and present) play in small businesses and economic growth

Entrepreneurs are the fuel that drive small businesses and, in turn, much of the U.S. and world’s economies. Their creativity and willingness to take a risk or follow a dream generate jobs, personal wealth, and national economic prosperity. No doubt you recognize the product shown below:

But . . . did you know that it originated here?
Believe it or not, Henry Ford gave us not only the Ford Motor Company but also Kingsford Charcoal. Henry Ford learned of a process for turning wood scraps from the production of Model Ts into charcoal briquets. So, he built a charcoal plant—and the rest is history. Read more about it here, and find out more about the role of entrepreneurs in the economy from the learning activity below.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Importance of Small Business to the U.S. Economy
- Self Check: The Role of Entrepreneurs

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
75. Reading: The Importance of Small Business to the U.S. Economy

What Is a “Small Business”?

To assess the value of small businesses to the U.S. economy, first we need to know what constitutes a small business. Let’s start by looking at the criteria used by the Small Business Administration. According to the SBA, a small business is one that is independently owned and operated, exerts little influence in its industry, and (with a few exceptions) has fewer than five hundred employees (“What is SBA’s Definition of a Small Business Concern?,” U.S. Small Business Administration, accessed August 28, 2011).

Why Are Small Businesses Important?

Small business constitutes a major force in the U.S. economy. There are more than twenty-seven million small businesses in this country, and they generate about 50 percent of our gross domestic product (GDP). The millions of individuals who have started businesses in the United States have shaped the business world as we know it today. Some small business founders like Henry Ford and Thomas Edison have even gained places in history. Others, including Bill Gates (Microsoft), Sam Walton (Wal-Mart), Steve Jobs (Apple Computer), Michael Dell (Dell, Inc.), Steve Case (AOL), Pierre Omidyar (eBay), and Larry Page and Sergey Brin (Google), have
changed the way business operates today. Still millions of others have collectively contributed to our standard of living.

Aside from contributions to our general economic well-being, founders of small businesses also contribute to growth and vitality in specific areas of economic and socioeconomic development. In particular, small businesses do the following:

- Create jobs
- Spark innovation
- Provide opportunities for many people, including women and minorities, to achieve financial success and independence

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

Let’s take a closer look at each of these contributions.

**Job Creation**

The majority of U.S. workers first entered the business world working for small businesses. According to the U.S. Small Business Administration:

“The United States’ 28.4 million small businesses play a vital role in our economy,” said Christine Kymn, Advocacy’s chief economist and director of economic research. “Small businesses represent 99.7 percent of all U.S. businesses with employees and employ about 56 million members of the nation’s private-sector workforce. The Office of Advocacy notes that this year’s state profiles signal improving conditions for small businesses and in turn, their respective state economies. We hope to see further improvements in 2015” (SBA, Small Business Advocate, February, 2015 Vol. 34 Issue 2).
On January 15, 2015, Maria Contreras-Sweet, SBA Administrator reported the following in regard to job creation and small business:

American businesses added back 252,000 jobs and the unemployment rate fell to its lowest level since June 2008. We’re in the midst of 58 month of consecutive job growth—the longest streak on record since the mid-1990s. Once again, it was not large corporations driving this train, but entrepreneurs and small businesses powering us out of the greatest economic crisis since the Great Depression. Small businesses created nearly 2 million of the roughly 3 million private-sector jobs generated in 2014. More than 7 million of the 11 million jobs created during our recovery have been generated by startups and small enterprises. . . . Entrepreneurs have been our life preserver in this economic storm, because of their resilience in budgeting wisely and effectively deploying their capital.
Innovation

Given the financial resources available to large businesses, you’d expect them to introduce virtually all the new products that hit the market. According to the SBA, small companies develop more patents per employee than do larger companies. During a recent four-year period, large firms generated 1.7 patents per hundred employees, whereas small firms generated an impressive 26.5 patents per employee (Anthony Breitzman and Diana Hicks, “An Analysis of Small Business Patents by Industry and Firm Size, Office of Advocacy, Small Business Administration,” U.S. Small Business Administration, accessed August 30, 2011). Over the years, the list of important innovations by small firms has included the airplane and air-conditioning, the defibrillator and DNA fingerprinting, oral contraceptives and overnight national delivery, the safety razor, strobe lights, and the zipper (William J. Baumol, “Small Firms: Why Market-Driven Innovation Can’t Get Along without Them,” U.S. Small Business Administration, Office of Advocacy, December 2005, table 8.1, 186, accessed October 10, 2008).

Small business owners are also particularly adept at finding new ways of doing old things. In 1994, for example, a young computer-science graduate working on Wall Street came up with the novel idea of selling books over the Internet. During the first year of operations, sales at Jeff Bezos’s new company—Amazon.com—reached half a million dollars. In less than twenty years, annual sales had topped $34 billion.
Why are small businesses so innovative? For one thing, they tend to offer environments that appeal to individuals with the talent to invent new products or improve the way things are done. Fast decision making is encouraged, their research programs tend to be focused, and their compensation structures typically reward top performers. According to one SBA study, the supportive environments of small firms are roughly thirteen times more innovative per employee than the less innovation-friendly environments in which large firms traditionally operate (William J. Baumol, “Small Firms: Why Market-Driven Innovation Can't Get Along without Them,” U.S. Small Business Administration, Office of Advocacy, December 2005, accessed October 10, 2008, p 187).

The success of small businesses in fostering creativity has not gone unnoticed by big businesses. In fact, many large companies
have responded by downsizing to act more like small companies. Some large organizations now have separate work units whose purpose is to spark innovation. Individuals working in these units can focus their attention on creating new products that can then be developed by the company.

Opportunities for Women and Minorities

Small business is the portal through which many people enter the economic mainstream. Business ownership allows individuals, including women and minorities, to achieve financial success, as well as pride in their accomplishments. While the majority of small businesses are still owned by white males, the past two decades have seen a substantial increase in the number of businesses owned by women and minorities.

### Table 1. Demographics of All United States Businesses, 2011

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of All Businesses</th>
<th>Share of All Businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male Owned</td>
<td>14,454,000</td>
<td>51.3%</td>
</tr>
<tr>
<td>Woman Owned</td>
<td>8,086,000</td>
<td>28.7%</td>
</tr>
<tr>
<td>Equally Male and Female Owned</td>
<td>4,790,000</td>
<td>17.0%</td>
</tr>
<tr>
<td>Minority Owned</td>
<td>5,989,000</td>
<td>21.3%</td>
</tr>
<tr>
<td>Veteran Owned</td>
<td>2,536,000</td>
<td>9.0%</td>
</tr>
</tbody>
</table>

What Small Businesses Do for Big Businesses

Small firms complement large firms in a number of ways. They supply many of the components needed by big companies. For example, the U.S. automakers depend on more than 1,700 suppliers to provide them with the parts needed to make their cars. While many of the suppliers are large, there are hundreds of smaller companies that provide a substantial portion of the 8,000 to 12,000 parts that go into each vehicle (Bill Canis and Brent D. Yacobucci, “The U.S. Motor Vehicle Industry: Confronting a New Dynamic in the Global Economy, Congressional Research Service,” Federation of American Scientists, accessed August 30, 2011). Small firms also provide large ones with such services as accounting, legal, and insurance. Many small firms provide outsourcing services to large firms—that is, they hire themselves out to help with special projects or handle certain business functions. A large firm, for example, might hire a small one to handle its billing or collection services or to manage its health care benefits. A large company might contract with a small information technology firm to manage its Web site or oversee software upgrades.

Small companies provide another valuable service to large companies by acting as sales agents for their products. For example, automobile dealerships, which are generally small businesses, sell vehicles for the big car makers. Local sporting goods stores sell athletic shoes made by industry giants, such as Adidas and Nike. Your corner deli sells products made by large companies, such as Coca-Cola and Frito-Lay.

KEY TAKEAWAYS

- According to the SBA, a small business is independently owned and operated, exerts little influence in its industry, and
(with minimal exceptions) has fewer than five hundred employees.

- The nearly twenty-seven million small businesses in the United States generate about 50 percent of our GDP. They also contribute to growth and vitality in several important areas of economic and socioeconomic development. In particular, small businesses do the following:
  - Create jobs
  - Spark innovation
  - Provide opportunities for women and minorities to achieve financial success and independence

- Small businesses tend to foster environments that appeal to individuals with the talent to invent new products or improve the way things are done. They typically make faster decisions, their research programs often are focused, and their compensation structures frequently reward top performers.

- Small firms supply many of the components needed by big companies. They also provide large firms with such services as accounting, legal, and insurance, and many provide outsourcing services to large companies—that is, they hire themselves out to help with special projects or handle certain business functions. Small companies (such as automotive dealerships) often act as sales agents for the products of large businesses (for example, car makers).

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count
toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=98
76. Outcome: Characteristics of Entrepreneurs

What you’ll learn to do: identify the characteristics of an entrepreneur and explain how these characteristics contribute to business success

What distinguishes people like Jeff Bezos, Mark Zuckerberg, and Steve Jobs from the rest of us? What is it about them that made them take on the challenge of starting their own business? What we know from extensive research is that entrepreneurs share a common set of traits or personality characteristics such as being driven, self-motivated, and possessing a high tolerance for risk. In this section we will look more closely at what makes an entrepreneur, and then you can decide if you possess some of those characteristics.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: What Is an Entrepreneur?
- Reading: Why Start Your Own Business?
- Self Check: Characteristics of Entrepreneurs

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
What Is an Entrepreneur?

We are going to start our discussion of what an entrepreneur is by taking a look at one: David Fox. As you will see, for this schoolteacher, board games aren’t just a hobby—they’re a way of life. David Fox travels to toy fairs pitching his ideas in hopes of landing a deal that will turn his big dreams into reality.
The Nature of Entrepreneurship

If we look a little more closely at the definition of entrepreneurship, we can identify three characteristics of entrepreneurial activity (adapted from Marc J. Dollinger, *Entrepreneurship: Strategies and Resources*, 3rd ed, Upper Saddle River, NJ: Prentice Hall, 2003, pp 5–7):

1. **Innovation.** Entrepreneurship generally means offering a new product, applying a new technique or technology, opening a new market, or developing a new form of organization for the purpose of producing or enhancing a product.

2. **Starting a business.** A business combines resources to produce goods or services. Entrepreneurship means setting up a business to make a profit.

3. **Risk taking.** The term risk means that the outcome of the entrepreneurial venture can’t be known. Entrepreneurs, therefore, are always working under a certain degree of uncertainty, and they can’t know the outcomes of many of the decisions that they have to make. Consequently, many of the steps they take are motivated mainly by their confidence in the innovation and in their understanding of the business environment in which they’re operating.

It isn’t hard to recognize all three of these characteristics in the entrepreneurial experience of the Jurmains. They certainly had an innovative idea. But was it a good business idea? In a practical sense, a “good” business idea has to become something more than just an idea. If, like the Jurmains, you’re interested in generating income from your idea, you’ll probably need to turn it into a product—something that you can market because it satisfies a need. If—again, like the Jurmains—you want to develop a product, you’ll need some kind of organization to coordinate the resources necessary to make it a reality (in other words, a business). Risk
enters the equation when, like the Jurmains, you make the decision to start up a business and when you commit yourself to managing it.

A Few Things to Know About Going into Business for Yourself

So what about you? Do you ever wonder what it would be like to start your own business? Maybe you want to try your hand at entrepreneurship. You could be the next Larry Page or Sergey Brin, cofounders of Google. Or the next David Marcks, a golf course manager who came up with the idea of Geese Police—training dogs to chase geese from golf courses, corporate parks, and municipal playgrounds (Isabel M. Isidro, “Geese Police: A Real-Life Home Business Success Story,” PowerHomeBiz.com (2008), accessed August 31, 2011). Or even the next Pierre Omidyar, the French-born software developer who built an online venue for person-to-person auctions, known as eBay. (See American Academy of Achievement, “Pierre Omidyar,” Academy of Achievement (November 9, 2005), accessed October 8, 2008).

You might even turn into a “serial entrepreneur” like Marcia Kilgore (Encyclopedia of World Biography, s.v. “Marcia Kilgore: Entrepreneur and spa founder,” accessed August 29, 2011). After high school, she moved from Canada to New York City to attend Columbia University. But when her financial aid was delayed, she abandoned her plans to attend college and took a job as a personal trainer (a natural occupation for

Mark Zuckerberg founded Facebook while a student at Harvard and, by age 27, has built up a personal wealth of $13.5 billion. Photo by Robert Scoble via Wikimedia Commons.
a former bodybuilder and middleweight title holder). But things got boring in the summer when her wealthy clients left the city for the Hamptons. To keep busy, she took a skin-care course at a Manhattan cosmetology institute. As a teenager, she was self-conscious about her bad complexion and wanted to know how to treat it herself. She learned how to give facials and work with natural remedies. Her complexion improved, and she started giving facials to her fitness clients who were thrilled with the results. As demand for her services exploded, she started her first business—Bliss Spa—and picked up celebrity clients, including Madonna, Oprah Winfrey, and Jennifer Lopez. The business went international, and she sold it for more than $30 million (Jessica Bruder, “The Rise Of The Serial Entrepreneur,” Forbes, August 12, 2010, accessed August 29, 2011).

But the story doesn't end here; she didn't just sit back and enjoy her good fortune. Instead, she launched two more companies: Soap and Glory, a supplier of affordable beauty products sold at Target, and FitFlops, which sells sandals that tone and tighten your leg muscles as you walk. And by the way, remember how Oprah loved Kilgore’s skin care products? She also loves Kilgore's sandals and plugged them on her talk show. You can't get a better endorsement than that. Kilgore never did finish college, but when asked if she would follow the same path again, she said, “If I had to decide what to do all over again, I would make the same choice . . . I found by accident what I’m good at, and I’m glad I did.”

For the sake of argument, let’s say that you would like to know a little more about going into business for yourself—in which case, you'll want some answers to questions like the following:

- Should I start a business?
- What are the advantages and disadvantages of starting a business?
- How do I come up with a business idea?
- Should I build a business from scratch, buy an existing business, or invest in a franchise?
• How do I go about planning a business?
• What steps are involved in developing a business plan?
• Where would I find help in getting my business started and operating it through the start-up phase?
• How can I increase the likelihood that I’ll succeed?

In this section, we’ll provide some answers to questions like these.
Why Start Your Own Business?

Let’s say that you are interested in the idea of going into business for yourself. Not everyone, of course, has a desire to take the risks and put in the work involved in starting up a business. What sort of characteristics distinguishes those who do from those who don’t want to start a business? Or, more to the point, why do some people actually follow through on the desire to start up their own businesses? According to the Small Business Administration (SBA), a government agency that provides assistance to small businesses, the most common reasons for starting a business are the following (U.S. Small Business Administration, “First Steps: How to Start a Small Business,” accessed April 21, 2006):

- To be your own boss
- To accommodate a desired lifestyle
- To achieve financial independence
- To enjoy creative freedom
- To use your skills and knowledge

The Small Business Administration points out, though, that these are likely to be advantages only “for the right person.” And how do you know if you’re one of the “right people”? The SBA suggests that you assess your strengths and weaknesses by asking yourself a few relevant questions (U.S. Small Business Administration, “Is Entrepreneurship for You?” accessed August 31, 2011).

- Am I a self-starter? You’ll need to develop and follow through
on your ideas. You'll need to be able to organize your time.

- **How well do I get along with different personalities?** You'll need to develop working relationships with a variety of people, including unreliable vendors and sometimes cranky customers.
- **How good am I at making decisions?** You'll be making decisions constantly—often under pressure.
- **Do I have the physical and emotional stamina?** Can you handle six or seven workdays of as long as twelve hours every week?
- **How well do I plan and organize?** If you can't stay organized, you'll get swamped by the details. In fact, poor planning is the culprit in most business failures.
- **Is my drive strong enough?** You'll need to be highly motivated to withstand bad periods in your business, and simply being responsible for your business’s success can cause you to burn out.
- **How will my business affect my family?** Family members need to know what to expect before you begin a business venture, such as financial difficulties and a more modest standard of living.

Later we'll take up the question of why businesses fail, but since we're still talking about the pros and cons of starting a business in the first place, we should consider one more issue: in addition to the number of businesses that start and then fail, a huge number of business ideas never even make it to the grand opening. One business analyst cites four reservations (or **fears**) that prevent people from starting businesses (Shari Waters, “Top Four Reasons People Don’t Start a Business,” About.com, accessed October 8, 2008):

- **Money.** Granted, without the cash, you can’t get very far. **What to do:** Conduct some research to find out where funding is available.
- **Security.** A lot of people don’t want to sacrifice the steady income that comes with the nine-to-five job. **What to do:** Don’t
give up your day job. At least at first, think about hiring someone to run your business while you’re gainfully employed elsewhere.

- **Competition.** A lot of people don’t know how to distinguish their business ideas from similar ideas. What to do: Figure out how to do something cheaper, faster, or better.

- **Lack of ideas.** Some people simply don’t know what sort of business they want to get into. What to do: Find out what trends are successful. Turn a hobby into a business. Think about a franchise.

If you’re still interested in going into business for yourself, feel free to regard these potential drawbacks as mere obstacles than can be overcome by a combination of planning and creative thinking. The following short video is an example of the entrepreneurial spirit triumphing over such challenges.

A YouTube element has been excluded from this version of the text. You can view it online here:
KEY TAKEAWAYS

• An entrepreneur is someone who identifies a business opportunity and assumes the risk of creating and running a business to take advantage of it.

• There are three characteristics of entrepreneurial activity:
  ◦ Innovating. An entrepreneur offers a new product, applies a new technique or technology, opens a new market, or develops a new form of organization for the purpose of producing or enhancing a product.
  ◦ Running a business. Entrepreneurship means setting up a business to make a profit from an innovative product or process.
  ◦ Risk taking. Risk means that an outcome is unknown. Entrepreneurs, therefore, are always working under a certain degree of uncertainty, and they can't know the outcomes of many of the decisions that they have to make.

• According to the SBA, a government agency that provides assistance to small businesses, there are five advantages to starting a business—"for the right person“:
  ◦ Be your own boss.
  ◦ Accommodate a desired lifestyle.
  ◦ Achieve financial independence.
  ◦ Enjoy creative freedom.
  ◦ Use your skills and knowledge.

• To determine whether you're one of the “right people” to
exploit the advantages of starting your own business, the SBA suggests that you assess your strengths and weaknesses by asking yourself the following questions:

- Am I a self-starter?
- How well do I get along with different personalities?
- How good am I at making decisions?
- Do I have the physical and emotional stamina?
- How well do I plan and organize?
- Is my drive strong enough?
- How will my business affect my family?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=101
79. Outcome: Opportunities and Challenges

What you’ll learn to do: identify the opportunities and challenges of starting a business

So, are you inspired to become an entrepreneur yet? Before you run out and start handing out business cards, it’s wise to take a step back and consider not just the opportunities but also the challenges of starting a business. In this section you will explore some of the advantages and disadvantages to small business ownership in greater depth and have a chance to evaluate more thoroughly whether starting a business is the right choice for you.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Advantages and Disadvantages of Business Ownership
• Reading: Is Entrepreneurship for You?
• Reading: Twenty Questions Before Starting a Business
• Self Check: Opportunities and Challenges

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Advantages of Small Business Ownership

Do you want to be a business owner someday? Before deciding, you might want to consider the following advantages and disadvantages of business ownership (Small Business Development Center, “Pros and Cons of Owning a Business,” accessed April 21, 2006).

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

- **Independence.** As a business owner, you’re your own boss. You can’t get fired. More important, you have the freedom to make the decisions that are crucial to your own business success.

- **Lifestyle.** Owning a small business gives you certain lifestyle advantages. Because you’re in charge, you decide when and where you want to work. If you want to spend more time on nonwork activities or with your family, you don’t have to ask for the time off. If it’s important that you be with your family all day, you might decide to run your business from your home. Given today’s technology, it’s relatively easy to do. Moreover, it eliminates commuting time.

- **Financial rewards.** In spite of high financial risk, running your own business gives you a chance to make more money than if you were employed by someone else. You benefit from your own hard work.
• Learning opportunities. As a business owner, you'll be involved in all aspects of your business. This situation creates numerous opportunities to gain a thorough understanding of the various business functions.

• Creative freedom and personal satisfaction. As a business owner, you'll be able to work in a field that you really enjoy. You'll be able to put your skills and knowledge to use, and you'll gain personal satisfaction from implementing your ideas, working directly with customers, and watching your business succeed.

Disadvantages of Small Business Ownership

As the little boy said when he got off his first roller-coaster ride, “I like the ups but not the downs!” Here are some of the risks you run if you want to start a small business:

• Financial risk. The financial resources needed to start and grow a business can be extensive. You may need to commit most of your savings or even go into debt to get started. If things don't go well, you may face substantial financial loss. In addition, there's no guaranteed income. There might be times, especially in the first few years, when the business isn't generating enough cash for you to live on.

• Stress. As a business owner, you are the business. There's a bewildering array of things to worry about—competition, employees, bills, equipment breakdowns, customer problems. As the owner, you're also responsible for the well-being of your employees.

• Time commitment. People often start businesses so that they'll have more time to spend with their families. Unfortunately, running a business is extremely time-consuming. In theory, you have the freedom to take time off, but in reality, you may
not be able to get away. In fact, you'll probably have less free
time than you'd have working for someone else. For many
entrepreneurs and small business owners, a forty-hour
workweek is a myth; see Figure 1, “The Entrepreneur’s
Workweek.” Vacations will be difficult to take and will often be
interrupted. In recent years, the difficulty of getting away from
the job has been compounded by cell phones, iPhones,
Internet-connected laptops and iPads, and many small
business owners have come to regret that they're always
reachable.

- **Undesirable duties.** When you start up, you'll undoubtedly be
responsible for either doing or overseeing just about
everything that needs to be done. You can get bogged down in
detail work that you don't enjoy. As a business owner, you'll
probably have to perform some unpleasant tasks, like firing
people.

In spite of these and other disadvantages, most small business
owners are pleased with their decision to start a business. A survey
conducted by the *Wall Street Journal* and Cicco and Associates
indicates that small business owners and top-level corporate
executives agree overwhelmingly that small business owners have a
more satisfying business experience. Interestingly, the researchers
had fully expected to find that small business owners were happy
with their choices; they were, however, surprised at the number of
corporate executives who believed that the grass was greener in
the world of small business ownership (Cicco and Associates Inc.,
“Type E Personality—Happy Days—Entrepreneurs Top Satisfaction
KEY TAKEAWAYS

• There are several advantages that, generally speaking, come with success in business ownership:
  ◦ Independence. As a business owner, you’re your own boss.
  ◦ Lifestyle. Because you’re in charge, you decide when and where you want to work.
  ◦ Financial rewards. In spite of high financial risk, running your own business gives you a chance to make more money than if you were employed by someone else.
  ◦ Learning opportunities. As a business owner, you’ll be involved in all aspects of your business.
  ◦ Creative freedom and personal satisfaction. As a business owner, you’ll be able to work in a field that you really enjoy, and you’ll gain personal satisfaction from watching your business succeed.

• There are also a number of potential disadvantages to consider in deciding whether to start a small business:
  ◦ Financial risk. The financial resources needed to start and grow a business can be extensive, and if things don’t go well, you may face substantial financial loss. In addition,
you'll have no guaranteed income.

- **Stress.** You'll have a bewildering array of things to worry about—competition, employees, bills, equipment breakdowns, customer problems.

- **Time commitment.** Running a business is extremely time-consuming. In fact, you'll probably have less free time than you'd have working for someone else.

- **Undesirable duties.** You'll be responsible for either doing or overseeing just about everything that needs to be done, and you'll probably have to perform some unpleasant tasks, like firing people.
Is Entrepreneurship for You?

Starting your own business can be an exciting and rewarding experience. It can offer numerous advantages such as being your own boss, setting your own schedule, and making a living doing something you enjoy. However, becoming a successful entrepreneur requires thorough planning, creativity, and hard work.

Consider whether you have the following characteristics and skills commonly associated with successful entrepreneurs:

- **Comfortable with taking risks:** Being your own boss also means you’re the one making tough decisions. Entrepreneurship involves uncertainty. Do you avoid uncertainty in life at all costs? If yes, then entrepreneurship may not be the best fit for you. Do you enjoy the thrill of taking calculated risks? Then read on.

- **Independent:** Entrepreneurs have to make a lot of decisions on their own. If you find you can trust your instincts — and you’re not afraid of rejection every now and then — you could be on your way to being an entrepreneur.

- **Persuasive:** You may have the greatest idea in the world, but if you cannot persuade customers, employees and potential lenders or partners, you may find entrepreneurship to be challenging. If you enjoy public speaking, engage new people with ease and find you make compelling arguments grounded in facts, it’s likely you’re poised to make your idea succeed.

- **Able to negotiate:** As a small business owner, you will need to negotiate everything from leases to contract terms to rates.
Polished negotiation skills will help you save money and keep your business running smoothly.

- **Creative:** Are you able to think of new ideas? Can you imagine new ways to solve problems? Entrepreneurs must be able to think creatively. If you have insights on how to take advantage of new opportunities, entrepreneurship may be a good fit.

- **Supported by others:** Before you start a business, it's important to have a strong support system in place. You'll be forced to make many important decisions, especially in the first months of opening your business. If you do not have a support network of people to help you, consider finding a business mentor. A business mentor is someone who is experienced, successful and willing to provide advice and guidance.
So you’ve got what it takes to be an entrepreneur? Now, ask yourself these twenty questions to make sure you’re thinking about the key business decisions:

1. Why am I starting a business?
2. What kind of business do I want?
3. Who is my ideal customer?
4. What products or services will my business provide?
5. Am I prepared to spend the time and money needed to get my business started?
6. What differentiates my business idea and the products or services I will provide from others in the market?
7. Where will my business be located?
8. How many employees will I need?
9. What types of suppliers do I need?
10. How much money do I need to get started?
11. Will I need to get a loan?
12. How soon will it take before my products or services are available?
13. How long do I have until I start making a profit?
14. Who is my competition?
15. How will I price my product compared to my competition?
16. How will I set up the legal structure of my business?
17. What taxes do I need to pay?
18. What kind of insurance do I need?
19. How will I manage my business?
20. How will I advertise my business?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=105
83. Outcome: Steps to Starting a Business

What you’ll learn to do: describe the steps necessary to start a business

Now it’s time to get down to the details of what you actually need to DO in order to start a business. The information contained in this section is a list of the best practices for doing that. The details, agencies, and contacts needed to accomplish these steps will vary from state to state and even city to city, so additional research may be required for a particular business or entrepreneur. Regardless of where you are located, though, the steps explained in this section will generally apply.
LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Ten Steps to Starting a Business
• Self Check: Steps to Starting a Business

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Ten Steps to Starting a Business

Starting a business involves planning, making key financial decisions, and completing a series of legal activities. These ten easy steps can help you plan, prepare, and manage your business.

Step 1: Write a Business Plan

A business plan generally contains the following parts (which we will expand on later):

- Executive Summary
- Company Description
- Market Analysis
- Organization and Management
- Service or Product Line
- Marketing and Sales
- Funding Request
- Financial Projections
- Appendix

Step 2: Get Business Assistance and Training

Take advantage of free training and counseling services, from
preparing a business plan and securing financing, to expanding or relocating a business.

Step 3: Choose a Business Location

Get advice on how to select a customer-friendly location and comply with zoning laws.

Choosing a business location is perhaps the most important decision a small business owner or startup will make, so it requires precise planning and research. It involves looking at demographics, assessing your supply chain, scoping the competition, staying on budget, understanding state laws and taxes, and much more.

Here are some tips to help you choose the right business location.

Determine Your Needs

Most businesses choose a location that provides exposure to customers. Additionally, there are less obvious factors and needs to consider, such as the following:

- **Brand Image**—Is the location consistent with the image you want to maintain?
- **Competition**—Are the businesses around you complementary or competing?
- **Local Labor Market**—Does the area have potential employees? What will their commute be like?
- **Plan for Future Growth**—If you anticipate further growth, look for a building that has extra space should you need it.
- **Proximity to Suppliers**—They need to be able to find you easily as well.
- **Safety**—Consider the crime rate. Will employees feel safe alone in the building or walking to their vehicles?
• **Zoning Regulations**—These determine whether you can conduct your type of business in certain properties or locations. You can find out how property is zoned by contacting your local planning agency.

**Evaluate Your Finances**

Besides determining what you can afford, you will need to be aware of other financial considerations:

- **Hidden Costs**—Very few spaces are business ready. Include costs like renovation, decorating, IT system upgrades, and so on.
- **Taxes**—What are the income and sales tax rates for your state? What about property taxes? Could you pay less in taxes by locating your business across a nearby state line?
- **Minimum Wage**—While the federal minimum wage is $7.25 per hour, many states have a higher minimum. View the Department of Labor's list of minimum wage rates by state.
- **Government Economic Incentives**—Your business location can determine whether you qualify for government economic business programs, such as state-specific small business loans and other financial incentives.

**Is the Area Business Friendly?**

Understanding laws and regulations imposed on businesses in a particular location is essential. As you look to grow your business, it can be advantageous to work with a small business specialist or counselor. Check what programs and support your state government and local community offer to small businesses. Many states offer online tools to help small business owners start up and
succeed. Local community resources such as SBA Offices, Small Business Development Centers, Women's Business Centers, and other government-funded programs specifically support small businesses.

The Bottom Line

Do your research. Talk to other business owners and potential co-tenants. Consult the small business community and utilize available resources, such as free government-provided demographic data, to help in your efforts.

Step 4: Finance Your Business

SBA offers a variety of loan programs for very specific purposes. Take some time to study the programs described on this website to learn more about which types of businesses qualify for different loans.

Step 5: Determine the Legal Structure of Your Business

Decide which form of ownership is best for you: sole proprietorship, partnership, Limited Liability Company (LLC), corporation, S corporation, nonprofit or cooperative.
Determine Your Federal Tax Obligations

When starting a business, you must decide what form of business entity to establish. Your form of business (e.g., sole proprietorship, partnership, LLC) determines which income tax return form you have to file. The federal government levies four basic types of business taxes:

- Income tax
- Self-employment tax
- Taxes for employers
- Excise taxes

To learn more about these taxes, visit the Internal Revenue Service's (IRS) Guide to Business Taxes.

**Federal Income Taxes**

Select the form of your business below to find out which federal tax forms you need to file:

- Sole Proprietorship
- Partnership
- Corporation
- S Corporation
- Limited Liability Company (LLC)

**State Income Taxes**

Nearly every state levies a business or corporate income tax. Like federal taxes, your state tax requirement depends on the legal structure of your business. For example, if your business is an LLC, the LLC is taxed separately from the owners of the business, while sole proprietors report their personal and business income taxes using the same form used to report their business taxes. Consult the General Tax Information link on the State and Local Tax Guide for specific requirements.
Step 6: Register a Business Name (“Doing Business As”)

Register your business name with your state government. Naming your business is an important branding exercise, but if you choose to name your business as anything other than your own personal name then you'll need to register it with the appropriate authorities. This process is known as registering your “Doing Business As” (DBA) name.

What is a “Doing Business As” Name?

A fictitious name (or assumed name, trade name or DBA name) is a business name that is different from your personal name, the names of your partners or the officially registered name of your LLC or corporation.

It’s important to note that when you form a business, the legal name of the business defaults to the name of the person or entity that owns the business, unless you choose to rename it and register it as a DBA name.

For example, consider this scenario: John Smith sets up a painting business. Rather than operate under his own name, John instead chooses to name his business: “John Smith Painting”. This name is considered an assumed name and John will need to register it with the appropriate local government agency.

The legal name of your business is required on all government forms and applications, including your application for employer tax IDs, licenses and permits.
Do I Need a “Doing Business As” Name?

A DBA is needed in the following scenarios:

- **Sole Proprietors or Partnerships** – If you wish to start a business under anything other than your real name, you'll need to register a DBA so that you can do business as another name.
- **Existing Corporations or LLCs** – If your business is already set up and you want to do business under a name other than your existing corporation or LLC name, you will need to register a DBA.

**Note**: Not all states require the registering of fictitious business names or DBAs.

**How to Register your “Doing Business As” Name**

Registering your DBA is done either with your county clerk's office or with your state government, depending on where your business is located. There are a few states that do not require the registering of fictitious business names.

**Step 7: Get a Tax Identification Number**

Learn which tax identification number you’ll need to obtain from the IRS and your state revenue agency. An Employer Identification Number (EIN) is also known as a Federal Tax Identification Number, and is used to identify a business entity. Generally, businesses need an EIN. You may apply for an EIN in various ways, and now you may apply online. You must check with your state to determine if you need a state number or charter. The following links will take you to the IRS's website for more information:
You can apply for an EIN online.

Step 8: Register for State and Local Taxes

Register with your state to obtain a tax identification number, workers’ compensation, unemployment and disability insurance.

Determine Your State Tax Obligations

In addition to business taxes required by the federal government, you will have to pay some state and local taxes. Each state and locality has its own tax laws. The links below provide access to key resources that will help you learn about your state tax obligations. Having knowledge of your state tax requirement can help you avoid problems and your business save money. The most common types of tax requirements for small business are income taxes and employment taxes.

Income Taxes

Nearly every state levies a business or corporate income tax. Your tax requirement depends on the legal structure of your business. For example, if your business is a Limited Liability Company (LLC), the LLC gets taxed separately from the owners, while sole proprietors report their personal and business income taxes using
the same form. Consult the General Tax Information link under your state for specific requirements.

**Employment Taxes**

In addition to federal employment taxes, business owners with employees are also responsible for paying certain taxes required by the state. All states require payment of state workers’ compensation insurance and unemployment insurance taxes. The following states/territories also require a business to pay for temporary disability insurance:

- California
- Hawaii
- New Jersey
- New York
- Rhode Island
- Puerto Rico
- State and Territory Tax Resources

Each state requires different steps and forms in order to register and be open for business. In general, you can look for these four things:

- Business Tax Registration
- General Tax Information and Forms
- Workers’ Compensation Insurance
- Unemployment Insurance Tax

**Step 9: Obtain Business Licenses and Permits**

Get a list of federal, state and local licenses and permits required for your business.
Federal Licenses and Permits

If your business is involved in activities supervised and regulated by a federal agency—such as selling alcohol, firearms, commercial fishing, etc.—then you may need to obtain a federal license or permit. Here is a brief list of business activities that require these forms and information on how to apply.

In addition, you can also discover which general business permits, licenses and registrations required by your state, county or city.

Agriculture

If you import or transport animals, animal products, biologics, biotechnology or plants across state lines, you'll need to apply for a permit from the U.S. Department of Agriculture (USDA).

Alcoholic Beverages

If you manufacture, wholesale, import, or sell alcoholic beverages at a retail location, you will need to register your business and obtain certain federal permits (for tax purposes) with the U.S. Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB). The website has a number of online tools that make this process straightforward. If you are just starting a business in this trade, start by reading the TTB's New Visitors Guide which offers helpful information for small business owners.

Remember, you will also need to contact your local Alcohol Beverage Control Board for local alcohol business permit and licensing information.

Aviation

Does your business involve the operation of aircraft; the transportation of goods or people via air; or aircraft maintenance? If so, you'll need to apply for one or more of the following licenses and certificates from the Federal Aviation Administration:

- FAA Licenses and Certificates – Get licensing information for airmen, aircraft, airports, airlines and medical aviation services.
- Pilot Licenses and Training Requirements
Aircraft Mechanic Licenses

Firearms, Ammunition, and Explosives

Businesses who manufacture, deal and import firearms, ammunitions and explosives must comply with the Gun Control Act’s licensing requirements. The Act is administered by the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF). Refer to the following resources from the ATF to make sure your business is properly licensed:

• Firearms Industry Guide – Includes information on obtaining and renewing a federal firearms license, importing firearms and ammunitions, and more.
• Explosives Industry Guide – Find out how to get a federal explosives license.
• How to Become a Federal Firearms Licensee (FFL)
• How to Become a Federal Explosives Licensee (FEL)

Fish and Wildlife

If your business is engaged in any wildlife related activity, including the import/export of wildlife and derivative products, must obtain an appropriate permit from the U.S. Fish and Wildlife Service.

Commercial Fisheries

Commercial fishing businesses are required to obtain a license for fishing activities from the NOAA Fisheries Service. This guide includes quick links to permit applications and information.

Maritime Transportation

If you provide ocean transportation or facilitate the shipment of cargo by sea, you'll need to apply here for a license from the Federal Maritime Commission.

Mining and Drilling

Businesses involved in the drilling for natural gas, oil or other mineral resources on federal lands may be required to obtain a drilling permit from the Bureau of Ocean Energy Management,
Regulation and Enforcement (formerly the Minerals Management Service).

**Nuclear Energy**
Producers of commercial nuclear energy and fuel cycle facilities as well as businesses involved in the distribution and disposal of nuclear materials must apply for a license from the U.S. Nuclear Regulatory Commission.

**Radio and Television Broadcasting**
If your business broadcasts information by radio, television, wire, satellite and cable, you may be required to obtain a license from The Federal Communications Commission (FCC).

**Transportation and Logistics**
If you operate an oversize or overweight vehicle, you'll need to abide by the U.S. Department of Transportation offers guidelines on maximum weight. Permits for oversize/overweight vehicles are issued by your state government.

**State Licenses and Permits**
Starting a business? Confused about whether you need a business license or permit?

Virtually every business needs some form of license or permit to operate legally. However, licensing and permit requirements vary depending on the type of business you are operating, where it's located, and what government rules apply.

To help you identify the specific licenses or permits your business may need, simply select a state from the list below to learn about specific license and permit requirements in the area where your business is located.
Step 10: Understand Employer Responsibilities

Learn the legal steps you need to take to hire employees. If your business is booming, but you are struggling to keep up, perhaps it’s time to hire some help.

The eight steps below can help you start the hiring process and ensure you are compliant with key federal and state regulations.

*Step 1: Obtain an Employer Identification Number (EIN)*

Before hiring your first employee, you need to get an employment identification number (EIN) from the U.S. Internal Revenue Service. The EIN is often referred to as an Employer Tax ID or as Form SS-4. The EIN is necessary for reporting taxes and other documents to the IRS. In addition, the EIN is necessary when reporting...
information about your employees to state agencies. Apply for EIN online or contact the IRS at 1-800-829-4933.

**Step 2: Set up Records for Withholding Taxes**

According to the IRS, you must keep records of employment taxes for at least four years. Keeping good records can also help you monitor the progress of your business, prepare financial statements, identify sources of receipts, keep track of deductible expenses, prepare your tax returns, and support items reported on tax returns.

Below are three types of withholding taxes you need for your business:

- **Federal Income Tax Withholding**—Every employee must provide an employer with a signed withholding exemption certificate (Form W-4) on or before the date of employment. The employer must then submit Form W-4 to the IRS. For specific information, read the IRS' Employer's Tax Guide [PDF].

- **Federal Wage and Tax Statement**—Every year, employers must report to the federal government wages paid and taxes withheld for each employee. This report is filed using Form W-2, wage and tax statement. Employers must complete a W-2 form for each employee who pays a salary, wage or other compensation.

Employers must send Copy A of W-2 forms to the Social Security Administration by the last day of February to report wages and taxes of your employees for the previous calendar year. In addition, employers should send copies of W-2 forms to their employees by Jan. 31 of the year following the reporting period.

- **State Taxes**—Depending on the state where your employees are located, you may be required to withhold state income
Step 3: Employee Eligibility Verification

Federal law requires employers to verify an employee’s eligibility to work in the United States. Within three days of hire, employers must complete Form I-9, employment eligibility verification, which requires employers to examine documents to confirm the employee's citizenship or eligibility to work in the U.S. Employers can only request documentation specified on the I-9 form.

Employers do not need to submit the I-9 form with the federal government but are required to keep them on file for three years after the date of hire or one year after the date of the employee's termination, whichever is later.

Employers can use information taken from the Form I-9 to electronically verify the employment eligibility of newly hired employees by registering with E-Verify.

Visit the U.S. Immigration and Customs Enforcement agency’s I-9 website to download the form and find more information.

Step 4: Register with Your State’s New Hire Reporting Program

All employers are required to report newly hired and re-hired employees to a state directory within 20 days of their hire or rehire date. Visit the New Hires Reporting Requirements page to learn more and find links to your state’s New Hire Reporting System.

Step 5: Obtain Workers’ Compensation Insurance

All businesses with employees are required to carry workers’
compensation insurance coverage through a commercial carrier, on a self-insured basis or through their state's Workers' Compensation Insurance program.

**Step 6: Post Required Notices**

Employers are required to display certain posters in the workplace that inform employees of their rights and employer responsibilities under labor laws. Visit the Workplace Posters page for specific federal and state posters you'll need for your business.

**Step 7: File Your Taxes**

Generally, employers who pay wages subject to income tax withholding, Social Security and Medicare taxes must file IRS Form 941, Employer's Quarterly Federal Tax Return. For more information, visit IRS.gov.

New and existing employers should consult the IRS Employer's Tax Guide to understand all their federal tax filing requirements.

Visit the state and local tax page for specific tax filing requirements for employers.

**Step 8: Get Organized and Keep Yourself Informed**

Being a good employer doesn't stop with fulfilling your various tax and reporting obligations. Maintaining a healthy and fair workplace, providing benefits and keeping employees informed about your company's policies are key to your business' success. Here are some additional steps you should take after you've hired your first employee:

**Set up Recordkeeping**

392 | Reading: Ten Steps to Starting a Business
In addition to requirements for keeping payroll records of your employees for tax purposes, certain federal employment laws also require you to keep records about your employees. Complying with standards for employee rights in regards to equal opportunity and fair labor standards is a requirement. Following statutes and regulations for minimum wage, overtime, and child labor will help you avoid error and a lawsuit. See the Department of Labor’s Employment Law Guide for up-to-date information on these statutes and regulations.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=107
85. Outcome: Business Plans

What you’ll learn to do: identify and describe the essential components of a business plan

No one plans to fail, but many individuals who start a small business fail to plan! Let’s go on a trip . . .

We decide that we are going to Malibu, which, according to our sign here, is 1,760 from wherever this sign is located. So, we grab our suitcases, sunglasses, and sunscreen and head west. We drive through rolling hills and scenic pastures and then realize that we have no idea how to actually get to Malibu because we don’t have a map—there’s no fancy GPS in the car, and even though we look great in our sunglasses, the battery on our phones died about three hours ago and no one brought a car charger. So, we begin stopping at roadside diners and gas stations asking people how to get to Malibu. Some of them have never even heard of Malibu and others seem
to know how to get there, but their directions seem very vague and generic. Our travels are taking a very long time, and we are wasting a lot of money. . . . Well, this isn’t how we expected the trip to go at all, is it? We had planned to be in Malibu by now—or had we? As I recall, we didn’t plan at all.

That’s what a business plan is—a map. It’s a map of what you will sell and to whom, how you will run your business, whom you will rely on, and where you will be located. Starting a business without a solid business plan is just as ill-advised as jumping into a car and heading on a cross-country trip with no map, no expert advice, and no support system in place. In this next section you’ll learn about the components of a well-crafted, solid plan to help entrepreneurs successfully launch a business and get where they’re trying to go.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Create Your Business Plan
- Self Check: Business Plans

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Executive Summary

This written guide will help you create a business plan and map out how you will start and run your business successfully.

The executive summary is often considered the most important section of a business plan. This section briefly tells your reader where your company is, where you want to take it, and why your business idea will be successful. If you are seeking financing, the executive summary is also your first opportunity to grab a potential investor's interest.

The executive summary should highlight the strengths of your overall plan and therefore be the last section you write. However, it usually appears first in your business plan document.

Below are several key points that your executive summary should include based on the stage of your business.

If You Are an Established Business

If you are an established business, be sure to include the following information:

- **The Mission Statement**—This explains what your business is all about. It should be between several sentences and a paragraph.
- **Company Information**—Include a short statement that covers when your business was formed, the names of the founders
and their roles, your number of employees, and your business location(s).

- **Growth Highlights**—Include examples of company growth, such as financial or market highlights (for example, “XYZ Firm increased profit margins and market share year-over-year since its foundation). Graphs and charts can be helpful in this section.
- **Your Products/Services**—Briefly describe the products or services you provide.
- **Financial Information**—If you are seeking financing, include any information about your current bank and investors.
- **Summarize future plans**—Explain where you would like to take your business.

With the exception of the mission statement, all of the information in the executive summary should be covered in a concise fashion and kept to one page. The executive summary is the first part of your business plan many people will see, so each word should count.

**If You Are a Startup or New Business**

If you are just starting a business, you won't have as much information as an established company. Instead, focus on your experience and background as well as the decisions that led you to start this particular enterprise.

Demonstrate that you have done thorough market analysis. Include information about a need or gap in your target market, and how your particular solutions can fill it. Convince the reader that you can succeed in your target market, then address your future plans.

Remember, your Executive Summary will be the last thing you write. So the first section of the business plan that you will tackle is the Company Description section.
Company Description

This section of your business plan provides a high-level review of the different elements of your business. This is akin to an extended elevator pitch and can help readers and potential investors quickly understand the goal of your business and its unique proposition.

What to Include in Your Company Description

• Describe the nature of your business and list the marketplace needs that you are trying to satisfy.
• Explain how your products and services meet these needs.
• List the specific consumers, organizations or businesses that your company serves or will serve.
• Explain the competitive advantages that you believe will make your business a success such as your location, expert personnel, efficient operations, or ability to bring value to your customers.

Next, you'll need to move on to the Market Analysis section of your plan.

Market Analysis

The market analysis section of your business plan should illustrate your industry and market knowledge as well as any of your research findings and conclusions.
What to Include in Your Market Analysis

- **Industry Description and Outlook**—Describe your industry, including its current size and historic growth rate as well as other trends and characteristics (e.g., life cycle stage, projected growth rate). Next, list the major customer groups within your industry.

- **Information About Your Target Market**—Narrow your target market to a manageable size. Many businesses make the mistake of trying to appeal to too many target markets. Research and include the following information about your market:
  - **Distinguishing Characteristics**—What are the critical needs of your potential customers? Are those needs being met? What are the demographics of the group and where are they located? Are there any seasonal or cyclical purchasing trends that may impact your business?
  - **Size of the Primary Target Market**—In addition to the size of your market, what data can you include about the annual purchases your market makes in your industry? What is the forecasted market growth for this group?
  - **How Much Market Share Can You Gain?**—What is the market share percentage and number of customers you expect to obtain in a defined geographic area? Explain the logic behind your calculation.
  - **Pricing and Gross Margin Targets**—Define your pricing structure, gross margin levels, and any discount that you plan to use.

- When you include information about any of the market tests or research studies you have completed, be sure to focus only on the results of these tests. Any other details should be included in the appendix (which we will discuss later).

- **Competitive Analysis**—Your competitive analysis should identify your competition by product line or service and
market segment. Assess the following characteristics of the competitive landscape:

- Market share
- Strengths and weaknesses
- How important is your target market to your competitors?
- Are there any barriers that may hinder you as you enter the market?
- What is your window of opportunity to enter the market?
- Are there any indirect or secondary competitors who may impact your success?
- What barriers to market are there (e.g., changing technology, high investment cost, lack of quality personnel)?

- **Regulatory Restrictions**—Include any customer or governmental regulatory requirements affecting your business, and how you'll comply. Also, cite any operational or cost impact the compliance process will have on your business.

Once you’ve completed this section, you can move on to the Organization and Management section of your business plan.

### Organization and Management

This section should include: your company’s organizational structure, details about the ownership of your company, profiles of your management team, and the qualifications of your board of directors.

Who does what in your business? What is their background and why are you bringing them into the business as board members or employees? What are they responsible for? These may seem like unnecessary questions to answer in a one- or two-person organization, but the people reading your business plan want to
know who's in charge, so tell them. Give a detailed description of each division or department and its function.

This section should include who's on the board (if you have an advisory board) and how you intend to keep them there. What kind of salary and benefits package do you have for your people? What incentives are you offering? How about promotions? Reassure your reader that the people you have on staff are more than just names on a letterhead.

Organizational Structure

A simple but effective way to lay out the structure of your company is to create an organizational chart with a narrative description. This will prove that you're leaving nothing to chance, you've thought out exactly who is doing what, and there is someone in charge of every function of your company. Nothing will fall through the cracks, and nothing will be done three or four times over. To a potential investor or employee, that is very important.

Ownership Information

This section should also include the legal structure of your business along with the subsequent ownership information it relates to. Have you incorporated your business? If so, is it a C or S corporation? Or perhaps you have formed a partnership with someone. If so, is it a general or limited partnership? Or maybe you are a sole proprietor.

The following important ownership information should be incorporated into your business plan:

- Names of owners
- Percentage ownership
• Extent of involvement with the company
• Forms of ownership (i.e., common stock, preferred stock, general partner, limited partner)
• Outstanding equity equivalents (i.e., options, warrants, convertible debt)
• Common stock (i.e., authorized or issued)

Management Profiles
Experts agree that one of the strongest factors for success in any growth company is the ability and track record of its owner/management team, so let your reader know about the key people in your company and their backgrounds. Provide resumes that include the following information:

• Name
• Position (include brief position description along with primary duties)
• Primary responsibilities and authority
• Education
• Unique experience and skills
• Prior employment
• Special skills
• Past track record
• Industry recognition
• Community involvement
• Number of years with company
• Compensation basis and levels (make sure these are reasonable — not too high or too low)
• Be sure you quantify achievements (e.g. “Managed a sales force of ten people,” “Managed a department of fifteen people,” “Increased revenue by 15 percent in the first six months,” “Expanded the retail outlets at the rate of two each year,” “Improved the customer service as rated by our customers from a 60 percent to a 90 percent rating”)

Also, highlight how the people surrounding you complement your
own skills. If you're just starting out, show how each person’s unique experience will contribute to the success of your venture.

Board of Directors’ Qualifications

The major benefit of an unpaid advisory board is that it can provide expertise that your company cannot otherwise afford. A list of well-known, successful business owners/managers can go a long way toward enhancing your company’s credibility and perception of management expertise.

If you have a board of directors, be sure to gather the following information when developing the outline for your business plan:

- Names
- Positions on the board
- Extent of involvement with company
- Background
- Historical and future contribution to the company’s success

Service or Product Line

Once you’ve completed the Organizational and Management section of your plan, the next part of your business plan is where you describe your service or product, emphasizing the benefits to potential and current customers. Focus on why your particular product will fill a need for your target customers.
What to Include in Your Service or Product Line Section

- **A Description of Your Product/Service**—Include information about the specific benefits of your product or service – from your customers’ perspective. You should also talk about your product or service’s ability to meet consumer needs, any advantages your product has over that of the competition, and the current development stage your product is in (e.g., idea, prototype).

- **Details About Your Product’s Life Cycle**—Be sure to include information about where your product or service is in its life cycle, as well as any factors that may influence its cycle in the future.

- **Intellectual Property**—If you have any existing, pending, or any anticipated copyright or patent filings, list them here. Also disclose whether any key aspects of a product may be classified as trade secrets. Last, include any information pertaining to existing legal agreements, such as nondisclosure or non-compete agreements.

- **Research and Development (R&D) Activities**—Outline any R&D activities that you are involved in or are planning. What results of future R&D activities do you expect? Be sure to analyze the R&D efforts of not only your own business, but also of others in your industry.

Marketing and Sales

Once you’ve completed the Service or Product Line section of your plan, the next part of your business plan should focus on your marketing and sales management strategy for your business.

Marketing is the process of creating customers, and customers
are the lifeblood of your business. In this section, the first thing you want to do is define your marketing strategy. There is no single way to approach a marketing strategy; your strategy should be part of an ongoing business-evaluation process and unique to your company. However, there are common steps you can follow which will help you think through the direction and tactics you would like to use to drive sales and sustain customer loyalty.

An overall marketing strategy should include four different strategies:

- A market penetration strategy.
- A growth strategy. This strategy for building your business might include: an internal strategy such as how to increase your human resources, an acquisition strategy such as buying another business, a franchise strategy for branching out, a horizontal strategy where you would provide the same type of products to different users, or a vertical strategy where you would continue providing the same products but would offer them at different levels of the distribution chain.
- Channels of distribution strategy. Choices for distribution channels could include original equipment manufacturers (OEMs), an internal sales force, distributors, or retailers.
- Communication strategy. How are you going to reach your customers? Usually a combination of the following tactics works the best: promotions, advertising, public relations, personal selling, and printed materials such as brochures, catalogs, flyers, etc.

After you have developed a comprehensive marketing strategy, you can then define your sales strategy. This covers how you plan to actually sell your product.

Your overall sales strategy should include two primary elements:

- A sales force strategy. If you are going to have a sales force, do you plan to use internal or independent representatives? How
many salespeople will you recruit for your sales force? What type of recruitment strategies will you use? How will you train your sales force? What about compensation for your sales force?

- Your sales activities. When you are defining your sales strategy, it is important that you break it down into activities. For instance, you need to identify your prospects. Once you have made a list of your prospects, you need to prioritize the contacts, selecting the leads with the highest potential to buy first. Next, identify the number of sales calls you will make over a certain period of time. From there, you need to determine the average number of sales calls you will need to make per sale, the average dollar size per sale, and the average dollar size per vendor.

Next, if you are seeking financing for your business, you’ll need to complete the next part of your plan—Funding Request.

**Funding Request**

If you are seeking funding for your business venture, use this section to outline your requirements. Your funding request should include the following information:

- Your current funding requirement
- Any future funding requirements over the next five years
- How you intend to use the funds you receive: Is the funding request for capital expenditures? Working capital? Debt retirement? Acquisitions? Whatever it is, be sure to list it in this section.
- Any strategic financial situational plans for the future, such as: a buyout, being acquired, debt repayment plan, or selling your business. These areas are extremely important to a future
creditor, since they will directly impact your ability to repay your loan(s).

When you are outlining your funding requirements, include the amount you want now and the amount you want in the future. Also include the time period that each request will cover, the type of funding you would like to have (e.g., equity, debt), and the terms that you would like to have applied.

To support your funding request you'll also need to provide historical and prospective financial information. Once you have completed your funding request, move on to the next part of your plan—Financial Projections.

**Financial Projections**

You should develop the Financial Projections section after you've analyzed the market and set clear objectives. That's when you can allocate resources efficiently. The following is a list of the critical financial statements to include in your business plan packet.

**Historical Financial Data**

If you own an established business, you will be requested to supply historical data related to your company's performance. Most creditors request data for the last three to five years, depending on the length of time you have been in business.

The historical financial data to include are your company's income statements, balance sheets, and cash flow statements for each year you have been in business (usually for up to three to five years). Often, creditors are also interested in any collateral that you
may have that could be used to ensure your loan, regardless of the stage of your business.

Prospective Financial Data

All businesses, whether startup or growing, will be required to supply prospective financial data. Most of the time, creditors will want to see what you expect your company to be able to do within the next five years. Each year’s documents should include forecasted income statements, balance sheets, cash flow statements, and capital expenditure budgets. For the first year, you should supply monthly or quarterly projections. After that, you can stretch it to quarterly and/or yearly projections for years two through five.

Make sure that your projections match your funding requests; creditors will be on the lookout for inconsistencies. It’s much better if you catch mistakes before they do. If you have made assumptions in your projections, be sure to summarize what you have assumed. This way, the reader will not be left guessing.

Finally, include a short analysis of your financial information. Include a ratio and trend analysis for all of your financial statements (both historical and prospective). Since pictures speak louder than words, you may want to add graphs of your trend analysis (especially if they are positive).

Next, you may want to include an Appendix to your plan. This can include items such as your credit history, resumes, letters of reference, and any additional information that a lender may request.

Appendix

The Appendix should be provided to readers on an as-needed basis.
In other words, it should not be included with the main body of your business plan. Your plan is your communication tool; as such, it will be seen by a lot of people. Some of the information in the business section you will not want everyone to see, but specific individuals (such as creditors) may want access to this information to make lending decisions. Therefore, it is important to have the appendix within easy reach.

The appendix would include:

- Credit history (personal and business)
- Resumes of key managers
- Product pictures
- Letters of reference
- Details of market studies
- Relevant magazine articles or book references
- Licenses, permits or patents
- Legal documents
- Copies of leases
- Building permits
- Contracts
- List of business consultants, including attorney and accountant

Any copies of your business plan should be controlled; keep a distribution record. This will allow you to update and maintain your business plan on an as-needed basis. Remember, too, that you should include a private placement disclaimer with your business plan if you plan to use it to raise capital.

How to Make Your Business Plan Stand Out

One of the first steps to business planning is determining your target market and why they would want to buy from you.

For example, is the market you serve the best one for your
product or service? Are the benefits of dealing with your business clear and are they aligned with customer needs? If you're unsure about the answers to any of these questions, take a step back and revisit the foundation of your business plan.

The following tips can help you clarify what your business has to offer, identify the right target market for it and build a niche for yourself.

Be Clear About What You Have to Offer

Ask yourself: Beyond basic products or services, what are you really selling? Consider this example: Your town probably has several restaurants all selling one fundamental product—food. But each is targeted at a different need or clientele.

One might be a drive-thru fast food restaurant, perhaps another sells pizza in a rustic Italian kitchen, and maybe there’s a fine dining seafood restaurant that specializes in wood-grilled fare. All these restaurants sell meals, but they sell them to targeted clientele looking for the unique qualities each has to offer. What they are really selling is a combination of product, value, ambience and brand experience.

When starting a business, be sure to understand what makes your business unique. What needs does your product or service fulfill? What benefits and differentiators will help your business stand out from the crowd?

Don’t Become a Jack of All Trades—Learn to Strategize

It's important to clearly define what you're selling. You do not want to become a jack-of-all trades and master of none because this can
have a negative impact on business growth. As a smaller business, it's often a better strategy to divide your products or services into manageable market niches. Small operations can then offer specialized goods and services that are attractive to a specific group of prospective buyers.

Identify Your Niche

Creating a niche for your business is essential to success. Often, business owners can identify a niche based on their own market knowledge, but it can also be helpful to conduct a market survey with potential customers to uncover untapped needs. During your research process, identify the following:

- Which areas your competitors are already well established
- Which areas are being ignored by your competitors
- Potential opportunities for your business

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=109
87. Outcome: Why Some Ventures Fail

What you’ll learn to do: explain why entrepreneurial ventures fail

Here are some interesting statistics: According to the Small Business Administration (SBA), about 80 percent of firms continue after the first year, two-thirds of businesses survive at least two years, and about half survive at least five years.¹ What happened to the 50 percent that didn’t make it? Why did they fail? Some of the reasons for small-business failure are avoidable, and others, sadly, are not. In this section you'll learn why.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Why Do So Many Small Business Startups Fail?
• Self Check: Why Some Ventures Fail

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Why Do So Many Small Business Startups Fail?

Valuable Lessons

With four out of five small business startups ending up in failure, the odds are stacked against small business owners and would-be entrepreneurs. That's why it's so important to understand how and where things go wrong—such information offers valuable lessons on what to avoid. There are six main causes of small business startup failure:

Lack of Planning

We've said it before: starting a business without planning where you want to go is like starting a car journey with no idea of your final destination or a map to get there; you're bound to get lost. To avoid this mistake, set a clear goal of where you want to be and how you plan to get there.

Failure to Delegate

Within every business someone needs to keep an eye on the bigger picture; and have an overview of everything happening internally and externally around the company. That person should be you and
if you have your head buried in the accounts you won't. So delegate and outsource all the tasks that can be done by others and free yourself to focus on the bigger picture.

Unwillingness to Change

As a small business you cannot afford to remain motionless as your market and the world around you drives forward. Adapt and develop your small business so it is forward-thinking and innovative, not behind the times.

Forgetting That Cash is King!

A small business needs to keep its eye firmly focused on cashflow. As soon as it loses sight of this, it’s prone to failure. Plot and analyze your incomings and outgoings to make sure your small business stays on the right track. Don’t expect massive profits from the outset, but don’t accept a loss.

Lack of Objective Targets

Not measuring the success of campaigns, products, or services can be disastrous for a small business. Is that PR campaign your running really worth the money? Does Twitter really bring traffic to your website? Know what to measure, and you'll know how successful you are.
Failure to Ask the Right Questions

When you’re a small business start-up, knowing which questions (and whom) to ask is difficult. There are numerous resources, such as the SBA, local economic development agencies, and chambers of commerce, that are a great place to start. Part of the process is “knowing what you don’t know,” and such organizations can help you figure that out.

While avoiding these pitfalls won’t guarantee small business success, knowing what not to do can help you to be proactive and focus on the things you should do.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in the previous section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=111
89. Putting It Together: Entrepreneurship

Summary

The Role of Entrepreneurs

Entrepreneurs are responsible for almost everything we use and consume in the course of a day. From switching on a lightbulb, talking on the phone, or driving your car to school—virtually everything we take for granted in our daily lives started with an entrepreneur who was willing to take the risk on some type of business venture.

Characteristics of Entrepreneurs

So, who are these entrepreneurs? You have seen that they are dynamic, risk-taking, self-motivated individuals who, even after suffering multiple failures, refuse to give up on their dreams and business aspirations.

Opportunities and Challenges

There are both opportunities and challenges, advantages and disadvantages of small business ownership. Each individual must weigh the pros and cons in order to decide whether small business
ownership is the right path for them. Time, lifestyle, finances, stress, and independence are just a few of the factors involved in making that decision.

Steps to Start a Business

Starting a business is a lot like baking a cake—there’s a recipe and a “procedure.” In this module you learned that there’s a series of procedures and steps that every business owner goes through in order to establish their business. Which steps must be taken depend on the business and its location. When we bake a cake there’s a series of cooking steps (measuring, mixing, baking, cooling, frosting) that results in dessert! Which ingredients you put into the cake depends on what type of cake you are baking. Which ingredients (steps) you use to launch a business depends on what type of business you are starting, but the end result is the same—business!

Business Plans

The business plan is the roadmap to business success. The components of the plan cover everything from financial projections to physical location to products and services. Having a complete and thorough plan is essential to the success of any business venture—small or large. Remember what we said earlier in this section: businesses never plan to fail, but they do fail to plan!

Why Some Ventures Fail

We would like to think that every business venture will be as
successful as Apple or Starbucks, but the fact is that the majority of small businesses last fewer than three years. Knowing why businesses fail is key to planning around and avoiding the circumstances that lead to failure. In other words, if you know where the land mines are you can work your way around them to get to the other side of the field!

**Synthesis**

We began this module by considering the contributions of entrepreneurs not only to the economy but to our daily lives. Reflecting on what you have learned in this module, think for a moment about how far entrepreneurs have taken us, our economy, and the world. From two brothers who owned a bicycle shop in Dayton, Ohio . . .

![Image of Wright brothers' plane](image-url)

. . . to this:
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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=112

Additional Resources:

The Small Business Administration website has a wealth of resources for starting entrepreneurial ventures in the U.S.
PART VI

MODULE 5: GLOBAL ENVIRONMENT
90. Why It Matters: Global Environment

Why summarize the characteristics, opportunities, and challenges of the global economic environment in which businesses operate?

Before trying to understand the global environment within which business operates, we might ask: What does the world really look like?—not the picture we see from outer space, but all the people and the environments of daily life? It’s difficult to comprehend something as vast as the world beyond what we know and experience in our own lives, so what if we could shrink the world into a village of just a hundred people and have that village represent the entire global environment? We can all picture a hundred people—in a classroom, at a wedding, or attending a soccer game, so why not picture the world as just one hundred people? That’s exactly what the following video does: It presents a miniature world that might give you a better understanding of the people that make up this place we call Earth.
Learning Outcomes

- Define globalization in the context of international business operations
- Explain why companies and nations engage in global trade
- Summarize the principles of competitive advantage and comparative advantage
- Describe how cultural, economic, and legal or political barriers can impact, restrict, or support international trade
- Describe ethical issues that businesses face when engaging in international markets
- Describe the impact of currency valuation on business
operations in global markets
• Explain the roles of the IMF and the World Bank in promoting international trade
• Explain the historical role of GATT in international trade and the WTO's impact on international trade.
What you’ll learn to do: define globalization in the context of international business operations

The globalization of business is bound to affect you. Not only will you buy products manufactured overseas, but it’s highly likely that you'll meet and work with individuals from various countries and cultures as customers, suppliers, colleagues, employees, or employers. The bottom line is that the globalization of world commerce has an impact on all of us. Therefore, it makes sense to learn more about how globalization works.

Never before has business spanned the globe the way it does today. But why is international business important? Why do companies and nations engage in international trade? What strategies do they employ in the global marketplace? What challenges do companies face when they do business overseas? How do governments and international agencies promote and regulate international trade? Is the globalization of business a good thing? What career opportunities are there for you in global business? How should you prepare yourself to take advantage of them? These are the questions that we’ll be addressing in this module.

LEARNING ACTIVITIES

The learning activities for this section include:
• Reading: What Is International Business?
• Video: Globalization Explained
• Self Check: Globalization and International Business

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
The Definition of International Business

International business relates to any situation where the production or distribution of goods or services crosses country borders. Globalization—the shift toward a more interdependent and integrated global economy—creates greater opportunities for international business. Such globalization can take place in terms of markets, where trade barriers are falling and buyer preferences are changing. It can also be seen in terms of production, where a company can source goods and services easily from other countries. Some managers consider the definition of international business to relate purely to “business.” However, a broader definition of international business may serve you better both personally and professionally in a world that has moved beyond simple industrial production.

International business encompasses a full range of cross-border exchanges of goods, services, or resources between two or more nations. These exchanges can go beyond the exchange of money for physical goods to include international transfers of other resources, such as people, intellectual property (e.g., patents, copyrights, brand trademarks, and data), and contractual assets or liabilities (e.g., the right to use some foreign asset, provide some future service to foreign customers, or execute a complex financial instrument). The entities involved in international business range from large multinational firms with thousands of employees doing business in many countries around the world to a small one-person company acting as an importer or exporter. This broader definition of international business also encompasses for-profit border-crossing
transactions as well as transactions motivated by nonfinancial gains (e.g., triple bottom line, corporate social responsibility, and political favor) that affect a business’s future.

Strategic Management and Entrepreneurship

A knowledge of both strategic management and entrepreneurship will enhance your understanding of international business.

Strategic Management

Strategic management is the body of knowledge that answers questions about the development and implementation of good strategies and is mainly concerned with the determinants of firm performance. A strategy, in turn, is the central, integrated, and externally oriented concept of how an organization will achieve its performance objectives. One of the basic tools of strategy is a SWOT (strengths, weaknesses, opportunities, threats) assessment. The SWOT tool helps you take stock of an organization’s internal characteristics—its strengths and weaknesses—to formulate an action plan that builds on what it does well while overcoming or working around weaknesses. Similarly, the external part of SWOT—the opportunities and threats—helps you assess those environmental conditions that favor or threaten the organization’s strategy. Because strategic management is concerned with organizational performance—be that social, environmental, or economic—your understanding of a company’s SWOT will help you better assess how international business factors should be accounted for in the firm’s strategy.
Entrepreneurship

Entrepreneurship, in contrast, is defined as the recognition of opportunities (i.e., needs, wants, problems, and challenges) and the use or creation of resources to implement innovative ideas for new, thoughtfully planned ventures. An entrepreneur is a person who engages in entrepreneurship. Entrepreneurship, like strategic management, will help you to think about the opportunities available when you connect new ideas with new markets. For instance, given Google's current global presence, it's difficult to imagine that the company started out slightly more than a decade ago as the entrepreneurial venture of two college students. Google was founded by Larry Page and Sergey Brin, students at Stanford University. It was first incorporated as a privately held company on September 4, 1998. Increasingly, as the Google case study demonstrates, international businesses have an opportunity to create positive social, environmental, and economic values across borders. An entrepreneurial perspective will serve you well in this regard.

Spotlight on International Strategy and Entrepreneurship

Hemali Thakkar and three of her fellow classmates at Harvard found a way to mesh the power of play with electrical power. The foursome invented “a soccer ball with the ability to generate electricity,” Thakkar said. Every kick of the ball creates a current that's captured for future use. Fifteen minutes of play lights a lamp for three hours.

Called the sOccket, the soccer ball can bring off-grid electricity to developing countries. Even better, the soccer ball can replace kerosene lamps. Burning kerosene is not only bad for the
environment because of carbon dioxide emissions but it's also a health hazard: according to the World Bank, breathing kerosene fumes indoors has the same effects as smoking two packs of cigarettes per day.

How did the idea of sOccket emerge? All four students (Jessica Lin, Jessica Matthews, Julia Silverman, and Hemali Thakkar) had experience with developing countries, so they knew that kids love playing soccer (it's the world's most popular sport). They also knew that most of these kids lived in homes that had no reliable energy.

As of November 2010, the sOccket prototype cost $70 to manufacture, but the team hopes to bring the cost down to $10 when production is scaled up. One ingenious way to bring costs down is to set up facilities where developing-world entrepreneurs assemble and sell the balls themselves.

KEY TAKEAWAYS

International business encompasses a full range of cross-border exchanges of goods, services, or resources between two or more nations. These exchanges can go beyond the exchange of money for physical goods to include international transfers of other resources, such as people, intellectual property (e.g., patents, copyrights, brand trademarks, and data), and contractual assets or liabilities (e.g., the right to use some foreign asset, provide some future service to foreign customers, or execute a complex financial instrument).

Strategic management is the body of knowledge that answers questions about the development and implementation of good strategies and is mainly concerned with the determinants of firm performance. Because strategic management is concerned with organizational performance, your understanding of a company's SWOT (strengths, weaknesses, opportunities, threats) helps you better assess how international business factors should be accounted for in the firm's strategy.
Entrepreneurship is the recognition of opportunities (i.e., needs, wants, problems, and challenges) and the use or creation of resources to implement innovative ideas. Entrepreneurship helps you think about the opportunities available when you connect new ideas with new markets.

Reflection Questions

• How do Harvard-educated students benefit from doing business in lesser-developed countries?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=116
Now that you have a basic understanding of international business and the roles of strategic management and entrepreneurship, what is this concept we refer to as “globalization”? As you watch the following video, reflect on the ways in which it directly impacts you and your family.

A YouTube element has been excluded from this version of the text. You can view it online here:
Reflection Questions

- Are the benefits of globalization worth the costs?
- Should governments work to encourage or discourage globalization?
94. Outcome: Reasons for Global Trade

What you’ll learn to do: explain why companies and nations engage in global trade

Consider the humble banana. Even if you are not a big fan of this yellow fruit, you have probably seen them in the grocery store or in a book or magazine. It is fair to say that if you walked through your city with a banana and asked people to identify it, it is unlikely you would encounter someone who had no idea what it was. Now, find a picture of a banana tree and conduct the same experiment. How many people would recognize it as a banana tree? Probably many, but not all. Why is that? In the United States bananas are grown in Hawaii, and not everyone has been to Hawaii. In fact, most of the bananas in the world are grown in Brazil. Well, if we as Americans love bananas and do not live in Hawaii and can't get to Brazil on a regular basis, then, without global trade, we do not have bananas for our cereal in the morning, for a snack during the day—or even worse, no banana splits at the local ice cream parlor. Consider our humble yellow fruit as you read through this next
section on the reasons companies and nations engage in global trade.

LEARNING ACTIVITIES

The learning activities for this section include:

- Video: Chinese Manufacturing for American Products
- Video: Why Do Nations Trade?
- Reading: The Balance of Trade
- Self Check: Reasons for Global Trade

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Chinese Manufacturing for American Products

No discussion of the reasons why companies and nations trade would be complete without stopping to take a look at the relationship between U.S. businesses and manufacturing facilities in China. The video below is an example of how a small business is using manufacturing facilities located in China to enter the global markets. Especially for small start-up companies, using established manufacturing facilities located outside of the U.S. allows them to enter into the global marketplace. Cost, logistics, finances, and speed are just some of the things that this type of arrangement can bring to businesses looking to take advantage of the growing global demand for U.S.-branded products.
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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=119
96. Video: Why Do Nations Trade?

Why Do Nations Trade?

Watch the following video that examines trade and the reason nations trade.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=120
97. Reading: The Balance of Trade

Why Nations Trade

Why does the United States import automobiles, steel, digital phones, and apparel from other countries? Why don’t we just make them ourselves? Why do other countries buy wheat, chemicals, machinery, and consulting services from us? Because no national economy produces all the goods and services that its people need.

• Countries are importers when they buy goods and services from other countries;
• When they sell products to other nations, they’re exporters.

The monetary value of international trade is enormous. In 2014, the total value of worldwide trade in merchandise and commercial services was $22.5 trillion.

How Do We Measure Trade between Nations?

To evaluate the nature and consequences of its international trade, a nation looks at two key indicators: balance of trade and balance of payments. We determine a country’s balance of trade by subtracting the value of its imports from the value of its exports. If a country sells more products than it buys, it has a favorable balance, called a trade surplus. If it buys more than it sells, it has an unfavorable balance, or a trade deficit.

\[
\text{Balance of trade} = \text{Value of exports} - \text{Value of imports}
\]
For many years, the United States has had a trade deficit: we buy far more goods from the rest of the world than we sell overseas. This fact shouldn't be surprising. With high income levels, we not only consume a sizable portion of our own domestically produced goods but enthusiastically buy imported goods. Other countries, such as China and Taiwan, which manufacture primarily for export, have large trade surpluses because they sell far more goods overseas than they buy.

Managing the National Credit Card

Are trade deficits a bad thing? Not necessarily. They can be positive if a country's economy is strong enough both to keep growing and to generate the jobs and incomes that permit its citizens to buy the best the world has to offer. That was certainly the case in the United States in the 1990s. Some experts, however, are alarmed at our rapidly accelerating trade deficit. Investment guru Warren Buffet, for example, cautions that no country can continuously sustain large and burgeoning trade deficits. Why not? Because creditor nations will eventually stop taking IOUs from debtor nations, and when that happens, the national spending spree will have to cease. “Our national credit card,” he warns, “allows us to charge truly breathtaking amounts. But that card’s credit line is not limitless.”

By the same token, trade surpluses aren't necessarily good for a nation's consumers. Japan's export-fueled economy produced high economic growth in the 1970s and 1980s. But most domestically made consumer goods were priced at artificially high levels inside Japan itself—so high, in fact, that many Japanese traveled overseas to buy the electronics and other high-quality goods on which Japanese trade was dependent. CD players and televisions were significantly cheaper in Honolulu or Los Angeles than in Tokyo. How did this situation come about? Though Japan manufactures a variety of goods, many of them are made for export. To secure
shares in international markets, Japan prices its exported goods competitively. Inside Japan, because competition is limited, producers can put artificially high prices on Japanese-made goods. Due to a number of factors (high demand for a limited supply of imported goods, high shipping and distribution costs, and other costs incurred by importers in a nation that tends to protect its own industries), imported goods are also expensive.

Balance of Payments

The second key measure of the effectiveness of international trade is balance of payments: the difference, over a period of time, between the total flow of money coming into a country and the total flow of money going out.

\[
\text{Balance of Payments} = \text{Total flow of money coming into a country} - \text{Total flow of money going out}
\]

As in its balance of trade, the biggest factor in a country’s balance of payments is the money that comes in and goes out as a result of imports and exports. But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid. For example, if a U.S. company buys some real estate in a foreign country, that investment counts in the U.S. balance of payments, but not in its balance of trade, which measures only import and export transactions. In the long run, having an unfavorable balance of payments can negatively affect the stability of a country’s currency. Some observers are worried about the U.S. dollar, which has undergone an accelerating pattern of unfavorable balances of payments since the 1970s. For one thing, carrying negative balances has forced the United States to cover its debt by borrowing from other countries. The figure below provides a brief historical overview to illustrate the relationship between the United States' balance of trade and its balance of payments.
Figure 1. U.S. Imports, Exports, and Balance of Payments, 1994–2010

Note: Figures are for “goods” only, not “goods and services.” Source: U.S. Census Bureau, Foreign Trade Division.

KEY TAKEAWAYS

• Nations trade because they don’t produce all the products that their inhabitants need.
  ◦ They import those that they need but don’t produce and export those that are needed elsewhere.
  ◦ To understand why certain countries import or export certain products, you need to realize that not all countries are good at producing or are able to produce the same products.
  ◦ The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world.
• To evaluate the impact of its international trade, a nation looks at two key indicators: balance of trade and balance of payments.
• We determine a country's **balance of trade** by subtracting the value of its imports from the value of its exports.

  ◦ If a country sells more products than it buys, it has a favorable balance, called a **trade surplus**.
  ◦ If it buys more than it sells, it has an unfavorable balance, or a **trade deficit**.

• The **balance of payments** is the difference, over a period of time, between the total flow coming into a country and the total flow going out.

  ◦ As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of exports and imports.
  ◦ But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid.

**Reflection Questions**

• Should the U.S. buy fewer foreign goods and seek to improve its balance of trade?

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.
Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=121
98. Outcome: Principles of Advantage

What you’ll learn to do: summarize the principles of competitive advantage and comparative advantage

Back to bananas! Who has the advantage in the banana market? Hawaii or Brazil? You should recall from our study of economics that supply and demand influence not only price but quantity supplied, so, in the banana market, where are you going to pay less for a banana? Correct—Brazil! In this module we will examine more closely the concept of advantage in international trade. Once you have a foundation, you will get to try your hand at maximizing your advantage to increase the wealth of your own island nation.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Absolute and Comparative Advantage
- Game: Trade Ruler
- Self Check: Principles of Advantage

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
99. Reading: Absolute and Comparative Advantage

Absolute and Comparative Advantage

To understand why certain countries import or export certain products, you need to realize that every country (or region) can’t produce the same products. The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world. Most economists use the concepts of absolute advantage and comparative advantage to explain why countries import some products and export others.

Absolute Advantage

A nation has an absolute advantage if (1) it’s the only source of a particular product or (2) it can make more of a product using the same amount of or fewer resources than other countries. Because of climate and soil conditions, for example, France had an absolute advantage in wine making until its dominance of worldwide wine production was challenged by the growing wine industries in Italy, Spain, and the United States. Unless an absolute advantage is based on some limited natural resource, it seldom lasts. That’s why there are few, if any, examples of absolute advantage in the world today.
Comparative Advantage

How can we predict, for any given country, which products will be made and sold at home, which will be imported, and which will be exported? This question can be answered by looking at the concept of comparative advantage, which exists when a country can produce a product at a lower opportunity cost compared to another nation. But what’s an opportunity cost? Opportunity costs are the products that a country must decline to make in order to produce something else. When a country decides to specialize in a particular product, it must sacrifice the production of another product.

Let’s simplify things by imagining a world with only two countries—the Republic of High Tech and the Kingdom of Low Tech. We’ll pretend that each country knows how to make two and only two products: wooden boats and telescopes. Each country spends half its resources (labor and capital) on each good. Table 1 shows the daily output for both countries: High Tech makes three boats and nine telescopes while Low Tech makes two boats and one telescope. (They’re not highly productive, as we’ve imagined two very small countries.)

<table>
<thead>
<tr>
<th>Country</th>
<th>Boats</th>
<th>Telescopes</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Tech</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>Low Tech</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make nine telescopes.
(see Figure 1). If it gives up the opportunity to make the nine telescopes, it can use the time gained by not making the telescopes to make three more boats (the number of boats it can make with half of its time). Because High Tech could make three more boats by giving up the opportunity to make the nine telescopes, the opportunity cost of making each boat is three telescopes (9 telescopes ÷ by 3 boats = 3 telescopes). First, note that High Tech has an absolute advantage (relative to Low Tech) in both boats and telescopes: it can make more boats (three versus two) and more telescopes (nine versus one) than Low Tech can with the same resources. So, why doesn’t High Tech make all the boats and all the telescopes needed for both countries? Because it lacks sufficient resources to make all the boats and all the telescopes, High Tech must, therefore, decide how much of its resources to devote to each of the two goods. Let’s assume that each country could devote 100 percent of its resources on either of the two goods. We’ll pick boats as a start. If both countries spend all their resources on boats (and make no telescopes), here’s what happens:

• When we assumed that Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make only one telescope (Figure 1). If it gives up the opportunity to make the telescope, it can use the time gained by not making the telescope to make two more boats. Because Low Tech could make two more boats by giving up the opportunity to make one telescope, the opportunity cost of making each boat is half a telescope (1 telescope ÷ 2 boats = 1/2 of a telescope).

• Low Tech, therefore, enjoys a lower opportunity cost: Because it must give up less to make the extra boats (1/2 telescope vs. 3 telescopes), it has a comparative advantage for boats. And because it’s better—that is, more efficient—at making boats than at making telescopes, it should specialize in boat making.

Now to telescopes. Here’s what happens if each country spends all its time making telescopes and makes no boats:
• When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make three boats (Figure 1). If it gives up the opportunity to make the three boats, it can use the time gained by not making the boats to make nine more telescopes. Because High Tech could make nine more telescopes by giving up the opportunity to make three boats, the opportunity cost of making each telescope is one-third of a boat (3 boats ÷ 9 telescopes = 1/3 of a boat).

• When Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make two boats. If it gives up the opportunity to make the two boats, it can use the time to make one more telescope. Thus, if Low Tech wants to make only telescopes, it could make one more telescope by giving up the opportunity to make two boats. Thus, the opportunity cost of making each telescope is two boats (2 boats ÷ 1 telescope = 2 boats).

• In this case, High Tech has the lower opportunity cost: Because it had to give up less to make the extra telescopes (1/3 of a boat vs. 2 boats), it enjoys a comparative advantage for telescopes. And because it’s better—more efficient—at making telescopes than at making boats, it should specialize in telescope making.

Each country will specialize in making the good for which it has a comparative advantage—that is, the good that it can make most efficiently, relative to the other country. High Tech will devote its resources to telescopes (which it's good at making), and Low Tech will put its resources into boat making (which it does well). High Tech will export its excess telescopes to Low Tech, which will pay for the telescopes with the money it earns by selling its excess boats to High Tech. Both countries will be better off.

Things are a lot more complex in the real world, but, generally speaking, nations trade to exploit their advantages. They benefit from specialization, focusing on what they do best, and trading the output to other countries for what they do best. The United
States, for instance, is increasingly an exporter of knowledge-based products, such as software, movies, music, and professional services (management consulting, financial services, and so forth). America’s colleges and universities, therefore, are a source of comparative advantage, and students from all over the world come to the United States for the world’s best higher-education system.

France and Italy are centers for fashion and luxury goods and are leading exporters of wine, perfume, and designer clothing. Japan’s engineering expertise has given it an edge in such fields as automobiles and consumer electronics. And with large numbers of highly skilled graduates in technology, India has become the world’s leader in low-cost, computer-software engineering.

KEY TAKEAWAYS

• To explain how countries decide what products to import and export, economists use the concepts of **absolute** and **comparative advantage**.
  
  ◦ A nation has an **absolute advantage** if it’s the only source of a particular product or can make more of a product with the same amount of or fewer resources than other countries.
  ◦ A **comparative advantage** exists when a country can produce a product at a lower opportunity cost than other nations.

• Nations trade to exploit their advantages: they benefit from specialization, focusing on what they do best and trading the output to other countries for what they do best.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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100. Game: Trade Ruler

**Trade Ruler**

Now you have a good working understanding of why nations trade, the concept of advantage, and some of the benefits of global business. But, it's one thing to talk and read about global business and another to actually engage in global trade. You don't have the time or the resources to set up your company, apply for permits, establish trade agreements with other nations, and manufacture your goods right now, but that's not a problem—those things have already been done for you!

The link below will take you to the Nobel Prize website, where you will play the simulation “Trade Ruler” and see how well you can leverage your advantage to increase the wealth of your island nation as Supreme Leader.

Once the game launches you will be prompted to select one of four islands to control. Choose wisely, as each of the islands is endowed with labor and capital, but they aren't equal. Some islands offer an abundance of labor but very little capital (technology), and others are capital rich but have a very small labor force. Which island you select will determine what you can produce to capitalize on your resources.

After you have chosen your island, you will be given the opportunity to create an avatar and your name. Once you have an identity, you must choose one of the remaining three islands with whom to trade. Look carefully at what your trade partner has to offer! Once you begin production you will be able to trade cell phones and blue jeans with your partner. At any time during the simulation you can ask for “council” by selecting the button on your television set! Listen carefully to the advice of your counselors, watch the economy of your island (as measured in seashells), and
adjust your production and trade transactions accordingly. You will be able to play three rounds, permitting you to improve the economic and social conditions for your citizens.

As you move through the simulation, reflect and use what you have already learned about economics, balance of trade, and balance of payments. Good luck and trade wisely!

Play the game “Trade Ruler” at nobelprize.org
101. Outcome: Barriers to Trade

What you’ll learn to do: describe how cultural, economic, and legal or political barriers can impact, restrict, or support international trade

By this time you should be understanding that international trade and global business are not as easy as opening a business in your hometown. As the Supreme Leader of your island you may have encountered some resistance from your trading partners or even your own citizens as you tried to negotiate for cell phones and blue jeans. In this section we will consider a range of factors that must be considered when conducting business in global markets.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Global Business Environment
- Reading: The Global Economic and Regulatory Environment
- Self Check: Barriers to Trade

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
The Global Business Environment

In the classic movie *The Wizard of Oz*, a magically misplaced Midwest farm girl takes a moment to survey the bizarre landscape of Oz and then comments to her little dog, “I don’t think we’re in Kansas anymore, Toto.” That sentiment probably echoes the reaction of many businesspeople who find themselves in the midst of international ventures for the first time. The differences between the foreign landscape and the one with which they’re familiar are often huge and multifaceted. Some are quite obvious, such as differences in language, currency, and everyday habits (using chopsticks, say, instead of silverware). But others are subtle, complex, and sometimes even hidden. Success in international business means understanding a wide range of cultural, economic, legal, and political differences between countries. Let’s look at some of the more important of these differences.

The Cultural Environment

Even when two people from the same country communicate, there’s always a possibility of misunderstanding. When people from different countries get together, that possibility increases substantially. Differences in communication styles reflect differences in culture: the system of shared beliefs, values, customs, and behaviors that govern the interactions of members of a society. Cultural differences create challenges to successful international
business dealings. We explain a few of these challenges in the following sections.

Language

English is the international language of business. The natives of such European countries as France and Spain certainly take pride in their own languages and cultures, but nevertheless English is the business language of the European community. Whereas only a few educated Europeans have studied Italian or Norwegian, most have studied English. Similarly, on the South Asian subcontinent, where hundreds of local languages and dialects are spoken, English is the official language. In most corners of the world, English-only speakers—such as most Americans—have no problem finding competent translators and interpreters. So why is language an issue for English speakers doing business in the global marketplace?

In many countries, only members of the educated classes speak English. The larger population—which is usually the market you want to tap—speaks the local tongue. Advertising messages and sales appeals must take this fact into account. More than one English translation of an advertising slogan have resulted in a humorous (and perhaps serious) blunder. Some classics are listed in Table 1 below.
Table 1. Lost in Translation

In Belgium, the translation of the slogan of an American auto-body company, “Body by Fisher,” came out as “Corpse by Fisher.”

Translated into German, the slogan “Come Alive with Pepsi” became “Come out of the Grave with Pepsi.”

A U.S. computer company in Indonesia translated “software” as “underwear.”

A German chocolate product called “Zit” didn’t sell well in the United States.

An English-speaking car-wash company in Francophone Quebec advertised itself as a “lavement d’auto” (“car enema”) instead of the correct “lavage d’auto.”

A proposed new soap called “Dainty” in English came out as “aloof” in Flemish (Belgium), “dimwitted” in Farsi (Iran), and “crazy person” in Korea; the product was shelved.

One false word in a Mexican commercial for an American shirt maker changed “When I used this shirt, I felt good” to “Until I used this shirt, I felt good.”

In the 1970s, GM’s Chevy Nova didn’t get on the road in Puerto Rico, in part because Nova in Spanish means “It doesn’t go.”

A U.S. appliance ad fizzled in the Middle East because it showed a well-stocked refrigerator featuring a large ham, thus offending the sensibilities of Muslim consumers, who don’t eat pork.

Furthermore, relying on translators and interpreters puts you as an international businessperson at a disadvantage. You're privy only to interpretations of the messages that you're getting, and this handicap can result in a real competitive problem. Maybe you'll misread the subtler intentions of the person with whom you're trying to conduct business. The best way to combat this problem is to study foreign languages. Most people appreciate some effort to communicate in their local language, even on the most basic level. They even appreciate mistakes you make resulting from a desire to demonstrate your genuine interest in the language of your counterparts in foreign countries. The same principle goes doubly when you're introducing yourself to non-English speakers in the United States. Few things work faster to encourage a friendly
atmosphere than a native speaker’s willingness to greet a foreign
guest in the guest’s native language.

Time and Sociability

Americans take for granted many of the cultural aspects of our
business practices. Most of our meetings, for instance, focus on
business issues, and we tend to start and end our meetings on
schedule. These habits stem from a broader cultural preference: we
don’t like to waste time. (It was an American, Benjamin Franklin, who
coined the phrase “Time is money.”) This preference, however, is
by no means universal. The expectation that meetings will start on
time and adhere to precise agendas is common in parts of Europe
(especially the Germanic countries), as well as in the United States,
but elsewhere—say, in Latin America and the Middle East—people
are often late to meetings.

High- and Low-Context Cultures

Likewise, don’t expect businesspeople from these regions—or
businesspeople from most of Mediterranean Europe, for that
matter—to “get down to business” as soon as a meeting has started.
They’ll probably ask about your health and that of your family,
inquire whether you’re enjoying your visit to their country, suggest
local foods, and generally appear to be avoiding serious discussion
at all costs. For Americans, such topics are conducive to nothing but
idle chitchat, but in certain cultures, getting started this way is a
matter of simple politeness and hospitality.

If you ever find yourself in such a situation, the best advice is to go
with the flow and be receptive to cultural nuances. In high-context
cultures, the numerous interlocking (and often unstated) personal
and family connections that hold people together have an effect on almost all interactions. Because people's personal lives overlap with their business lives (and vice versa), it's important to get to know your potential business partners as human beings and individuals.

By contrast, in low-context cultures, such as those of the United States, Germany, Switzerland, and the Scandinavian countries, personal and work relationships are more compartmentalized: you don't necessarily need to know much about the personal context of a person's life to deal with him or her in the business arena.

Intercultural Communication

Different cultures have different communication styles—a fact that can take some getting used to. For example, degrees of animation in expression can vary from culture to culture. Southern Europeans and Middle Easterners are quite animated, favoring expressive body language along with hand gestures and raised voices. Northern Europeans are far more reserved. The English, for example, are famous for their understated style and the Germans for their formality in most business settings. In addition, the distance at which one feels comfortable when talking with someone varies by culture. People from the Middle East like to converse from a distance of a foot or less, while Americans prefer more personal space.

Finally, while people in some cultures prefer to deliver direct, clear messages, others use language that's subtler or more indirect. North Americans and most Northern Europeans fall into the former category and many Asians into the latter. But even within these categories, there are differences. Though typically polite, Chinese and Koreans are extremely direct in expression, while Japanese are indirect: They use vague language and avoid saying “no” even if they do not intend to do what you ask. They worry that turning someone
down will result in their “losing face,” and so they avoid doing this in public.

This discussion brings up two important points. First, avoid lumping loosely related cultures together. We sometimes talk, for example, about “Asian culture,” but such broad categories as “Asian” are usually oversimplifications. Japanese culture is different from Korean, which is different from Chinese. Second, never assume that two people from the same culture will always act in a similar manner. Not all Latin Americans are casual about meeting times, not all Italians use animated body language, and not all Germans are formal.

In summary, learn about a country’s culture and use your knowledge to help improve the quality of your business dealings. Learn to value the subtle differences among cultures, but don’t allow cultural stereotypes to dictate how you interact with people from any culture. Treat each person as an individual and spend time getting to know what he or she is about.
The Economic Environment

If you plan to do business in a foreign country, you need to know its level of economic development. You also should be aware of factors influencing the value of its currency and the impact that changes in that value will have on your profits.

Economic Development

If you don't understand a nation's level of economic development, you'll have trouble answering some basic questions, such as, Will consumers in this country be able to afford the product I want to sell? How many units can I expect to sell? Will it be possible to make a reasonable profit? A country's level of economic development can be evaluated by estimating the annual income earned per citizen. The World Bank, which lends money for improvements in underdeveloped nations, divides countries into the following four income categories:

- **High income**—$12,276 or higher (United States, Germany, Japan)
- **Upper-middle income**—$3,976 to $12,275 (China, South Africa, Mexico)
- **Lower-middle income**—$1,006 to $3,975 (Vietnam, Philippines, India)
• **Low income**—$1,005 or less (Kenya, Bangladesh, Haiti)

Note that that even though a country has a low annual income per citizen, it can still be an attractive place for doing business. India, for example, is a lower-middle-income country, yet it has a population of a billion, and a segment of that population is well educated—an appealing feature for many business initiatives.

The long-term goal of many countries is to move up the economic development ladder. Some factors conducive to economic growth include a reliable banking system, a strong stock market, and government policies to encourage investment and competition while discouraging corruption. It’s also important that a country have a strong *infrastructure*—its systems of communications (telephone, Internet, television, newspapers), transportation (roads, railways, airports), energy (gas and electricity, power plants), and social facilities (schools, hospitals). These basic systems will help countries attract foreign investors, which can be crucial to economic development.

**The Legal and Regulatory Environment**

One of the more difficult aspects of doing business globally is dealing with vast differences in legal and regulatory environments. The United States, for example, has an established set of laws and regulations that provide direction to businesses operating within its borders. But because there is no global legal system, key areas of business law—for example, contract provisions and copyright protection—can be treated in different ways in different countries. Companies doing international business often face many inconsistent laws and regulations. To navigate this sea of confusion, American businesspeople must know and follow both U.S. laws and regulations and those of nations in which they operate.

Business history is filled with stories about American companies
that have stumbled in trying to comply with foreign laws and regulations. Coca-Cola, for example, ran afoul of Italian law when it printed its ingredients list on the bottle cap rather than on the bottle itself. Italian courts ruled that the labeling was inadequate because most people throw the cap away. In another case, 3M applied to the Japanese government to create a joint venture with the Sumitomo Industrial Group to make and distribute magnetic tape products in Japan. 3M spent four years trying to satisfy Japan’s complex regulations, but by the time it got approval, domestic competitors, including Sony, had captured the market. By delaying 3M, Japanese regulators managed, in effect, to stifle foreign competition.

One approach to dealing with local laws and regulations is hiring lawyers from the host country who can provide advice on legal issues. Another is working with local businesspeople who have experience in complying with regulations and overcoming bureaucratic obstacles.

**Foreign Corrupt Practices Act**

One U.S. law that creates unique challenges for American firms operating overseas is the Foreign Corrupt Practices Act, which prohibits the distribution of bribes and other favors in the conduct of business. Unfortunately, though they’re illegal in this country, such tactics as kickbacks and bribes are business-as-usual in many nations. According to some experts, American businesspeople are at a competitive disadvantage if they’re prohibited from giving bribes or undercover payments to foreign officials or businesspeople who expect them; it’s like asking for good service in a restaurant when the waiter knows you won’t be giving a tip. In theory, because the Foreign Corrupt Practices Act warns foreigners that Americans can’t give bribes, they’ll eventually stop expecting them.

Where are American businesspeople most likely and least likely
to encounter bribe requests and related forms of corruption? Transparency International, an independent German-based organization, annually rates nations according to “perceived corruption,” which it defines as “the abuse of public office for private gain.” Table 2, “Corruptibility Around the World, 2010,” reports a sampling of the 2010 rankings.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>CPI Score*</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Denmark</td>
<td>9.3</td>
</tr>
<tr>
<td>1</td>
<td>New Zealand</td>
<td>9.3</td>
</tr>
<tr>
<td>1</td>
<td>Singapore</td>
<td>9.3</td>
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<tr>
<td>4</td>
<td>Finland</td>
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<td>4</td>
<td>Sweden</td>
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<tr>
<td>6</td>
<td>Canada</td>
<td>8.9</td>
</tr>
<tr>
<td>15</td>
<td>Germany</td>
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</tr>
<tr>
<td>17</td>
<td>Japan</td>
<td>7.8</td>
</tr>
<tr>
<td>20</td>
<td>United Kingdom</td>
<td>7.6</td>
</tr>
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<td>22</td>
<td>United States</td>
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<tr>
<td>98</td>
<td>Mexico</td>
<td>3.1</td>
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<tr>
<td>175</td>
<td>Iraq</td>
<td>1.6</td>
</tr>
<tr>
<td>176</td>
<td>Afghanistan</td>
<td>1.4</td>
</tr>
<tr>
<td>178</td>
<td>Somalia</td>
<td>1.1</td>
</tr>
</tbody>
</table>

*A score of 10 means that a country is squeaky clean. Anything under 3 means that corruption is rampant.

KEY TAKEAWAYS

• Success in international business means understanding an assortment of cultural, economic, and legal differences between countries.
• Cultural challenges stem from differences in language, concepts of time and sociability, and communication styles.
• If you do business in a foreign country, you need to know the country’s level of economic development.
• In dealing with countries whose currency is different from yours, you have to be aware of the impact that fluctuations in exchange rates will have on your profits.
• Finally, in doing business globally, you must deal with the challenges that come from the vast differences in legal and regulatory environments.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=127
104. Outcome: Ethics in International Markets

What you’ll learn to do: describe ethical issues that businesses face when engaging in international markets

“Business ethics” has been in the spotlight here in the United States with increasing frequency over the past decade. Companies like Enron and WorldCom and even celebrities such as Martha Stewart have all been marked by ethical shortcomings in their business dealings. Consider the situation faced by Goodyear Tire & Rubber in Africa:

Goodyear is paying $16 million to settle allegations that two of its Africa-based subsidiaries paid bribes to win tire sales in Kenya and Angola. Goodyear failed to prevent or detect more than $3.2 million in bribes during a four-year period as the result of inadequate compliance controls at the sub-Saharan affiliates. Many of the bribes were paid in cash to employees of private companies or government-owned entities, along with other local authorities, the SEC said. The Goodyear subsidiaries allegedly recorded the payments as legitimate business expenses.”

How does this happen? The ethical landscape of international business is cloudy, and the diverse nature of the cultural, political, and legal systems around the globe often makes the line between

1. USA Today, February 24, 2015
ethical and unethical business practices difficult to negotiate. In this section you will learn about some of the ethical challenges and issues that businesses face in international markets.

Learning Activities

The learning activities for this section include:

- Reading: Global Business Ethics
- Reading: Ethics and Corruption
- Video: Ethics and International Standards of Behavior
- Self Check: Ethics in International Markets

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Global Business Ethics

The field of ethics is a branch of philosophy that explores the nature of virtue and morality, addressing questions about “right” and “wrong” in secular (as opposed to religious) terms; essentially, ethics tries to set standards for how human beings ought to act. The study of ethics comes from a variety of sources—religion, philosophy, the laws of nature, political and social theory, and science—and its ideas have an impact on many fields besides business—medicine, government, and science, to name a few.

The text below is organized in the way that people tend to think about ethics: first they consider where ethical principles come from; then they consider how people ought to apply those principles to specific tasks or issues. Though global business ethics is the focus of the discussion, you won’t find a tangible list of dos and don’ts here. Instead, the material is meant to help you understand some of the critical issues that global managers must deal with on an operational and strategic basis.

Where Do Our Values Come From?

Just as people look to history to understand political, technical, and social changes, so, too, do they look to history to understand changes in thinking and philosophy. Believe it or not, there is a history of thought and belief. What may or may not have been acceptable just a hundred years ago may be very different
today—from how people present themselves and how they act and interact to customs, values, and beliefs.

Ethics can be defined as a system of moral standards or values. Cultural beliefs and programming influence our values. A sense of ethics is determined by a number of social, cultural, and religious factors; this sense influences us beginning early in childhood. People are taught how to behave by their families, exposure to education and thinking, and the society in which they live. Ethical behavior also refers to behavior that is generally accepted within a specific culture. Some behaviors are universally accepted—for example, people shouldn't physically hurt other people. Other actions are less clear, such as discrimination based on age, race, gender, or ethnicity.

Culture impacts how local values influence global business ethics. There are differences in how much importance cultures place on specific ethical behaviors. For example, bribery remains widespread in many countries, and while people may not approve of it, they accept it as a necessity of daily life. Each professional is influenced by the values, social programming, and experiences encountered from childhood on. These collective factors affect how a person perceives an issue and the related correct or incorrect behaviors. Even within a specific culture, individuals have different ideas of what constitutes ethical or unethical behavior. Judgments may differ greatly depending on an individual's social or economic standing, education, and experiences with other cultures and beliefs. Just as in the example of bribery, it should be noted that there is a difference between ethical behavior and normal practice. It may be acceptable to discriminate in certain cultures, even if the people in that society know that it is not right or fair. In global business ethics, people try to understand what the ethical action is and what the normal practice might be. If these are not consistent, the focus is placed on how to encourage ethical actions.

While it's clear that ethics is not religion, values based on religious teachings have influenced our understanding of ethical behavior. Given the influence of Western thought and philosophy over the
world in the last few centuries, many would say that global business has been heavily influenced by the ideas and values of the Reformation and Enlightenment, which emphasize equality and individual rights. As a result, it has become accepted that all people in any country and of any background are equal and should have equal opportunity. Companies incorporate this principle in their employment, management, and operational guidelines. However, enforcing it in global operations can be both tricky and inconsistent.

It's important to understand the impact and influence of these two critical historical periods on our modern sense of global business ethics. The prevailing corporate values—including those of institutional and individual equality; the right of every employee to work hard and reap the rewards (both financial and non-financial); corporate social responsibility; and the application of science and reason to all management and operational processes—have their roots in the thoughts and values of those historical periods.

Impact of Ethics on Global Business

At first, it may seem relatively easy to identify unethical behavior. When the topic of business ethics is raised, most people immediately focus on corruption and bribery. While this is a critical result of unethical behavior, the concept of business ethics and global business ethics is much broader. It impacts human resources, social responsibility, and the environment. The areas of business impacted by global perceptions of ethical, moral, and socially responsible behavior include the following:

- Ethics and management
- Ethics and corruption
- Corporate social responsibility
Ethics and Management Practices

Ethics affects various aspects of management and operations, including human resources, marketing, research and development, and even the corporate mission.

The role of ethics in management practices, particularly those practices involving human resources and employment, differs from culture to culture. Local culture affects the way people view the employee-employer relationship. In many cultures, there are no clear social rules preventing discrimination against people based on age, race, gender, sexual preference, handicap, and so on. Even when there are formal rules or laws against discrimination, they may not be enforced, as normal practice may allow people and companies to act in accordance with local cultural and social practices.

Culture can influence the way people view one another in the workplace, and local views—of, say, women—can be at odds with a company’s ethics. So how do companies handle local customs and values for the treatment of women in the workplace? If you're a senior officer of an American company, do you send a woman to Saudi Arabia or Afghanistan to negotiate with government officials or manage the local office? Does it matter what your industry is or whether your firm is the seller or buyer? In theory, most global firms have clear guidelines articulating anti-discrimination policies. In reality, global businesses routinely self-censor. Companies often determine whether a person—based on their gender, ethnicity, or race—can be effective in a specific culture based on the prevailing values of that culture. The largest and most respected global companies, typically the Fortune Global 500, can often make management and employment decisions regardless of local practices. Most people in each country will want to deal with these large and well-respected companies. The person representing the larger company brings the clout of their company to any business interaction. In contrast, lesser-known, midsize, and smaller
companies may find that who their representative is will be more important. Often lacking business recognition in the marketplace, these smaller and midsize companies have to rely on their corporate representatives to create the professional image and bond with their in-country counterparts.

Cultural norms may make life difficult for the company as well as the employee. In some cultures, companies are seen as “guardians” or paternal figures. Any efforts to lay off or fire employees may be perceived as culturally unethical. In Japan, where lifelong loyalty to the company was expected in return for lifelong employment, the decade-long recession beginning in the 1990s triggered a change in attitude. Japanese companies finally began to alter this ethical perception and lay off workers without being perceived as unethical.

Global corporations are increasingly trying to market their products based not only on the desirability of the goods but also on their social and environmental merits. Companies whose practices are considered unethical may find their global performance impacted when people boycott their products. Most corporations understand this risk. However, ethical questions have grown increasingly complicated, and the “correct” or ethical choice has, in some cases, become difficult to define.

For example, the pharmaceutical industry is involved in a number of issues that have medical ethicists squirming. First, there's the well-publicized issue of cloning. No matter what choice the companies make about cloning, they are sure to offend a great many consumers. At the same time, pharmaceutical companies must decide whether to forfeit profits and give away free drugs or cheaper medicines to impoverished African nations. Pharmaceutical companies that do donate medicines often promote this practice in their corporate marketing campaigns in hopes that consumers see the companies in a favorable light.

Tobacco companies are similarly embroiled in a long-term ethical debate. Health advocates around the world agree that smoking is bad for a person's long-term health. Yet in many countries, smoking
is not only acceptable but can even confer social status. The United States has banned tobacco companies from adopting marketing practices that target young consumers by exploiting tobacco’s social caché. However, many other countries don’t have such regulations. Should tobacco companies be held responsible for knowingly marketing harmful products to younger audiences in other countries?

**Corporate Social Responsibility**

Corporate social responsibility (CSR) is defined in Wikipedia as “the corporate conscience, citizenship, social performance, or sustainable responsible business, and is a form of corporate self-regulation integrated into a business model. CSR policy functions as a built-in, self-regulating mechanism whereby business monitors and ensures its active compliance with the spirit of the law, ethical standards, and international norms.”

CSR emerged more than three decades ago, and it has gained increasing strength over time as companies seek to generate goodwill with their employees, customers, and stakeholders. “Corporate social responsibility encompasses not only what companies do with their profits, but also how they make them. It goes beyond philanthropy and compliance and addresses how companies manage their economic, social, and environmental impacts, as well as their relationships in all key spheres of influence: the workplace, the marketplace, the supply chain, the community, and the public policy realm.”

Companies may support nonprofit causes and organizations, global initiatives, and prevailing themes. Promoting environmentally friendly and green initiatives is an example of a current prevailing theme.

Coca-Cola is an example of global corporation with a long-term commitment to CSR. In many developing countries, Coca-Cola promotes local economic development through a combination of philanthropy and social and economic development. Whether by using environmentally friendly containers or supporting local education initiatives through its foundation, Coca-Cola is only one of many global companies that seek to increase their commitment to local markets while enhancing their brand, corporate image, and reputation by engaging in socially responsible business practices.

Companies use a wide range of strategies to communicate their socially responsible strategies and programs. Under the auspices of the United Nations, the Global Compact “is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anticorruption.”

Enforcement of Ethical Guidelines and Standards

The concept of culture impacting the perception of ethics is one that many businesspeople debate. While culture does impact business ethics, international companies operate in multiple countries and need a standard set of global operating guidelines. Professionals engage in unethical behavior primarily as a result of their own personal ethical values, the corporate culture within a company, or from unrealistic performance expectations.

In the interest of expediency, many governments—the U.S. government included—may not strictly enforce the rules governing corporate ethics. The practice of gift giving is one aspect of business that many governments don't examine too closely. Many companies have routinely used gifts to win favor from their customers, without engaging in direct bribery. American companies frequently invite prospective buyers to visit their U.S. facilities or attend company conferences in exotic locales with all expenses paid. These trips often have perks included. Should such spending be considered sales and marketing expenses, as they are often booked, or are these companies engaging in questionable behavior? It's much harder to answer this question when you consider that most of the company's global competitors are likely to engage in similarly aggressive marketing and sales behavior.

Governments often do not enforce laws until it's politically expedient to do so. Take child labor, for example. Technically, companies operating in India or Pakistan are not permitted to use child labor in factories, mines, and other areas of hazardous employment. However, child labor is widespread in these countries due to deep-rooted social and economic challenges. Local governments are often unable and unwilling to enforce national rules and regulations. Companies and consumers who purchase goods made by children are often unaware that these practices remain unchecked.

The Evolution of Ethics

Ethics evolves over time. It is difficult for both companies and professionals to operate within one set of accepted standards or guidelines only to see them gradually evolve or change. For example, bribery has been an accepted business practice for centuries in Japan and Korea. When these nations adjusted their practices in order to enter the global system, the questionable practices became
illegal. Hence a Korean businessman who engaged in bribery ten or twenty years ago may not do so today without finding himself on the other side of the law. Even in the United States, discrimination and business-regulation laws have changed tremendously over the last several decades. And who can know what the future holds? Some of the business practices that are commonly accepted today may be frowned on tomorrow.

It's clear that changing values, as influenced by global media, and changing perceptions and cultures will impact global ethics. The most challenging aspect is that global business does not have a single definition of “fair” or “ethical.” While culture influences the definitions of those ideas, many companies are forced to navigate this sensitive area very carefully, as it impacts both their bottom line and their reputations.

KEY TAKEAWAYS

• Culture impacts how local values influence the concept of global business ethics. Each professional is influenced by the values, social programming, and experiences he or she has absorbed since childhood. These collective factors impact how a person perceives an issue and the related correct or incorrect behavior. For some cultures, the evolution of international business and culture sometimes creates a conflict, such as what is seen in gift-giving practices or views on women in the workplace.
• Ethics impacts global business in the areas of management, corruption, and corporate social responsibility.
106. Reading: Ethics and Corruption

Ethics and Corruption

To begin our discussion of corruption, let’s first define it in a business context. Corruption is “giving or obtaining advantage through means which are illegitimate, immoral, and/or inconsistent with one’s duty or the rights of others.”

Our modern understanding of business ethics notes that following culturally accepted norms is not always the ethical choice. What may be acceptable at certain points in history, such as racism or sexism, became unacceptable with the further development of society’s mind-set. What happens when cultures change but business practices don’t? Does that behavior become unethical, and is the person engaged in the behavior unethical? In some cultures, there may be conflicts with global business practices, such as in the area of gift giving, which has evolved into bribery—a form of corruption.

Paying bribes is relatively common in many countries, and bribes often take the form of grease payments, which are small inducements intended to expedite decisions and transactions. In India and Mexico, for example, a grease payment may help get your phones installed faster—at home or at work. Transparency International tracks illicit behavior, such as bribery and embezzlement, in the public sector in 180 countries by surveying international business executives. It assigns a CPI (Corruption Perceptions Index) rating to each country. New Zealand, Denmark, Singapore, and Sweden have the lowest levels of corruption, while the highest levels of corruption are seen in most African nations, Russia, Myanmar, and Afghanistan.
Even the most respected of global companies has found itself on the wrong side of the ethics issue and the law. In 2008, after years of investigation, Siemens agreed to pay more than 1.34 billion euros in fines to American and European authorities to settle charges that it routinely used bribes and slush funds to secure huge public-works contracts around the world. “Officials said that Siemens, beginning in the mid-1990s, used bribes and kickbacks to foreign officials to secure government contracts for projects like a national identity card project in Argentina, mass transit work in Venezuela, a nationwide cell phone network in Bangladesh, and a United Nations oil-for-food program in Iraq under Saddam Hussein. ‘Their actions were not an anomaly,’ said Joseph Persichini Jr., the head of the Washington office of the Federal Bureau of Investigation. ‘They were standard operating procedures for corporate executives, who viewed bribery as a business strategy.’”

Ethics in Action

Each year Transparency International analyzes trends in global corruption. The following is an excerpt from their 2010 Global Corruption Barometer report, which captures the experiences and views of 91,500 people in 86 countries and territories:

“Corruption has increased over the last three years,” say six out of ten people around the world. One in four people report paying bribes in the last year.

Views on corruption were most negative in Western Europe and North America, where 73 percent and 67 percent of people, respectively, thought corruption had increased over the last three years.

“The fallout of the financial crises continues to affect people’s opinions of corruption, particular in North America and Western Europe. Institutions everywhere must be resolute in their efforts to
restore good governance and trust,” said Huguette Labelle, Chair of Transparency International.

In the past twelve months one in four people reported paying a bribe to one of nine institutions and services, from health to education to tax authorities. The police are cited as being the most frequent recipient of bribes, according to those surveyed. About 30 percent of those who had contact with the police reported having paid a bribe.

More than twenty countries have reported significant increases in petty bribery since 2006. The biggest increases were in Chile, Colombia, Kenya, FYR Macedonia, Nigeria, Poland, Russia, Senegal and Thailand. More than one in two people in Sub-Saharan Africa reported paying a bribe—more than anywhere else in the world.

Poorer people are twice as likely to pay bribes for basic services, such as education, than wealthier people. A third of all people under the age of thirty reported paying a bribe in the past twelve months, compared to less than one in five people aged fifty-one years and over.

Most worrying is the fact that bribes to the police have almost doubled since 2006, and more people report paying bribes to the judiciary and for registry and permit services than five years ago.

Sadly, few people trust their governments or politicians. Eight out of ten say political parties are corrupt or extremely corrupt, while half the people questioned say their government’s action to stop corruption is ineffective.

“The message from the 2010 Barometer is that corruption is insidious. It makes people lose faith. The good news is that people are ready to act,” said Labelle. “Public engagement in the fight against corruption will force those in authority to act—and will give people further courage to speak out and stand up for a cleaner, more transparent world.”

Gift giving in the global business world is used to establish or pay respects to a relationship. Bribery, on the other hand, is more commonly considered the practice in which an individual would benefit with little or no benefit to the company. It's usually paid in relation to winning a business deal, whereas gift giving is more likely to be ingrained in the culture and not associated with winning a specific piece of business. Bribery, usually in the form of a cash payment, has reached such high proportions in some countries that even locals express disgust with the corruption and its impact on daily life for businesses and consumers.

The practice of using connections to advance business interests exists in just about every country in the world. However, the extent and manner in which it is institutionalized differs from culture to culture.

In Western countries, connections are viewed informally and sometimes even with a negative connotation. In the United States and other similar countries, professionals prefer to imply that they have achieved success on their own merits and without any connections. Gift giving is not routine in the United States except during the winter holidays, and even then gift giving involves a modest expression. Businesses operating in the United States send modest gifts or cards to their customers to thank them for business loyalty in the previous year. Certain industries, such as finance, even set clear legal guidelines restricting the value of gifts, typically a maximum of $100.

In contrast, Asian, Latin American, and Middle Eastern cultures are quick to value connections and relationships and view gifts quite positively. Connections are considered essential for success. In Asia, gift giving is so ingrained in the culture, particularly in Japan and China, that it is formalized and structured.

For example, gift giving in Japan was for centuries an established practice in society and is still taken seriously. There are specific guidelines for gift giving depending on the identity of the giver or recipient, the length of the business relationship, and the number of gifts exchanged. The Japanese may give gifts out of a sense of
obligation and duty as well as to convey feelings such as gratitude and regret. Therefore, much care is given to the appropriateness of the gift as well as to its aesthetic beauty.

Today there are still business gift-giving occasions in Japan, specifically *oseibo* (year’s end) and *ochugen* (midsummer). These are must-give occasions for Japanese businesses. *Oseibo* gifts are presented in the first half of December as a token of gratitude for earlier favors and loyalty. This is a good opportunity to thank clients for their business. *Ochugen* usually occurs in mid-July in Tokyo and mid-August in some other regions. Originally an occasion to provide consolation to the families of those who had died in the first half of the year, *ochugen* falls two weeks before *obon*, a holiday honoring the dead.

Businesses operating in Japan at these times routinely exchange *oseibo* and *ochugen* gifts. While a professional is not obligated to participate, it clearly earns goodwill. At the most senior levels, it is not uncommon for people to exchange gifts worth $300 or $400. There is an established price level that one should pay for each corporate level.

Despite these guidelines, gift giving in Japan has occasionally crossed over into bribery. This level of corruption became more apparent in the 1980s as transparency in global business gained media attention. Asians tend to take a very different view of accountability than most Westerners. In the 1980s and 1990s, several Japanese CEOs resigned in order to apologize and take responsibility for their companies’ practices, even when they did not personally engage in the offending practices. This has become an accepted managerial practice in an effort to preserve the honor of the company. While Japanese CEOs may not step down as quickly as in the past, the notion of honor remains an important business characteristic.

Long an established form of relationship development in all business conducted in Asia, the Arab world, and Africa, gift giving was clearly tipping over into outright bribery. In the past two decades, many countries have placed limits on the types and value
of gifts while simultaneously banning bribery in any form. In the United States, companies must adhere to the Foreign Corrupt Practices Act, a federal law that specifically bans any form of bribery. Even foreign companies that are either listed on an American stock exchange or conduct business with the U.S. government come under the purview of this law.

There are still global firms that engage in questionable business gift giving; when caught, they face fines and sanctions. But for the most part, firms continue with business as usual. Changing the cultural practices of gift giving is an evolving process that will take time, government attention, and more transparency in the awarding of global business contracts.

Companies and their employees routinely try to balance ethical behavior with business interests. While corruption is now widely viewed as unethical, firms still lose business to companies that may be less diligent in adhering to this principle. While the media covers stories of firms that have breached this ethical conduct, the misconduct of many more companies goes undetected. Businesses, business schools, and governments are increasingly making efforts to deter firms and professionals from making and taking bribes. There are still countless less visible gestures that some would argue are also unethical.

For example, imagine that an employee works at a firm that wants to land a contract in China. A key government official in China finds out that you went to the business school that his daughter really wants to attend. He asks you to help her in the admission process. Do you? Should you? Is this just a nice thing to do, or is it a potential conflict of interest if you think the official will view your company more favorably? This is a gray area of global business ethics. Interestingly, a professional's answer to this situation may depend on his or her culture. Cultures that have clear guidelines for right and wrong behavior may see this situation differently than a culture in which doing favors is part of the normal practice. A company may declare this inappropriate behavior, but employees may still do what they think is best for their jobs. Cultures that have
a higher tolerance for ambiguity, as this module discusses, may find it easier to navigate the gray areas of ethics—when it is not so clear.

Most people agree that bribery in any form only increases the cost of doing business—a cost that is either absorbed by the company or eventually passed on to the buyer or consumer in some form. While businesses agree that corruption is costly and undesirable, losing profitable business opportunities to firms that are less ethically motivated can be just as devastating to the bottom line. Until governments in every country consistently monitor and enforce anticorruption laws, bribery will remain a real and very challenging issue for global businesses.
107. Video: Ethics and International Standards of Behavior

Ethics and International Standards of Behavior

Watch the following video that examines business and decision making that are impacted by globalization. As you watch consider why it matters that different cultures have different beliefs, behaviors, traditions, etc., and consider the standards that apply to each culture. video.

A YouTube element has been excluded from this version of the text. You can view it online here:
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:

https://library.achievingthedream.org/baycollegeintrobusiness/?p=131
What you’ll learn to do: describe the impact of currency valuation on business operations in global markets

Have you ever gotten change back at a store and later discovered that among your U.S. currency was a Canadian quarter or nickel? It looks almost like its U.S. counterpart, and feels almost like its U.S. counterpart—but something about it is different. The value of that Canadian coin may very well differ from its U.S. counterpart, depending on the exchange rate that day. Imagine carrying this $100,000,000,000,000 Zimbabwean banknote in your wallet . . . feeling pretty rich? Well, don’t go shopping for a new sports car quite yet! If you were to take this $100 trillion banknote to your local banker and ask for it to be exchanged into U.S. dollars, you would walk out of the bank with about $276,000,000,000 ($276 billion dollars). Now, that’s still more money than some countries’ GDP, but it’s a far cry from $100 TRILLION! Why is that? The answer is currency valuation, which is the topic for this section of our module.
Learning Activities

The learning activities for this section include:

• Reading: Currency Valuations and Exchange Rates
• Self Check: Currency Valuation

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
The Ups and Downs of Currency Valuations and Exchange Rates

If every nation used the same currency, international trade and travel would be a lot easier. Unfortunately, this is not the case. There are about 175 currencies in the world: Some you’ve heard of, such as the British pound; others are likely unknown to you, such as the manat, the official currency of Azerbaijan, a small nation in Southwest Asia. Let’s pretend you suddenly find yourself in Azerbaijan and all you have with you is a credit card (which none of the restaurants or hotels will take) and U.S. dollars (which no one wants either). How can you get some Azerbaijani manats so you can buy a good meal and check into a hotel? If it’s during the day, you’re in luck. Head to the closest bank and ask someone there who speaks English to exchange your dollars for Azerbaijan manats. If you give the bank clerk $300 (all of your travel money), don’t expect to get back 300 manats; the two currencies are not equal. To determine how much Azerbaijan money you’ll get in exchange for your $300, the bank clerk will look up the day’s foreign exchange rate—which tells you how much one currency is worth relative to another currency. If today were August 23, 2011, the clerk would find an exchange rate of 1 U.S. dollar equals .79 manats (which means that you get 79 manats for every dollar you give to the bank clerk). In other words, when you hand the clerk your $300 you’ll get back only 235 manats (.79 × $300).

Most likely, the deal does not sound good to you, but you have
no choice—that’s what the exchange rate is. Plus, you’re lucky that it’s during the day and the banks are open: sleeping outside in Azerbaijan with an empty stomach doesn’t sound like fun, although it would give you time to wonder what would happen if an Azerbaijani traveled to the United States. When the traveler goes to exchange manats for U.S. dollars, he or she will get back $1.27 for each manat. Exchanging 300 manats for U.S. dollars yields $381 in U.S. dollars (1.27097 × $300). Well, this doesn’t sound fair. Why did you receive fewer manats for your U.S. dollars while the Azerbaijani traveler received more dollars for his or her manats? It is because the U.S. dollar is weak relative to the Azerbaijan manat. There are many reasons for the weakness of the U.S. dollar, but one possible culprit is the huge $14 trillion debt (and rising) carried by the United States. And if you are looking for things to get upset about, your share of this huge U.S. debt is about $47,000 (and rising).
Now, we'll look at two business examples. First, let's say that your business is importing watches from Switzerland. Because the watchmaker will want to be paid in Swiss francs, you have to figure out how many U.S. dollars you'll need to buy the francs with which to pay the watchmaker. You'd start by finding out the exchange rate between the Swiss franc and the U.S. dollar.

You could simply look in a newspaper or go to any number of websites—say, http://www.oanda.com—to get the current exchange rate. To keep things simple, let's assume that the exchange rate is 1 Swiss franc = U.S. $1.27 (i.e., 1 Swiss franc is worth $1.27). Let's also assume that you owe the Swiss watchmaker 1,000 francs. Doing some quick math, you figure that it will take $1,270 to buy 1,000 francs (1,000 francs × the exchange rate of 1.27 = $1,270).

Now let's say that you don't have the cash flow to pay the watchmaker for two weeks. When you check the exchange rate two weeks later, you find that it has gone up to 1 Swiss franc = $1.37. Are you better off or worse off? It's easy to check: 1,000 francs × the new exchange rate of 1.37 = $1,370. You've just learned the hard way that when the value of the franc relative to the dollar goes up, it costs you more to buy something from Switzerland. You probably can't help but wonder what would have happened if the value of the franc relative to the dollar had gone down—say, to $1.17 per franc. At this rate, you'd need only $1,170 to pay the 1,000 francs (1,000 × 1.17). In other words, when the value of the franc relative to the dollar drops, it costs less to buy goods from Switzerland. In sum you've learned the following:

- If a foreign currency goes up relative to the U.S. dollar, Americans must pay more for goods and services purchased
from sellers in the country issuing the currency (foreign products are more expensive). This is bad for exporters who have to pay more for the foreign-made goods they buy to bring back to the United States to sell.

• If a foreign currency goes *down* relative to the U.S. dollar, Americans pay less for products from the country issuing the currency (foreign products are cheaper).

In the interest of being thorough, let’s look at this phenomenon from the perspective of an American seller and a Swiss buyer. First, we need to know the exchange rate for the U.S. dollar relative to the franc, which happens to be .79 francs = US$1. This means that if you want to sell something—let’s say your latest painting—for $1,000 U.S. to an art lover in Switzerland, the Swiss buyer will need only 790 francs to get the $1,000 needed to pay you. If the exchange rate went up to .89 francs = US$1, the cost of the painting would be $890. If the exchange rate went down to .69 francs = US$1, the cost of the painting would be $690. So now you also know the following:

• If the U.S. dollar goes *up* relative to a foreign currency, foreign buyers must pay *more* for American goods and services (they become more expensive).

• If the U.S. dollar goes *down* relative to a foreign currency, foreign buyers pay *less* for American products (they become cheaper). This is good for importers as their “cheaper” goods are more attractive to customers in the foreign country.

**Reflection Questions**

• How do exchange rates affect pricing in international markets?
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=133
110. Outcome: The IMF and the World Bank

What you’ll learn to do: explain the roles of the IMF and the World Bank in promoting international trade

Hundreds of nations, hundreds of currencies, each with their own value that changes on a daily basis—that's what you learned in the previous section. It sounds like a crazy system that no one controls but everyone needs in order to conduct business in today’s global economy, doesn’t it? Well, it is a complex system!

Our international monetary system is one that was established in the 1940s and continues to evolve as technology, consumer demand, and international competition change. However, there are organizations in place to help regulate, promote, and monitor the international monetary system in a way that promotes international trade. The two key organizations in this field are the IMF (International Monetary Fund) and the World Bank. As you'll see in this next section, there are important distinctions between the two, and each has a different role and set of responsibilities within the international community.

Learning Activities

The learning activities for this section include:

- Reading: The IMF and the World Bank: How Do They Differ?
- Self Check: The IMF and the World Bank
Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
If you have difficulty distinguishing the World Bank from the International Monetary Fund, you are not alone. Most people have only the vaguest idea of what these institutions do, and very few people indeed could, if pressed, say why and how they differ. Even John Maynard Keynes, a founding father of the two institutions and considered by many the most brilliant economist of the twentieth century, admitted at the inaugural meeting of the International Monetary Fund that he was confused by the names: he thought the Fund should be called a bank, and the Bank should be called a fund. Confusion has reigned ever since.

Known collectively as the Bretton Woods Institutions after the remote village in New Hampshire, U.S.A., where they were founded by the delegates of 44 nations in July 1944, the Bank and the IMF are twin intergovernmental pillars supporting the structure of the world's economic and financial order. That there are two pillars rather than one is no accident. The international community was consciously trying to establish a division of labor in setting up the two agencies. Those who deal professionally with the IMF and Bank find them categorically distinct. To the rest of the world, the niceties of the division of labor are even more mysterious than are the activities of the two institutions.

Similarities between them do little to resolve the confusion. Superficially the Bank and IMF exhibit many common
characteristics. Both are in a sense owned and directed by the governments of member nations. The People's Republic of China, by far the most populous state on earth, is a member, as is the world's largest industrial power (the United States). In fact, virtually every country on earth is a member of both institutions. Both institutions concern themselves with economic issues and concentrate their efforts on broadening and strengthening the economies of their member nations. Staff members of both the Bank and IMF often appear at international conferences, speaking the same recondite language of the economics and development professions, or are reported in the media to be negotiating involved and somewhat mystifying programs of economic adjustment with ministers of finance or other government officials. The two institutions hold joint annual meetings, which the news media cover extensively. Both have headquarters in Washington, D.C., where popular confusion over what they do and how they differ is about as pronounced as everywhere else. For many years both occupied the same building and even now, though located on opposite sides of a street very near the White House, they share a common library and other facilities, regularly exchange economic data, sometimes present joint seminars, daily hold informal meetings, and occasionally send out joint missions to member countries.

Despite these and other similarities, however, the Bank and the IMF remain distinct. The fundamental difference is this: the Bank is primarily a development institution; the IMF is a cooperative institution that seeks to maintain an orderly system of payments and receipts between nations. Each has a different purpose, a distinct structure, receives its funding from different sources, assists different categories of members, and strives to achieve distinct goals through methods peculiar to itself.
At Bretton Woods, the international community assigned to the World Bank—its formal name was the International Bank for Reconstruction and Development (IBRD)—the primary responsibility for financing economic development. The Bank’s first loans were extended during the late 1940s to finance the reconstruction of the war-ravaged economies of Western Europe. When these nations recovered some measure of economic self-sufficiency, the Bank turned its attention to assisting the world’s poorer nations, known as developing countries, to which it has since the 1940s loaned more than $330 billion. The World Bank has one central purpose: to promote economic and social progress in developing countries by helping to raise productivity so that their people may live a better and fuller life.

The international community assigned to the IMF a different purpose. In establishing the IMF, the world community was reacting to the unresolved financial problems instrumental in initiating and protracting the Great Depression of the 1930s: sudden, unpredictable variations in the exchange values of national currencies and a widespread disinclination among governments to allow their national currency to be exchanged for foreign currency. Set up as a voluntary and cooperative institution, the IMF attracts to its membership nations that are prepared, in a spirit of enlightened self-interest, to relinquish some measure of national sovereignty by abjuring practices injurious to the economic well-being of their fellow member nations. The rules of the institution, contained in the IMF’s Articles of Agreement signed by all members, constitute a code of conduct. The code is simple: it requires members to allow their currency to be exchanged for foreign currencies freely and without restriction, to keep the IMF informed of changes they contemplate in financial and monetary policies that will affect fellow members’ economies, and, to the extent possible, to modify
these policies on the advice of the IMF to accommodate the needs of the entire membership.

To help nations abide by the code of conduct, the IMF administers a pool of money from which members can borrow when they are in trouble. The IMF is not, however, primarily a lending institution as is the Bank. It is first and foremost an overseer of its members’ monetary and exchange rate policies and a guardian of the code of conduct. Philosophically committed to the orderly and stable growth of the world economy, the IMF is an enemy of surprise. It receives frequent reports on members’ economic policies and prospects, which it debates, comments on, and communicates to the entire membership so that other members may respond in full knowledge of the facts and a clear understanding of how their own domestic policies may affect other countries. The IMF is convinced that a fundamental condition for international prosperity is an orderly monetary system that will encourage trade, create jobs, expand economic activity, and raise living standards throughout the world. By its constitution the IMF is required to oversee and maintain this system, no more and no less.

Size and Structure

The IMF is small (about 2,300 staff members) and, unlike the World Bank, has no affiliates or subsidiaries. Most of its staff members work at headquarters in Washington, D.C., although three small offices are maintained in Paris, Geneva, and at the United Nations in New York. Its professional staff members are for the most part economists and financial experts.

The structure of the Bank is somewhat more complex. The World Bank itself comprises two major organizations: the International Bank for Reconstruction and Development and the International Development Association (IDA). Moreover, associated with, but legally and financially separate from the World Bank are the
International Finance Corporation, which mobilizes funding for private enterprises in developing countries, the International Center for Settlement of Investment Disputes, and the Multilateral Guarantee Agency. With over 7,000 staff members, the World Bank Group is about three times as large as the IMF, and maintains about 40 offices throughout the world, although 95 percent of its staff work at its Washington, D.C., headquarters. The Bank employs a staff with an astonishing range of expertise: economists, engineers, urban planners, agronomists, statisticians, lawyers, portfolio managers, loan officers, project appraisers, as well as experts in telecommunications, water supply and sewerage, transportation, education, energy, rural development, population and health care, and other disciplines.

Source of Funding

The World Bank is an investment bank, intermediating between investors and recipients, borrowing from the one and lending to the other. Its owners are the governments of its 180 member nations with equity shares in the Bank, which were valued at about $176 billion in June 1995. The IBRD obtains most of the funds it lends to finance development by market borrowing through the issue of bonds (which carry an AAA rating because repayment is guaranteed by member governments) to individuals and private institutions in more than 100 countries. Its concessional loan associate, IDA, is largely financed by grants from donor nations. The Bank is a major borrower in the world’s capital markets and the largest nonresident borrower in virtually all countries where its issues are sold. It also borrows money by selling bonds and notes directly to governments, their agencies, and central banks. The proceeds of these bond sales are lent in turn to developing countries at affordable rates of interest to help finance projects and policy reform programs that give promise of success.
Despite Lord Keynes’s profession of confusion, the IMF is not a bank and does not intermediate between investors and recipients. Nevertheless, it has at its disposal significant resources, presently valued at over $215 billion. These resources come from quota subscriptions, or membership fees, paid in by the IMF’s 182 member countries. Each member contributes to this pool of resources a certain amount of money proportionate to its economic size and strength (richer countries pay more, poorer less). While the Bank borrows and lends, the IMF is more like a credit union whose members have access to a common pool of resources (the sum total of their individual contributions) to assist them in times of need. Although under special and highly restrictive circumstances the IMF borrows from official entities (but not from private markets), it relies principally on its quota subscriptions to finance its operations. The adequacy of these resources is reviewed every five years.

Recipients of Funding

Neither wealthy countries nor private individuals borrow from the World Bank, which lends only to creditworthy governments of developing nations. The poorer the country, the more favorable the conditions under which it can borrow from the Bank. Developing countries whose per capita gross national product (GNP) exceeds $1,305 may borrow from the IBRD. (Per capita GNP, a less formidable term than it sounds, is a measure of wealth, obtained by dividing the value of goods and services produced in a country during one year by the number of people in that country.) These loans carry an interest rate slightly above the market rate at which the Bank itself borrows and must generally be repaid within 12-15 years. The IDA, on the other hand, lends only to governments of very poor developing nations whose per capita GNP is below $1,305, and in practice IDA loans go to countries with annual per capita incomes
below $865. IDA loans are interest free and have a maturity of 35 or 40 years.

In contrast, all member nations, both wealthy and poor, have the right to financial assistance from the IMF. Maintaining an orderly and stable international monetary system requires all participants in that system to fulfill their financial obligations to other participants. Membership in the IMF gives to each country that experiences a shortage of foreign exchange—preventing it from fulfilling these obligations—temporary access to the IMF’s pool of currencies to resolve this difficulty, usually referred to as a balance of payments problem. These problems are no respecter of economic size or level of per capita GNP, with the result that over the years almost all members of the IMF, from the smallest developing country to the largest industrial country, have at one time or other had recourse to the IMF and received from it financial assistance to tide them over difficult periods. Money received from the IMF must normally be repaid within three to five years, and in no case later than ten years. Interest rates are slightly below market rates, but are not so concessional as those assigned to the World Bank’s IDA loans. Through the use of IMF resources, countries have been able to buy time to rectify economic policies and to restore growth without having to resort to actions damaging to other members’ economies.

World Bank Operations

The World Bank exists to encourage poor countries to develop by providing them with technical assistance and funding for projects and policies that will realize the countries’ economic potential. The Bank views development as a long-term, integrated endeavor.

During the first two decades of its existence, two thirds of the assistance provided by the Bank went to electric power and transportation projects. Although these so-called infrastructure
projects remain important, the Bank has diversified its activities in recent years as it has gained experience with and acquired new insights into the development process.

The Bank gives particular attention to projects that can directly benefit the poorest people in developing countries. The direct involvement of the poorest in economic activity is being promoted through lending for agriculture and rural development, small-scale enterprises, and urban development. The Bank is helping the poor to be more productive and to gain access to such necessities as safe water and waste-disposal facilities, health care, family-planning assistance, nutrition, education, and housing. Within infrastructure projects there have also been changes. In transportation projects, greater attention is given to constructing farm-to-market roads. Rather than concentrating exclusively on cities, power projects increasingly provide lighting and power for villages and small farms. Industrial projects place greater emphasis on creating jobs in small enterprises. Labor-intensive construction is used where practical. In addition to electric power, the Bank is supporting development of oil, gas, coal, fuelwood, and biomass as alternative sources of energy.

The Bank provides most of its financial and technical assistance to developing countries by supporting specific projects. Although IBRD loans and IDA credits are made on different financial terms, the two institutions use the same standards in assessing the soundness of projects. The decision whether a project will receive IBRD or IDA financing depends on the economic condition of the country and not on the characteristics of the project.

Its borrowing member countries also look to the Bank as a source of technical assistance. By far the largest element of Bank-financed technical assistance—running over $1 billion a year recently—is that financed as a component of Bank loans or credits extended for other purposes. But the amount of Bank-financed technical assistance for free-standing loans and to prepare projects has also increased. The Bank serves as executing agency for technical assistance projects financed by the United Nations Development
Program in agriculture and rural development, energy, and economic planning. In response to the economic climate in many of its member countries, the Bank is now emphasizing technical assistance for institutional development and macroeconomic policy formulation.

Every project supported by the Bank is designed in close collaboration with national governments and local agencies, and often in cooperation with other multilateral assistance organizations. Indeed, about half of all Bank-assisted projects also receive cofinancing from official sources, that is, governments, multilateral financial institutions, and export-credit agencies that directly finance the procurement of goods and services, and from private sources, such as commercial banks.

In making loans to developing countries, the Bank does not compete with other sources of finance. It assists only those projects for which the required capital is not available from other sources on reasonable terms. Through its work, the Bank seeks to strengthen the economies of borrowing nations so that they can graduate from reliance on Bank resources and meet their financial needs, on terms they can afford directly from conventional sources of capital.

The range of the Bank's activities is far broader than its lending operations. Since the Bank's lending decisions depend heavily on the economic condition of the borrowing country, the Bank carefully studies its economy and the needs of the sectors for which lending is contemplated. These analyses help in formulating an appropriate long-term development assistance strategy for the economy.

Graduation from the IBRD and IDA has occurred for many years. Of the 34 very poor countries that borrowed money from IDA during the earliest years, more than two dozen have made enough progress for them no longer to need IDA money, leaving that money available to other countries that joined the Bank more recently. Similarly, about 20 countries that formerly borrowed money from the IBRD no longer have to do so. An outstanding example is Japan. For a period of 14 years, it borrowed from the IBRD. Now, the IBRD borrows large sums in Japan.
IMF Operations

The IMF has gone through two distinct phases in its 50-year history. During the first phase, ending in 1973, the IMF oversaw the adoption of general convertibility among the major currencies, supervised a system of fixed exchange rates tied to the value of gold, and provided short-term financing to countries in need of a quick infusion of foreign exchange to keep their currencies at par value or to adjust to changing economic circumstances. Difficulties encountered in maintaining a system of fixed exchange rates gave rise to unstable monetary and financial conditions throughout the world and led the international community to reconsider how the IMF could most effectively function in a regime of flexible exchange rates. After five years of analysis and negotiation (1973–78), the IMF’s second phase began with the amendment of its constitution in 1978, broadening its functions to enable it to grapple with the challenges that have arisen since the collapse of the par value system. These functions are three.

First, the IMF continues to urge its members to allow their national currencies to be exchanged without restriction for the currencies of other member countries. As of May 1996, 115 members had agreed to full convertibility of their national currencies. Second, in place of monitoring members’ compliance with their obligations in a fixed exchange system, the IMF supervises economic policies that influence their balance of payments in the presently legalized flexible exchange rate environment. This supervision provides opportunities for an early warning of any exchange rate or balance of payments problem. In this, the IMF’s role is principally advisory. It confers at regular intervals (usually once a year) with its members, analyzing their economic positions and apprising them of actual or potential problems arising from their policies, and keeps the entire membership informed of these developments. Third, the IMF continues to provide short- and medium-term financial assistance to member nations that run into temporary balance of payments problems.
difficulties. The financial assistance usually involves the provision by the IMF of convertible currencies to augment the afflicted member's dwindling foreign exchange reserves, but only in return for the government's promise to reform the economic policies that caused the balance of payments problem in the first place. The IMF sees its financial role in these cases not as subsidizing further deficits but as easing a country's painful transition to living within its means.

How in practice does the IMF assist its members? The key opening the door to IMF assistance is the member's balance of payments, the tally of its payments and receipts with other nations. Foreign payments should be in rough balance: a country ideally should take in just about what it pays out. When financial problems cause the price of a member's currency and the price of its goods to fall out of line, balance of payments difficulties are sure to follow. If this happens, the member country may, by virtue of the Articles of Agreement, apply to the IMF for assistance.

To illustrate, let us take the example of a small country whose economy is based on agriculture. For convenience in trade, the government of such a country generally pegs the domestic currency to a convertible currency: so many units of domestic money to a U.S. dollar or French franc. Unless the exchange rate is adjusted from time to time to take account of changes in relative prices, the domestic currency will tend to become overvalued, with an exchange rate, say, of one unit of domestic currency to one U.S. dollar, when relative prices might suggest that two units to one dollar is more realistic. Governments, however, often succumb to the temptation to tolerate overvaluation, because an overvalued currency makes imports cheaper than they would be if the currency were correctly priced.

The other side of the coin, unfortunately, is that overvaluation makes the country's exports more expensive and hence less attractive to foreign buyers. If the currency is thus overvalued, the country will eventually experience a fall-off in export earnings (exports are too expensive) and a rise in import expenditures.
(imports are apparently cheap and are bought on credit). In effect, the country is earning less, spending more, and going into debt, a predicament as unsustainable for a country as it is for any of us. Moreover, this situation is usually attended by a host of other economic ills for the country. Finding a diminished market for their export crops and receiving low prices from the government marketing board for produce consumed domestically, farmers either resort to illegal black market exports or lose the incentive to produce. Many of them abandon the farm to seek employment in overcrowded cities, where they become part of larger social and economic problems. Declining domestic agricultural productivity forces the government to use scarce foreign exchange reserves (scarce because export earnings are down) to buy food from abroad. The balance of payments becomes dangerously distorted.

As an IMF member, a country finding itself in this bind can turn to the IMF for consultative and financial assistance. In a collaborative effort, the country and the IMF can attempt to root out the causes of the payments imbalance by working out a comprehensive program that, depending on the particulars of the case, might include raising producer prices paid to farmers so as to encourage agricultural production and reverse migration to the cities, lowering interest rates to expand the supply of credit, and adjusting the currency to reflect the level of world prices, thereby discouraging imports and raising the competitiveness of exports.

Because reorganizing the economy to implement these reforms is disruptive and not without cost, the IMF will lend money to subsidize policy reforms during the period of transition. To ensure that this money is put to the most productive uses, the IMF closely monitors the country’s economic progress during this time, providing technical assistance and further consultative services as needed.

In addition to assisting its members in this way, the IMF also helps by providing technical assistance in organizing central banks, establishing and reforming tax systems, and setting up agencies to gather and publish economic statistics. The IMF is also authorized
to issue a special type of money, called the SDR, to provide its members with additional liquidity. Known technically as a fiduciary asset, the SDR can be retained by members as part of their monetary reserves or be used in place of national currencies in transactions with other members. To date the IMF has issued slightly over 21.4 billion SDRs, presently valued at about U.S. $30 billion.

Over the past few years, in response to an emerging interest by the world community to return to a more stable system of exchange rates that would reduce the present fluctuations in the values of currencies, the IMF has been strengthening its supervision of members’ economic policies. Provisions exist in its Articles of Agreement that would allow the IMF to adopt a more active role, should the world community decide on stricter management of flexible exchange rates or even on a return to some system of stable exchange rates.

Measuring the success of the IMF’s operations over the years is not easy, for much of the IMF’s work consists in averting financial crises or in preventing their becoming worse. Most observers feel that merely to have contained the debt crisis of the 1980s, which posed the risk of collapse in the world's financial system, must be counted a success for the IMF. The Fund has also gained some recognition for assisting in setting up market-based economies in the countries of the former Soviet Union and for responding swiftly to the Mexican peso crisis in 1994, but its main contribution lies in its unobtrusive, day-to-day encouragement of confidence in the international system. Nowhere will you find a bridge or a hospital built by the IMF, but the next time you buy a Japanese camera or drive a foreign car, or without difficulty exchange dollars or pounds for another currency while on holiday, you will be benefiting from the vast increase in foreign trade over the past 50 years and the widespread currency convertibility that would have been unimaginable without the world monetary system that the IMF was created to maintain.
Cooperation Between Bank and IMF

Although the Bank and IMF are distinct entities, they work together in close cooperation. This cooperation, present since their founding, has become more pronounced since the 1970s. Since then the Bank's activities have increasingly reflected the realization that the pace of economic and social development accelerates only when sound underlying financial and economic policies are in place. The IMF has also recognized that unsound financial and economic policies are often deeply rooted in long-term inefficient use of resources that resists eradication through short-term adaptations of financial policies. It does little good for the Bank to develop a long-term irrigation project to assist, say, the export of cotton, if the country’s balance of payments position is so chaotic that no foreign buyers will deal with the country. On the other hand, it does little good for the IMF to help establish a sound exchange rate for a country's currency, unless the production of cotton for export will suffice to sustain that exchange rate over the medium to long term.

The key to solving these problems is seen in restructuring economic sectors so that the economic potential of projects might be realized throughout the economy and the stability of the economy might enhance the effectiveness of the individual project.

Around 75 percent of the Bank's lending is applied to specific projects dealing with roads, dams, power stations, agriculture, and industry. As the global economy became mired in recession in the early 1980s, the Bank expanded the scope of its lending operations to include structural- and sector-adjustment loans. These help developing countries adjust their economic policies and structures in the face of serious balance of payments problems that threaten continued development. The main objective of structural-adjustment lending is to restructure a developing country's economy as the best basis for sustained economic growth. Loans support programs that are intended to anticipate and avert economic crises through economic reforms and changes in
investment priorities. By using so-called policy-based lending, the Bank stimulates economic growth in heavily indebted countries—particularly in Latin America and in sub-Saharan Africa—that are undertaking, often at much social pain, far-reaching programs of economic adjustment.

In addition to its traditional function as provider of short-term balance of payments assistance, the advent of the oil crisis in the mid-1970s and the debt crisis in the early 1980s induced the IMF, too, to rethink its policy of restricting its financial assistance to short-term lending. As balance of payments shortfalls grew larger and longer-term structural reforms in members’ economies were called for to eliminate these shortfalls, the IMF enlarged the amount of financial assistance it provides and lengthened the period within which its financial assistance would be available. In doing so, the IMF implicitly recognizes that balance of payments problems arise not only from a temporary lack of liquidity and inadequate financial and budgetary policies but also from long-standing contradictions in the structure of members’ economies, requiring reforms stretching over a number of years and suggesting closer collaboration with the World Bank, which commands both the expertise and experience to deal with protracted structural impediments to growth.

Focusing on structural reform in recent years has resulted in considerable convergence in the efforts of the Bank and IMF and has led them to greater reliance on each other’s special expertise. This convergence has been hastened by the debt crisis, brought on by the inability of developing countries to repay the enormous loans they contracted during the late 1970s and early 1980s. The debt crisis has emphasized that economic growth can be sustained only when resources are being used efficiently and that resources can be used efficiently only in a stable monetary and financial environment.

The bedrock of cooperation between the Bank and IMF is the regular and frequent interaction of economists and loan officers who work on the same country. The Bank staff brings to this
interchange a longer-term view of the slow process of development and a profound knowledge of the structural requirements and economic potential of a country. The IMF staff contributes its own perspective on the day-to-day capability of a country to sustain its flow of payments to creditors and to attract from them investment finance, as well as on how the country is integrated within the world economy. This interchange of information is backed up by a coordination of financial assistance to members. For instance, the Bank has been approving structural- or sector-adjustment loans for most of the countries that are taking advantage of financial assistance from the IMF. In addition, both institutions encourage other lenders, both private and official, to join with them in cofinancing projects and in mobilizing credits to countries that are in need. Cooperation between the Bretton Woods Institutions has two results: the identification of programs that will encourage growth in a stable economic environment and the coordination of financing that will ensure the success of these programs. Other lenders, particularly commercial banks, frequently make credits available only after seeing satisfactory performance by the borrowing country of its program of structural adjustment.

Cooperation between the Bank and the IMF has over the past decade been formalized with the establishment in the IMF of procedures to provide financing at below market rates to its poorest member countries. These procedures enable the IMF to make available up to $12 billion to those 70 or so poor member countries that adjust the structure of their economies to improve their balance of payment position and to foster growth. The Bank joins with the IMF in providing additional money for these countries from IDA. But what IDA can provide in financial resources is only a fraction of the world’s minimum needs for concessional external finance. Happily, various governments and international agencies have responded positively to the Bank’s special action program for low-income, debt-distressed countries of the region by pledging an extra $7 billion for cofinancing programs arranged by the Bank.

The Bank and the IMF have distinct mandates that allow them to
contribute, each in its own way, to the stability of the international monetary and financial system and to the fostering of balanced economic growth throughout the entire membership. Since their founding 50 years ago, both institutions have been challenged by changing economic circumstances to develop new ways of assisting their membership. The Bank has expanded its assistance from an orientation toward projects to the broader aspects of economic reform. Simultaneously the IMF has gone beyond concern with simple balance of payment adjustment to interest itself in the structural reform of its members’ economies. Some overlapping by both institutions has inevitably occurred, making cooperation between the Bank and the IMF crucial. Devising programs that will integrate members’ economies more fully into the international monetary and financial system and at the same time encourage economic expansion continues to challenge the expertise of both Bretton Woods Institutions.
### The International Monetary Fund and the World Bank at a Glance

<table>
<thead>
<tr>
<th>International Monetary Fund</th>
<th>World Bank</th>
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<tr>
<td>• oversees the international monetary system</td>
<td>• seeks to promote the economic development of the world's poorer countries</td>
</tr>
<tr>
<td>• promotes exchange stability and orderly exchange relations among its member countries</td>
<td>• assists developing countries through long-term financing of development projects and programs</td>
</tr>
<tr>
<td>• assists all members—both industrial and developing countries—that find themselves in temporary balance of payments difficulties by providing short- to medium-term credits</td>
<td>• provides to the poorest developing countries whose per capita GNP is less than $865 a year special financial assistance through the International Development Association (IDA)</td>
</tr>
<tr>
<td>• supplements the currency reserves of its members through the allocation of SDRs (special drawing rights); to date SDR 21.4 billion has been issued to member countries in proportion to their quotas</td>
<td>• encourages private enterprises in developing countries through its affiliate, the International Finance Corporation (IFC)</td>
</tr>
<tr>
<td>• draws its financial resources principally from the quota subscriptions of its member countries</td>
<td>• acquires most of its financial resources by borrowing on the international bond market</td>
</tr>
<tr>
<td>• has at its disposal fully paid-in quotas now totaling SDR 145 billion (about $215 billion)</td>
<td>• has an authorized capital of $184 billion, of which members pay in about 10 percent</td>
</tr>
<tr>
<td>• has a staff of 2,300 drawn from 182 member countries</td>
<td>• has a staff of 7,000 drawn from 180 member countries</td>
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### Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=135
II2. Outcome: GATT and the WTO

What you’ll learn to do: explain the historical role of GATT in international trade and the WTO’s impact on international trade

In the post–World War II environment, countries came to realize that a major component of achieving any degree of global peace was global cooperation—politically, economically, and socially. The intent was to level the trade playing field and reduce economic areas of disagreement, since inequality in these areas could lead to more serious conflicts. Among the initiatives, nations agreed to work together to promote free trade and entered into bilateral and multilateral agreements. The General Agreement on Tariffs and Trade (GATT) resulted from these agreements. In this section, you’ll review GATT—learn why it was created and what its historical successes and challenges have been. You’ll then look at the World Trade Organization (WTO), which replaced GATT in 1995, and study the impact of both these organizations on international trade. While GATT started as a set of rules between countries, the WTO has become an institution overseeing international trade.

Learning Activities

The learning activities for this section include:

- Video: GATT/WTO
- Reading: International Economic Cooperation among Nations
• Self Check: GATT and the WTO

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
II3. Video: GATT/WTO

Overview of GATT and WTO

Before you begin your reading on GATT and WTO, take a few minutes to watch the following video that will give you some background and an overview of GATT and WTO. Remember, the world is much smaller today than when your parents and grandparents were growing up, and international trade has not always been the “norm.” After watching the video, as you work through the materials in this module, think about how impossible world trade would be without some type of agreement among nations.

Enjoy!

A YouTube element has been excluded from this version of the
text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=137
II.4. Reading: International Economic Cooperation among Nations

General Agreement on Tariffs and Trade (GATT)

The General Agreement on Tariffs and Trade (GATT) is a series of rules governing trade that were first created in 1947 by twenty-three countries. By the time it was replaced with the WTO, there were 125 member nations. GATT has been credited with substantially expanding global trade, primarily through the reduction of tariffs.

The basic underlying principle of GATT was that trade should be free and equal. In other words, countries should open their markets equally to member nations, and there should be neither discrimination nor preferential treatment. One of GATT's key provisions was the most-favored-nation clause (MFN). It required that once a benefit, usually a tariff reduction, was agreed on between two or more countries, it was automatically extended to all other member countries. GATT's initial focus was on tariffs, which are taxes placed on imports or exports.

Did You Know?

As a concept, MFN can be seen in many aspects of business; it's an important provision. Companies require MFN of their trading partners for pricing, access, and other provisions. Corporate or government customers require it of the company from which they
Venture capitalists (VC) require it of the companies in which they invest. For example, a VC wants to make sure that it has negotiated the best price for equity and will ask for this provision in case another financier negotiates a cheaper purchase price for the equity. The idea behind the concept of MFN is that the country, company, or entity that has MFN status shouldn’t be disadvantaged in comparison with others in similar roles as a trading partner, buyer, or investor. In practice, the result is that the signing party given MFN status benefits from any better negotiation and receives the cheaper price point or better term. This terminology is also used in sales contracts or other business legal agreements.

Gradually, the GATT member countries turned their attention to other nontariff trade barriers. These included government procurement and bidding, industrial standards, subsidies, duties and customs, taxes, and licensing. GATT countries agreed to limit or remove trade barriers in these areas. The only agreed-on export subsidies were for agricultural products. Countries agreed to permit a wider range of imported products to enter their home markets by simplifying licensing guidelines and developing consistent product standards between imports and domestically produced goods. Duties had to result from uniform and consistent procedures for the same foreign and domestically produced items.

The initial successes in these categories led some countries to get more creative with developing barriers to trade as well as entering into bilateral agreements and providing more creative subsidies for select industries. The challenge for the member countries of GATT was enforcement. Other than complaining and retaliating, there was little else that a country could do to register disapproval of another country’s actions and trade barriers.

Gradually, trade became more complex, leading to the Uruguay Round beginning in 1986 and ending in 1994. These trade meetings were called rounds in reference to the series of meetings among global peers held at a “roundtable.” Prior to a round, each series of
trade discussions began in one country. The round of discussions was then named after that country. It sometimes took several years to conclude the topic discussions for a round. The Uruguay Round took eight years and actually resulted in the end of GATT and the creation of the World Trade Organization (WTO). The current Doha Development Round began in 2001 and is actually considered part of the WTO.

World Trade Organization (WTO)

Brief History and Purpose

The World Trade Organization (WTO) developed as a result of the Uruguay Round of GATT. Formed officially on January 1, 1995, the concept of the WTO had been in development for several years. When the WTO replaced GATT, it absorbed all of GATT’s standing agreements. In contrast to GATT, which was a series of agreements, the WTO was designed to be an actual institution charged with the mission of promoting free and fair trade. As explained on its website, the WTO “is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world’s trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business.”

The global focus on multilateral trade agreements and cooperation has expanded trade exponentially. “The past 50 years have seen an exceptional growth in world trade. Merchandise exports grew on average by 6 percent annually. Total trade in 2000 was 22-times the level of 1950. GATT and the WTO have helped
to create a strong and prosperous trading system contributing to unprecedented growth.”¹

The WTO’s primary purpose is to serve as a negotiating forum for member nations to dispute, discuss, and debate trade-related matters. More than just a series of trade agreements, as it was under GATT, the WTO undertakes discussions on issues related to globalization and its impact on people and the environment, as well as trade-specific matters. It doesn’t necessarily establish formal agreements in all of these areas but does provide a forum to discuss how global trade impacts other aspects of the world.

Headquartered in Geneva, Switzerland, the current round is called the Doha Round and began in 2001. With 153 member nations, the WTO is the largest, global trade organization. Thirty nations have observer status, and many of these are seeking membership. With so many member nations, the concept of MFN has been eased into a new principle of normal trade relations (NTR). Advocates say that no nation really has a favored nation status; rather, all interact with each other as a normal part of global trade.

The biggest change from GATT to the WTO is the provision for the settlement of disputes. If a country finds another country's trade practices unfair or discriminatory, it may bring the charges to the WTO, which will hear from both countries and mediate a solution.

The WTO has also undertaken the effort to focus on services rather than just goods. Resulting from the Uruguay Round, the General Agreement on Trade in Services (GATS) seeks to reduce the
barriers to trade in services. Following the GATT commitment to nondiscrimination, GATS requires member nations to treat foreign service companies as they would domestic ones. For example, if a country requires banks to maintain 10 percent of deposits as reserves, then this percentage should be the same for foreign and domestic banks. Services have proven to be more complex to both define and regulate, and the member nations are continuing the discussions.

Similar to GATS is the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Intellectual property refers to just about anything that a person or entity creates with the mind. It includes inventions, music, art, and writing, as well as words, phrases, sayings, and graphics—to name a few. The basic premise of intellectual property rights (IPR) law is that the creator of the property has the right to financially benefit from his or her creation. This is particularly important for protecting the development for the creation, known as the research and development (R&D) costs. Companies can also own the intellectual property that their employees generate. This section focuses on the protection that countries agree to give to intellectual property created in another country.

Over the past few decades, companies have become increasingly diligent in protecting their intellectual property and pursuing abusers. Whether it’s the knock-off designer handbag from China that lands on the sidewalks of New York or the writer protecting her thoughts in the written words of a book (commonly understood as content), or the global software company combating piracy of its technical know-how, IPR is now formally a part of the WTO agreements and ongoing dialogue.

Current Challenges and Opportunities

Agriculture and textiles are two key sectors in which the WTO
faces challenges. Trade in agriculture has been impacted by export-country subsidies, import-country tariffs and restrictions, and nontariff barriers. Whether the United States provides low-cost loans and subsidies to its farmers or Japan restricts the beef imports, agriculture trade barriers are an ongoing challenge for the WTO. Global companies and trade groups that support private-sector firms seek to have their governments raise critical trade issues on their behalf through the WTO.

For example, Japan's ban of beef imports in response to mad cow disease had a heavy impact on the US beef industry during the first decade of the 21st century. Japan was the largest foreign buyer of U.S. beef before it banned all imports when the first case of the brain-wasting disease, also known bovine spongiform encephalopathy [i.e., mad cow disease], was discovered in the U.S.

Japanese restrictions on U.S. beef created distance between Japan and the U.S. Japan Agriculture Minister Hirotaka Akamatsu told reporters in 2010 after meeting [US Agriculture Secretary Tom] Vilsack in Tokyo. “For us, food safety based on Japan's scientific standards is the priority. The OIE standards are different from the Japanese scientific ones.” During the beef export ban, the U.S. beef industry lost about $1 billion a year in sales because of the restrictions, according to the National Cattlemen's Beef Association, [a trade group supporting the interests of American beef producers].

The ban was eased in 2005 to allow meat from cattle aged 20 months or less, which scientists say are less likely to have contracted the fatal illness. ...Japan was the third-largest destination for U.S. beef [in 2009], with trade totaling $470 million, up from $383 million in 2008, according to the U.S. Meat Export Federation. That compares with $1.39 billion in 2003. Mexico and Canada were the biggest buyers of U.S. beef [in 2009].

2. Source: Jae Hur and Ichiro Suzuki, “Japan, U.S. to Continue Dialogue on Beef Import Curbs (Update 1),”
The role of the WTO is to facilitate agreements in difficult bilateral and multilateral trade disputes, but this certainly isn’t easy. Japan’s reluctance for American beef may have appeared to be the result of mad cow disease, but business observers note Japan’s historical cultural preference for Japanese goods, which the country often claims are superior. A similar trade conflict was triggered in the 1980s when Japan discouraged the import of rice from other countries. The prevailing Japanese thought was that its local rice was easier for the Japanese to digest. After extensive discussions in the Uruguay Round of trade talks, on “December 14, 1993 the Japanese government accepted a limited opening of the rice market under the GATT plan.”

Antidumping is another area on which the WTO has focused its attention. Dumping occurs when a company exports to a foreign market at a price that is either lower than the domestic prices in that country or less than the cost of production. Antidumping charges can be harder to settle, as the charge is against a company and not a country. One example is in India, which has, in the past, accused Japan and Thailand of dumping acetone, a chemical used in drugs and explosives, in the Indian market. In an effort to protect domestic manufacturers, India has raised the issue with the WTO. In fact, India was second only to Argentina among the G-20 (or Group of Twenty) nations in initiating antidumping investigations during 2009, according to a WTO report.

BusinessWeek, April 7, 2010. Restrictions were further eased in 2013.
Future Outlook

The future for the WTO and any related organizations remains strong. With companies and countries facing a broader array of trade issues than ever before, the WTO plays a critical role in promoting and ensuring free and fair trade. Many observers expect that the WTO will have to emphasize the impact of the Internet on trade. In most cases, the WTO provides companies and countries with the best options to dispute, discuss, and settle unfair business and trade practices.

Key Takeaways

- The General Agreement on Tariffs and Trade (GATT) is a series of rules governing trade that were first created in 1947 by twenty-three countries. It remained in force until 1995, when it was replaced by the WTO.
- The World Trade Organization (WTO) is the only global, international organization dealing with the rules of trade between nations. The WTO agreements that have been negotiated and signed by the organization’s 153 member nations and ratified in their parliaments are the heart of the organization. Its goal is to help the producers, exporters, and importers of goods and services conduct business. The latest round of the WTO trade negotiations is called the Doha Round.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count
toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
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115. Putting It Together: Global Environment

Summary

This module covered the global business environment. Below is a summary of the topics covered in this module.

Define Globalization

Globalization is a process with a long history. People have been exploring, migrating, and trading with one another throughout human history, and these activities have created interactive networks connecting the different parts of the planet and producing dependent economic relationships. In modern times, globalization can be recognized by noting iconic global corporations, such as Walmart, McDonald's, or Toyota, that trade across international borders and integrate labor and resources from different countries to sell a product or service in the global marketplace. (From Regional Geography of the World.)

Why Do Nations Trade?

Why do countries trade? Shouldn't a strong country such as the United States produce all of the computers, television sets, automobiles, cameras, and VCRs it wants rather than import such
products from Japan? Why do the Japanese and other countries buy wheat, corn, chemical products, aircraft, manufactured goods, and informational services from the United States? Because countries have different natural, human, and capital resources and different ways of combining these resources, they are not equally efficient at producing the goods and services that their residents demand. The decision to produce any good or service has an **opportunity cost**, which is the amount of another good or service that might otherwise have been produced. Given a choice of producing one good or another, it is more efficient to produce the good with the lower opportunity cost, using the increased production of that good to trade for the good with the higher opportunity cost.

Comparative vs. Competitive Advantage

A nation has a **comparative advantage** at producing something if it can produce it at a lower cost than another. A **competitive advantage** is a term describing attributes that allows a nation to outperform competing nations. These attributes may include access to natural resources, such as high-grade ores or inexpensive power, highly skilled personnel, geographic location, high entry barriers, etc.

How Cultural, Economic, and Legal or Political Barriers Impact, Restrict, or Support International Trade

Firms desiring to enter international business face several obstacles. The most common barriers to effective business are cultural, social, and political barriers, and tariffs and trade restrictions.

The first one that can impede effective business is **cultural**
Barriers. A nation’s culture can restrict international business activities. Culture consists of a country’s general concepts and values and tangible items such as food, clothing, and buildings. The second barrier is the social forces that can create obstacles to international trade. Social forces include family, education, religion, and customs. In some countries, purchasing items as basic as food and clothing can be influenced by religion. Individuals do not have the same choices in food, clothing, and health care in every nation. The third one is political barriers. The political climate of a country can have a major impact on international business. Nations experiencing intense political unrest may change their attitude toward foreign firms at any time; this instability creates an unfavorable atmosphere for international trade. The last one is tariffs and trade restrictions. Tariffs and trade restrictions are also barriers to international business. A nation can restrict trade through import tariffs, quotas and embargoes, and exchanges controls.

Ethical Issues in International Trade

Culture impacts how local values influence the concept of global business ethics. Each professional is influenced by the values, social programming, and experiences he or she has absorbed since childhood. These collective factors affect how a person perceives an issue and the associated correct or incorrect behavior. For some cultures, the evolution of international business and culture sometimes creates a conflict, such as what is seen in gift-giving practices or views on women in the workplace.
The IMF and the World Bank

The **IMF’s** key roles are the following: promote international monetary cooperation; facilitate the expansion and balanced growth of international trade; promote exchange stability; assist in the establishment of a multilateral system of payments; give confidence to members by making the IMF’s general resources temporarily available to them under adequate safeguards; shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The **World Bank** has one central purpose: to promote economic and social progress in developing countries by helping raise productivity so that their people can live a better and fuller life. The World Bank provides more than $46.9 billion for 303 projects in developing countries worldwide, with financial and/or technical expertise aimed at helping those countries reduce poverty. The Bank is currently involved in more than 1,800 projects in virtually every sector and developing country.

International Trade: GATT and WTO

The **GATT** consists of a set of promises or commitments that countries make to one another regarding their own trade policies. The goal of the GATT is to make trade freer (i.e., to promote trade liberalization), and thus the promises countries make must involve reductions in trade barriers.

The **WTO’s** main purpose is to monitor the trade liberalization agreements reached by GATT-member countries in the Uruguay Round. The most important “power” of the WTO is its ability to adjudicate disputes between member countries regarding compliance with the agreements.
Remember the humble banana we talked about at the start of this module? Now you know at least some of what it takes to get bananas from Brazil to your local grocery store: trade agreements, currency exchange rates, compliance with federal laws, bribery and possible corruption, national comparative advantages, tariffs, trade restrictions, cultural differences, and more. Those are just a few of the things that had to fall into place to get those bananas into your local market and ultimately into a banana split served at the local ice cream shop!
Why describe the primary functions, responsibilities, and skills of effective leadership and management?

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

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

• Identify skills needed for successful managers, such as technical, interpersonal, conceptual, organizational, problem-solving, and decision-making skills
• Identify and explain the primary functions of management: plan, organize, lead, and control
• Identify the types of planning managers engage in and how these relate to the achievement of organizational goals
• Explain how organizational structure contributes to the achievement of each organization’s mission
• Identify the different leadership styles a manager can adopt and determine the circumstances under which each style is appropriate
• Explain why control is an essential part of being a manager and how this function contributes to effective management
II7. Outcome: Skills of a Manager

What you’ll learn to do: identify skills needed for a successful manager, such as technical, interpersonal, conceptual, organizational, problem-solving, and decision-making skills.

Being a successful manager can seem like a juggling act—keeping many balls in the air while maintaining your composure and professional demeanor. What are the skills that make managers successful? In this module you will learn about the technical, interpersonal, conceptual, organizational and problem-solving skills that all successful managers possess.

LEARNING ACTIVITIES

The learning activities for this section include:
• Reading: Managerial Skills
• Self Check: Skills of a Manager

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Managerial Skills

To be a successful manager, you'll have to master a number of skills. To get an entry-level position, you will have to be technically competent at the tasks you are asked to perform. To advance, you'll need to develop strong interpersonal and conceptual skills. The relative importance of different skills varies from job to job and organization to organization, but to some extent, you'll need them all to forge a managerial career. Throughout your career, you'll also be expected to communicate ideas clearly, use your time efficiently, and reach sound decisions.

Technical Skills

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

As you move up the corporate ladder, you'll find that you can't do everything yourself: you'll have to rely on other people to help you achieve the goals for which you're responsible. That's why interpersonal skills—the ability to get along with and motivate other people—are critical for managers in midlevel positions. These managers play a pivotal role because they report to top-level managers while overseeing the activities of first-line managers. Thus, they need strong working relationships with individuals at all levels and in all areas. More than most other managers, they must use "people skills" to foster teamwork, build trust, manage conflict, and encourage improvement.¹

Conceptual Skills

Managers at the top, who are responsible for deciding what's good for the organization from the broadest perspective, rely on conceptual skills—the ability to reason abstractly and analyze complex situations. Senior executives are often called on to "think outside the box"—to arrive at creative solutions to complex, sometimes ambiguous problems. They need both strong analytical abilities and strong creative talents.

Communication Skills

Effective communication skills are crucial to just about everyone. At all levels of an organization, you'll often be judged on your ability to communicate, both orally and in writing. Whether you're talking informally or making a formal presentation, you must express yourself clearly and concisely. Talking too loudly, rambling, and using poor grammar reduce your ability to influence others, as does poor written communication. Confusing and error-riddled documents (including e-mails) don't do your message any good, and they will reflect poorly on you.²

Time-Management Skills

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

- Prioritize tasks, focusing on the most important things first.
- Set aside a certain time each day to return phone calls and answer e-mail.
- Delegate routine tasks.

• Don't procrastinate.
• Insist that meetings start and end on time, and stick to an agenda.
• Eliminate unnecessary paperwork. 3

Decision-Making Skills

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

A Six-Step Approach to Problem Solving

Assuming your top priority is salvaging your GPA, let’s tackle your problem by using a six-step approach to solving problems that don’t have simple solutions. We’ve summarized this model in Figure 1 below.4

Figure 1. How to Solve a Problem

1. **Identify the problem you want to work on.** Step one is getting to know your problem, which you can formulate by asking yourself a basic question: How can I improve my grades?
2. **Gather relevant data.** Step two is gathering information that will shed light on the problem. Let’s rehash some of the relevant information that you’ve already identified: (a) you did poorly on your finals because you didn’t spend enough time studying; (b) you didn’t study because you went to see your girlfriend (who lives about three hours from campus) over the weekend before your exams (and on most other weekends, as a
matter of fact); (c) what little studying you got in came at the expense of your team project and lacrosse practice; and (d) while you were away for the weekend, you forgot to tell members of the mountain-biking club that you had to cancel the planned meeting.

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

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

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

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

Key Takeaways

- The skills needed by managers vary according to level.
- Top managers need strong conceptual skills, while those at midlevels need good interpersonal skills, and those at lower levels need technical skills.
- All managers need strong communication, decision-making, and time-management skills.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
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II9. Outcome: Functions of Management

What you’ll learn to do: identify and explain the primary functions of management: to plan, organize, lead, and control

In the previous section you looked at the skills managers need in order to be successful. Now we will see those skills in action by examining what managers actually do. As you read through this module, think about your interactions with people in the workplace or in the classroom—it is likely that you have experienced (or demonstrated) the four primary management functions: planning, organizing, leading, and controlling.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: What Do Managers Do?
- Self Check: Functions of Management

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Functions of Management

We have discussed the skills that are important for a manager. These skills need to come together to support the process of management, or the process of planning, organizing, directing, and controlling resources to achieve specific goals. A plan enables you to take your business concept beyond the idea stage. It does not, however, get the work done. You have to organize things if you want your plan to become a reality. You have to put people and other resources in place to make things happen. And because your note-taking venture is supposed to be better off with you in charge, you need to be a leader who can motivate your people to do well. Finally, to know whether things are in fact going well, you'll have to control your operations—that is, measure the results and compare them with the results that you laid out in your plan. Figure 1 gives you a good idea of the interrelationship between planning and the other functions that managers perform.

![Figure 1. The Role of Planning](image-url)

If you visit any small or large company, not-for-profit organization, or government agency, you will find managers doing the same
things you would be doing to run your note-taking business—planning, organizing, directing, and controlling.

In the rest of this module, we will look at these four interrelated functions in detail.

KEY TAKEAWAYS

• Managers plan, organize, direct, and control resources to achieve specific goals.
• **Planning** involves the setting of goals and then determining the best way to achieve them.
• **Organizing** means allocating resources (people, equipment, and money) to carry out the company’s plans.
• **Directing** is the process of providing focus for employees and motivating them to achieve organizational goals.
• **Controlling** involves comparing actual to expected performance and taking corrective action when necessary.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
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What you’ll learn to do: identify the types of planning managers engage in and how these relate to the achievement of organizational goals

In this module we will explore not just the importance of planning, but the different types of planning and plans that managers are responsible for within the organization. Many of the managers’ planning activities are established during the early stages of an organization through its business plan. The business plan provides the foundation for planning activities, but as the business grows and develops it’s the manager’s responsibility to adapt and take the plans to the next level. A business without solid strategic, operational, and contingency plans will have a hard time meeting its organizational goals—unless it intends to survive by luck alone.

In this section we’ll see what effective planning looks like from the manager’s perspective.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Planning
- Self Check: Planning

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Developing a Strategic Plan

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

Coming up with an idea—starting a note-taking business—is a good start, but it's only a start. Planning for it is a step forward. Planning begins at the highest level and works its way down through the organization. Step one is usually called strategic planning, which is the process of establishing an overall course of action. To begin this process, you should ask yourself a couple of very basic questions: Why, for example, does the organization exist? What value does it create? After you've identified the purpose of your company, you're ready to take the remaining steps in the strategic-planning process:

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

Mission Statement

The mission statement describes the purpose of your organization—the reason for its existence. It tells the customer what the organization is committed to doing. A strong mission statement should also inspire employees and resonate with their inner motivations for working and being part of the organization.

Mission statements can be very concise, like the one from Mary Kay Inc. (the cosmetics company):

To enrich the lives of women around the world.¹

Or it can be as detailed as the one from Harley-Davidson:

We fulfill dreams inspired by the many roads of the world by providing extraordinary motorcycles and customer experiences. We fuel the passion for freedom in our customers to express their own individuality."²

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1. Mary Kay Inc. website, Employment at Mary Kay section, accessed September 21, 2011.
Core Values

Having defined your mission, your next step is to ask, what does this organization stand for? What values will define it? What principles should guide our actions as we build and operate the business? The set of guiding principles that you identify as crucial to your company are known as core values—fundamental beliefs about what’s important and what is and isn’t appropriate in conducting company activities. Core values affect the overall planning processes and operations. At Volvo, for example, three core values—safety, quality, and environmental care—define the firm’s “approach to product development, design and production.” Core values should also guide the behavior of every individual in the organization. Coca-Cola, for instance, reports that its stated core values—leadership, collaboration, integrity, accountability, passion, diversity and quality—tell employees exactly what behaviors are acceptable. How do companies communicate core values to employees and hold them accountable for putting those values into practice? They link core values to performance evaluations and compensation.

Conduct a SWOT Analysis

The next step in the strategic-planning process is to assess your company’s fit with its environment. A common approach to environmental analysis is matching the strengths of your business with the opportunities available to it. It’s called SWOT.

analysis because it calls for analyzing an organization’s Strengths, Weaknesses, Opportunities, and Threats. It begins with an examination of external factors that could influence the company in either a positive or a negative way. These could include economic conditions, competition, emerging technologies, laws and regulations, and customers’ expectations.

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

The next step is to evaluate the company’s strengths and weaknesses. Strengths might include a motivated workforce, state-of-the-art technology, impressive managerial talent, or a desirable location. The opposite of any of these strengths (poor workforce, obsolete technology, incompetent management, or poor location) could signal a potential weakness. Armed with a good idea of external opportunities and threats, as well as internal strengths and weaknesses, managers want to capitalize on opportunities by taking advantage of organizational strengths. Likewise, they want to protect the organization from both external threats and internal weaknesses.
Set Goals and Objectives

Your mission statement affirms what your organization is generally committed to doing, but it doesn’t tell you how to do it. So the next step in the strategic-planning process is establishing goals and objectives. Goals are major accomplishments that the company wants to achieve over a long period (say, five years). Objectives are shorter-term performance targets that direct the activities of the organization toward the attainment of a goal. They should be clearly stated, attainable, and measurable: they should give target dates for
the completion of tasks and stipulate who’s responsible for taking necessary actions.5

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

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

The world has changed. Our customers have changed. We have to change too. Growth comes from being better, not just expanding to have more restaurants. The new McDonald’s is focused on building sales at existing restaurants rather than on adding new restaurants. We are introducing a new level of discipline and efficiency to all aspects of the business and are setting a new bar for performance.6

This change in focus was accompanied by specific performance objectives—annual sales growth of 3 to 5 percent and income growth of 6 to 7 percent at existing restaurants, plus a five-point

improvement (based on customer surveys) in speed of service, friendliness, and food quality.

**Develop Tactical and Operational Plans**

The planning process begins at the top of the organization, where upper-level managers create a strategic plan, but it doesn’t end there. The *execution* of the strategic plan involves managers at all levels.

**Tactical Plans**

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

**Operational Plans**

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

Plan for Contingencies and Crises

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

Contingency Planning

With contingency planning, managers identify those aspects of the business that are most likely to be adversely affected by change. Then, they develop alternative courses of action in case an anticipated change does occur. You probably do your own contingency planning: for example, if you’re planning to take in a sure-fire hit movie on its release date, you may decide on an alternative movie in case you can’t get tickets to your first choice.

Crisis Management

Organizations also face the risk of encountering crises that require immediate attention. Rather than waiting until such a crisis occurs and then scrambling to figure out what to do, many firms practice crisis management. Some, for instance, set up teams
trained to deal with emergencies. Members gather information quickly and respond to the crisis while everyone else carries out his or her normal duties. The team also keeps the public, the employees, the press, and government officials informed about the situation and the company's response to it.\(^7\)

An example of how to handle crisis management involves Wendy's. After learning that a woman claimed she found a fingertip in a bowl of chili she bought at a Wendy's restaurant in San Jose, California, the company's public relations team responded quickly. Within a few days, the company announced that the finger didn't come from an employee or a supplier. Soon after, the police arrested the woman and charged her with attempted grand larceny for lying about how the finger got in her bowl of chili and trying to extort $2.5 million from the company. But the crisis wasn't over for Wendy's. The incident was plastered all over the news as a grossed-out public sought an answer to the question “Whose finger is (or was) it?” A $100,000 reward was offered by Wendy's to anyone with information that would help the police answer this question. The challenge Wendy's faced was how to entice customers to return to its fifty San Francisco–area restaurants (where sales had plummeted) while keeping a low profile nationally. It accomplished this by giving out free milkshakes and discount coupons to customers in the affected regions and, to avoid calling attention to the missing finger, by making no changes in its national advertising. The crisis-management strategy worked and the story died down (though it flared up temporarily when the police arrested the woman's husband, who allegedly bought the finger from a coworker who had severed it in an accident months earlier).\(^8\)

8. Stewart Elliott, "Wendy's Gets a Break, but Still Has Work
BP Oil Spill

The response to the BP oil spill by its former CEO, Tony Hayward, is an example of poor crisis management.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=147

Even with crisis-management plans in place, however, it is unlikely that most companies will emerge from a damaging or potentially damaging episode as unscathed as Wendy’s did. For one thing, the culprits in the Wendy’s case were caught, and the public is willing

to forgive an organization it views as a victim. Given the current public distrust of corporate behavior, however, companies whose reputations have suffered due to questionable corporate judgment don’t fare as well. These companies include the international oil company, BP, whose CEO, Tony Hayward, did a disastrous job handling the crisis created when a BP controlled oil rig exploded in the Gulf Coast killing eleven workers and creating the largest oil spill in U.S. history. Hayward’s lack of sensitivity will be remembered forever; particularly his response to a reporter’s question on what he would tell those whose livelihoods were ruined: “We’re sorry for the massive disruption it’s caused their lives. There’s no one who wants this over more than I do. I would like my life back.” His comment was obviously upsetting to the families of the eleven men who lost their lives on the rig and had no way to get their lives back.9

Given the high risk associated with a crisis, it should come as no surprise that contemporary managers spend more time anticipating crises and practicing their crisis-management responses.

Key Takeaways

• Successful managers decide where they want the organization to go and then determine how to get there.
• Planning for a business starts at the top and works its way down.
• It begins with strategic planning—the process of establishing an overall course of action.
• Step one is identifying the purpose of the organization.
• Then, management is ready to take the remaining steps in the

strategic planning process:

1. Prepare a mission statement that describes the purpose of the organization and tells customers, employees, and others what it’s committed to doing.
2. Select the core values that will guide the behavior of members of the organization by letting them know what is and isn’t appropriate and important in conducting company activities.
3. Use SWOT analysis to assess the company’s strengths and weaknesses and its fit with the external environment.
4. Set goals and objectives, or performance targets, to direct all the activities needed to achieve the organization’s mission.
5. Develop tactical plans and operational plans to implement objectives.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
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https://library.achievingthedream.org/baycollegeintrobusiness/?p=147
Organizing is an important but sometimes overlooked function of managers. The way an organization is structured determines how tasks are assigned, who reports to whom, what processes are in place to resolve customer concerns and complaints, and, most important, it designates the manager’s span of control. The best organizations build their structure (organization) around their mission, goals, and objectives, while others allow the company to
grow in multiple directions, letting it assume whatever shape the
environment encourages. Just as there is no one-size-fits-all legal
structure for business, you will learn in this section that there is
no one-size-fits-all organizational structure. The expression “form
follows function” applies as much to business as it does to bike racks
and art.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Organizing
- Reading: The Organization Chart and Reporting Structure
- Self Check: Organizational Structure

Take time to review and reflect on this activity in order to improve
your performance on the assessment for this section.
How Managers Are Organized

A manager engaged in organizing allocates resources (people, equipment, and money) to achieve a company’s plans. Successful managers make sure that all the activities identified in the planning process are assigned to some person, department, or team and that everyone has the resources needed to perform assigned activities.

A typical organization has several layers of management. Think of these layers as forming a pyramid like the one in Figure 1, with top managers occupying the narrow space at the peak, first-line
managers the broad base, and middle managers the levels in
between. As you move up the pyramid, management positions get
more demanding, but they carry more authority and responsibility
(along with more power, prestige, and pay). Top managers spend
most of their time in planning and decision making, while first-
line managers focus on day-to-day operations. For obvious reasons,
there are far more people with positions at the base of the pyramid
than there are with jobs at the other two levels (as you get to the
top, there are only a few positions). Let's look at each management
level in more detail.

Top Managers

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

Middle Managers

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

First-Line Managers

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

How Companies Get the Job Done

The organizing process raises some important questions: What jobs need to be done? Who does what? Who reports to whom? What are the formal relationships among people in the organization? You provide answers to these questions by developing an organizational structure: an arrangement of positions that's most appropriate for your company at a specific point in time. Remember, given the rapidly changing environment in which businesses operate, a structure that works today might be outdated tomorrow. That's why you hear so often about companies restructuring—altering existing organizational structures to become more competitive under conditions that have changed. In building an organizational structure, you engage in two activities: job specialization (dividing
tasks into jobs) and departmentalization (grouping jobs into units). We'll now see how these two processes are accomplished.

Specialization

The first step in designing an organizational structure is twofold:

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

This twofold process of organizing activities into clusters of related tasks that can be handled by certain individuals or groups is called specialization. Its purpose is to improve efficiency. Obviously, specialization has advantages. In addition to increasing efficiency, for example, it results in jobs that are easier to learn. But it has disadvantages, too. Doing the same thing over and over bores people and will eventually leave employees dissatisfied with their jobs. Before long, you'll notice decreased performance and increased absenteeism and turnover.

Departmentalization

The next step in designing an organizational structure is departmentalization—grouping specialized jobs into meaningful units. Depending on the organization and the size of the work units, they may be called divisions, departments, or just plain groups. Traditional groupings of jobs result in different organizational structures, and for the sake of simplicity, we'll focus on two types—functional and divisional organizations.
Functional Organization

A functional organization groups together people who have comparable skills and perform similar tasks. This form of organization is fairly typical for small to medium-size companies, which group their people by business functions: accountants are grouped together, as are people in finance, marketing and sales, human resources, production, and research and development. Each unit is headed by an individual with expertise in the unit’s particular function. The head of an accounting department, for example, will be a senior accountant; the head of a hospital nursing unit will obviously be an experienced nurse. This structure is also appropriate for nonprofits. Think about your school, for instance: mathematics teachers are in the math department, history teachers are in the history department, those who run athletic programs are in the athletic department, and librarians work at the library.

If a company adopted a functional approach to departmentalization, jobs might be grouped into four clusters:

- Human resources (hiring, training, and evaluating employees)
- Operations (overseeing production)
- Marketing (arranging for advertising, sales, and distribution)
- Accounting (handling cash collection and disbursement)

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

Large companies often find it unruly to operate as one large unit under a functional organizational structure. Sheer size makes it difficult for managers to oversee operations and serve customers. To rectify this problem, most large companies are structured as divisional organizations made up of several smaller, self-contained units, or divisions, which are accountable for their own performance. Each division functions autonomously because it contains all the functional expertise (production, marketing, accounting, finance, human resources) needed to meet its objectives. The challenge is to find the most appropriate way of structuring operations to achieve overall company goals. Toward this end, divisions can be formed according to products, customers, processes, or geography.

Product Division

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

Customer Division

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

Process Division

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

3. Northwest Forest Industry, Pulp and Paper Manufacturing, "From the Forest to the Office and
Geographical Division

Geographical division enables companies that operate in several locations to be responsive to customers at a local level. McDonald’s, for example, is organized according to the regions of the world in which it operates. In the United States, the national unit is further subdivided into three geographic operating divisions: east, west and central.  

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


4. "Franchising," McDonald's Corp., accessed October 8, 2011). (This approach might be appealing to Notes-4-You if it expands to serve schools around the country.
The Organization Chart

Once an organization has set its structure, it can represent that structure in an organization chart: a diagram delineating the interrelationships of positions within the organization. Having decided on a functional structure, a company might create the organization chart shown in Figure 1.

Figure 1. Organization Chart

Using the figure above for reference you can complete a
hypothetical organization chart. Begin by putting yourself at the top of the chart, as the company's president. Then fill in the level directly below your name with the names and positions of the people who work directly for you—your accounting, marketing, operations, and human resources managers. The next level identifies the people who work for these managers. In this example, because you've started out small, neither your accounting manager nor your human resources manager currently manage anyone directly. Your marketing manager, however, oversees one person in advertising and a sales supervisor (who, in turn, oversees the sales staff). Your operations manager oversees two individuals—one to supervise notetakers and one to supervise people responsible for making copies.

Reporting Relationships

With these relationships in mind, you can now draw lines to denote reporting relationships, or patterns of formal communication. Because four managers report to you, you'll be connected to four positions; that is, you'll have four direct “reports.” Your marketing and operations managers will each be connected to two positions and their supervisors to one position each. The organization chart shows that if a member of the sales staff has a problem, he or she will report it to the sales supervisor. If the sales supervisor believes that the problem should be addressed at a higher level, then he or she will report it to the marketing manager.

Theoretically, you will communicate only with your four direct reports, but this isn't the way things normally work. Behind every formal communication network there lies a network of informal communications—unofficial relationships among members of an organization. You might find that over time, you receive communications directly from members of the sales staff; in fact, you might encourage this line of communication.
Now let’s look at the chart of an organization that relies on a divisional structure based on goods or services produced—say, a theme park. The top layers of this company’s organization chart might look like the one in Figure 2a. We see that the president has two direct reports—a vice president in charge of rides and a vice president in charge of concessions. What about a bank that’s structured according to its customer base? The bank’s organization chart would begin like the one in Figure 2b. Once again, the company’s top manager has two direct reports, in this case a VP of retail-customer accounts and a VP of commercial-customer accounts.

![Figure 2. Organization Charts for Divisional Structures](image)

Over time, companies revise their organizational structures to accommodate growth and changes in the external environment. It’s not uncommon, for example, for a firm to adopt a functional structure in its early years. Then, as it becomes bigger and more complex, it might move to a divisional structure—perhaps to accommodate new products or to become more responsive to certain customers or geographical areas. Some companies might ultimately rely on a combination of functional and divisional structures. This could be a good approach for a credit card company that issues cards in both the United States and Europe. A skeleton of this firm’s organization chart might look like the one in Figure 3.
Lines of Authority

You can learn a lot about a firm’s reporting and authority relationships by looking at its organization chart. To whom does a particular person report? Does each person report to one or more supervisors? How many people does a manager supervise? How many layers are there, for example, between the top managerial position and the lowest managerial level?

Chain of Command

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

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

![Figure 4. Organization Chart: Matrix Structure](image)

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

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

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

There are trade-offs between the advantages and disadvantages of flat and tall organizations. Companies determine which trade-offs to make according to a principle called span of control, which measures the number of people reporting to a particular manager. If, for example, you remove layers of management to make your organization flatter, you end up increasing the number of positions reporting to a particular supervisor.

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

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

Responsibility and Authority

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

Centralization and Decentralization

If and when a company expands, the owner will have to decide whether most decisions should still be made by individuals at the top or delegated to lower-level employees. The first option, in which most decision making is concentrated at the top, is called centralization. The second option, which spreads decision making throughout the organization, is called decentralization. Naturally,
there are some decisions—such as strategic planning—that won’t be delegated to lower-level employees, but others can be delegated, such as the management of copy-center operations. In fact, putting someone in charge of this function would probably improve customer satisfaction, because copy-center customers would be dealing directly with the manager. It would also give the manager valuable decision-making experience, and while he or she is busy making daily decisions about the copy center, upper level management and owners will have more time to work on higher-level tasks.

KEY TAKEAWAYS

- Managers coordinate the activities identified in the planning process among individuals, departments, or other units and allocate the resources needed to perform them.
- Typically, there are three levels of management: top managers, who are responsible for overall performance; middle managers, who report to top managers and oversee lower-level managers; and first-line managers, who supervise employees to make sure that work is performed correctly and on time.
- Management must develop an organizational structure, or arrangement of people within the organization, that will best achieve company goals.
- The process begins with specialization—dividing necessary tasks into jobs; the principle of grouping jobs into units is called departmentalization.
- Units are then grouped into an appropriate organizational structure. Functional organization groups people with comparable skills and tasks; divisional organization creates a structure composed of self-contained units based on product, customer, process, or geographical division. Forms of
organizational division are often combined.

- An organization’s structure is represented in an **organization chart**—a diagram showing the interrelationships of its positions.
- This chart highlights the **chain of command**, or authority relationships among people working at different levels.
- It also shows the number of layers between the top and lowest managerial levels. An organization with few layers has a wide **span of control**, with each manager overseeing a large number of subordinates; with a narrow span of control, only a limited number of subordinates reports to each manager.

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:

https://library.achievingthedream.org/baycollegeintrobusiness/?p=150
126. Outcome: Leadership Styles

What you’ll learn to do: identify the different leadership styles a manager can adopt, and determine the circumstances under which each style is appropriate

Leaders come in as many “flavors” as ice cream. Some leaders are directing; others are more relaxed—more like a coach than a boss. Leaders might not lead with the same style all the time, either. There are occasions when leaders must take a firm stand, making critical decisions on their own, and other times when they might work with their employees to build a consensus before acting. Each leadership style has its place and time, and each leader has his or her own preferred approach. As you read through this section, consider the CEO of Japan Airlines profiled in the following video and what his actions say about his leadership style.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Leadership Styles
- Self Check: Leadership Styles

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Leadership Styles

Leading an organization can be compared to conducting an orchestra. The leader directs the various parts of the orchestra—the string, brass, woodwind, and percussion sections—indicating when and how they should play. It’s fairly easy to pick up a baton, cue each section, and strike up the band. But it doesn’t follow that the music will be good.

What if your cues are ambiguous, ignored, or misinterpreted? Or what if your musicians don’t like your approach to the music and decide to walk away? On top of everything else, you don’t simply want to make music: you want to inspire your musicians to make great music. How do you accomplish this goal? How do you become an effective leader? What style or approach should you use to motivate others to achieve organizational goals? Unfortunately, there are no definitive answers to questions like these. Over time,
every manager refines his or her own leadership style or way of interacting with and influencing others. Despite a vast range of personal differences, leadership styles tend to reflect one of the following approaches to directing and motivating people: the autocratic, the democratic, or the laissez-faire. Let’s see how managerial styles reflect each of them in a work situation.

- **Autocratic style.** Managers who have developed an autocratic leadership style tend to make decisions without soliciting input from subordinates. They exercise authority and expect subordinates to take responsibility for performing the required tasks without undue explanation.

- **Democratic style.** Managers who favor a democratic leadership style generally seek input from subordinates while retaining the authority to make the final decisions. They’re also more likely to keep subordinates informed about things that affect their work.

- **Laissez-faire style.** In practicing a laissez-faire leadership style, managers adopt a “hands-off” approach and provide relatively little direction to subordinates. They may advise employees but usually give them considerable freedom to solve problems and make decisions on their own.

At first glance, you’d probably not want to work for an autocratic leader. After all, you certainly don’t want to be told what to do without having any input. You probably like the idea of working for a democratic leader; it’s flattering to be asked for your input. Though working in a laissez-faire environment might seem a little unsettling at first, the opportunity to make your own decisions is appealing. In general, your assessments of the three leadership styles would be accurate. Employees generally dislike working for autocratic leaders; they like working for democratic leaders, and they find working for laissez-faire leaders rewarding (as long as they feel they can handle the job). But there are situations when these
generalities don't hold. To learn what these situations are, let's turn things around and pretend you're the leader.

To make it applicable to your current life, we'll say that you're leading a group of fellow students in a team project for your class. Are there times when it would be best for you to use an autocratic leadership style? What if your team was newly formed, unfamiliar with what needs to be done, under a tight deadline, and looking to you for direction? In this situation, you might find it appropriate to follow an autocratic leadership style (on a temporary basis) and assign tasks to each member of the group. Now let's look at the leadership style you probably prefer—the democratic leadership style. Can you think of a situation where this style would not work for your team? What if the members of your team are unmotivated, don't seem interested in providing input, and aren't getting along? It might make sense to move away from a democratic style of leadership (temporarily) and delegate specific tasks to each member of the group that they can do on their own. How about laissez-faire leadership? Will this always work with your group? Not always. It will work if your team members are willing and able to work independently and welcome the chance to make decisions. Otherwise, it could cause the team to miss deadlines or do poorly on the project. The point being made here is that no one leadership style is effective all the time for all people. While the democratic style is viewed as the most appropriate (as is the laissez-faire style, to a lesser extent), there are times when following an autocratic style is better. Good leaders learn how to adjust their styles to fit both the situation and the individuals being directed.

Transformational Leadership

Theories on what constitutes effective leadership evolve over time. One theory that has received a lot of attention in the last decade contrasts two leadership styles: transactional and transformational.
So-called transactional leaders exercise authority based on their rank in the organization. They let subordinates know what’s expected of them and what they will receive if they meet stated objectives. They focus their attention on identifying mistakes and disciplining employees for poor performance. By contrast, transformational leaders mentor and develop subordinates, providing them with challenging opportunities, working one-on-one to help them meet their professional and personal needs, and encouraging people to approach problems from new perspectives. They stimulate employees to look beyond personal interests to those of the group. So, which leadership style is more effective? You probably won’t be surprised by the opinion of most experts. In today’s organizations, in which team building and information sharing are important and projects are often collaborative in nature, transformational leadership has proven to be more effective. Modern organizations look for managers who can develop positive relationships with subordinates and motivate employees to focus on the interests of the organization.¹

### KEY TAKEAWAYS

- A manager’s **leadership style** varies depending on the manager, the situation, and the people being directed. There are three common styles.
- Using an **autocratic style**, a manager tends to make decisions without soliciting input and expects subordinates to follow instructions without undue explanation.

• Managers who prefer a **democratic style** seek input on decisions.

• Exercising a **laissez-faire style**, the manager provides no more guidance than necessary and lets subordinates make decisions and solve problems.

• One current leadership theory focuses on two contrasting leadership styles: transactional and transformational.

• Managers adopting a **transactional style** exercise authority according to their rank in the organization, let subordinates know what's expected of them, and step in when mistakes are made.

• Practicing a **transformational style**, managers mentor and develop subordinates and motivate them to achieve organizational rather than merely personal goals. Transformational leadership is effective in organizations that value team building and information sharing.

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=152
128. Outcome: Control

What you’ll learn to do: explain why control is an essential part of being a manager and how this function contributes to effective management

Consider the two images below . . . one with control and one without:

Consider the two parking lots as two different organizations. What you can see is that one has management controls in place, and the other . . . well, you can tell how that’s working out. In the second photo no one is in charge of controlling the actions and activities of the employees within the company—it’s a free-for-all.
It might seem attractive, at first, to work for a company where people aren't telling you what to do, how to do it, or when things are due. But it wouldn't take too long, probably, for all that freedom to feel like chaos. In this next section we'll focus on the control function of management to better understand how it helps people and organizations achieve goals and objectives.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Controlling: A Five-Step Process
• Self Check: Control

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Controlling

Controlling involves ensuring that performance does not deviate from standards. Controlling consists of five steps: (1) set standards, (2) measure performance, (3) compare performance to standards, (4) determine the reasons for deviations and then (5) take corrective action as needed (see Figure 1, below). Corrective action can include changes made to the performance standards—setting them higher or lower or identifying new or additional standards. Performance standards are often stated in monetary terms such as revenue, costs, or profits but may also be stated in other terms, such as units produced, number of defective products, or levels of quality or customer service.
The measurement of performance can be done in several ways, depending on the performance standards, including financial statements, sales reports, production results, customer satisfaction, and formal performance appraisals. Managers at all levels engage in the managerial function of controlling to some degree.

The managerial function of controlling should not be confused with control in the behavioral or manipulative sense. This function does not imply that managers should attempt to control or to manipulate the personalities, values, attitudes, or emotions of their subordinates. Instead, this function of management concerns the
manager's role in taking necessary actions to ensure that the work-related activities of subordinates are consistent with and contributing toward the accomplishment of organizational and departmental objectives.

Effective controlling requires the existence of plans, since planning provides the necessary performance standards or objectives. Controlling also requires a clear understanding of where responsibility for deviations from standards lies. Two traditional control techniques are budget and performance audits. An audit involves an examination and verification of records and supporting documents. A budget audit provides information about where the organization is with respect to what was planned or budgeted for, whereas a performance audit might try to determine whether the figures reported are a reflection of actual performance. Although controlling is often thought of in terms of financial criteria, managers must also control production and operations processes, procedures for delivery of services, compliance with company policies, and many other activities within the organization.

Controls also come at a cost. It is useful to know that there are trade-offs between having and not having organizational controls. Let's look at some of the costs and benefits of organizational controls.

**Costs**

Financial costs—direct (i.e., paying for an accountant for an audit) and indirect (i.e., people employed by the organization whose primary function is related to control—internal quality control, for instance).

Culture and reputation costs—the intangible costs associated with any form of control. Examples include damaged relationships with employees or tarnished reputation with investors or government.
Responsiveness costs—downtime between a decision and the actions required to implement it due to compliance with controls.

Poorly implemented controls—implementation is botched or the implementation of a new control conflicts with other controls.

Benefits

Cost and productivity control—ensures that the firm functions effectively and efficiently.

Quality control—contributes to cost control (i.e., fewer defects, less waste), customer satisfaction (i.e., fewer returns), and greater sales (i.e., repeat customers and new customers).

Opportunity recognition—helps managers identify and isolate the source of positive surprises, such as a new growth market. Though opportunities can also be found in internal comparisons of cost control and productivity across units.

Manage uncertainty and complexity—keeps the organization focused on its strategy, and helps managers anticipate and detect negative surprises and respond opportunistically to positive surprises.

Decentralized decision making—allows the organization to be more responsive by moving decision making to those closest to customers and areas of uncertainty.

The management functions of planning, organizing, leading, and controlling are widely considered to be the best means of describing the manager’s job, as well as the best way to classify accumulated knowledge about the study of management. Although there have been tremendous changes in the environment faced by managers and the tools used by managers to perform their roles, managers still perform these essential functions.
KEY TAKEAWAYS

The control function can be viewed as a five-step process: (1) Establish standards, (2) Measure performance, (3) Compare actual performance with standards and identify any deviations, (4) Determine the reason for deviations, and (5) Take corrective action, if needed.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

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130. Putting It Together: Management

Summary

Skills of a Manager

Managers wear many hats and must bring with them an entire toolkit of skills—ranging from interpersonal to technical skills—in order to reach organizational goals and objectives effectively. Without the proper skill set, managers can find themselves unable to gain the trust and support of those around them, making their job more difficult and, in some cases, impossible.

Functions of Management

Although the world of business has changed tremendously over time, the four functions of management—planning, organizing, leading, and controlling—originally identified by Fayol in the early 1900s still hold. What has changed is where and how managers perform these four primary functions.

Planning

Planning within a business ranges from the big picture to the very granular, from the organization’s foundational plan (its mission) and
set of strategic plans to its daily operations plans. Each one builds upon the other, and without a well-developed set of plans that management can implement, an organization will likely drift from one venture or problem to another without ever really achieving success.

Organizational Structure

The structure of an organization can have a tremendous impact on the organization's ability to react to both internal and external forces. Organizational structure also determines the managers' span of control, communication channels, and operational responsibilities. The organization should be structured in such a way that it reflects the company's mission and supports its customer and product/services goals to the greatest advantage.

Leadership Styles

From autocratic to laissez-faire, leadership styles run the entire spectrum. Some of the most effective leaders are those who can adopt different styles to fit the situation at hand.

Control

The control function of management has two aims: to make order out of chaos and to evaluate whether the company's efforts and resources are being maximized. Remember that the “control function” doesn’t give management license to be manipulative or autocratic. Instead it refers to the importance of control through
evaluation, since evaluation is the key to knowing whether a company is producing the desired results or not.

**Synthesis**

Conductors, ship captains, ice cream flavors, jugglers, parking lots . . . Why have we used so many different analogies to describe managers and management? Because all of them are appropriate given the diversity of roles and responsibilities that managers have on any given day. They must truly possess a broad range of skills in order to react, adapt, plan, and change course swiftly to stay ahead of changes inside and outside of the organization. Perhaps the best way to sum it up is that managers and leaders need to be prepared because . . .
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=155
Why It Matters: Legal Ownership

Why distinguish among the legal forms of ownership for a business?

It may seem that learning about the various ways that businesses can be formed and operate under the legal system is something that should be left to the lawyers and students of the law. However, the way a business is formed as a legal entity has implications far beyond the business. Did you know that if your business fails and you can’t pay your business creditors the money you owe them that you can lose your home, car, and most of your personal belongings? Or, if you select the wrong legal form of ownership, you can find yourself in a position of owing a large sum of money to the Internal Revenue Service? Did you realize that if your business has not been formed in a way that protects you if someone slips and falls in your store that you could be personally liable for their pain and suffering?

NOW, do you still think that the legal side of forming a business is just for lawyers? If not, then you are getting the idea behind this module. If you’re not sure, take a look at the video below and see what happened to a family who ran their own business as a sole proprietorship and experienced the impact of the recent recession. After watching the video, you will spend the remainder of this module learning about forms of ownership, options available to business owners, and even places where you can get assistance.
Learning Outcomes

- Recognize the advantages and disadvantages of the various forms of business ownership relative to a business opportunity
- Differentiate among the different types of corporations available to business owners (C, S, B)
- Explain the concept of franchising and the associated risks and benefits to the franchisor and franchisee
- Explain how a business can expand market share and diversify through mergers and acquisitions
- Identify sources of assistance available to individuals to start a business
132. Outcome: Forms of Business Ownership

What you’ll learn to do: recognize the advantages and disadvantages of the various forms of business ownership relative to a business opportunity

Who would have thought it? Two ex-hippies with strong interests in social activism would end up starting one of the best-known ice cream companies in the country—Ben & Jerry’s. Perhaps it was meant to be.

The Ice Cream Men

It seems that Ben Cohen (the “Ben” of Ben & Jerry’s) always had a fascination with ice cream. As a child, he made his own ice cream mixtures by smashing his favorite cookies and candies into his ice cream. But it wasn’t until his senior year in high school that he became an official “ice cream man,” happily driving his truck through neighborhoods filled with kids eager to buy his ice cream pops. After high school, Ben tried college but it wasn’t for him. He attended Colgate University for a
year and a half before he dropped out to return to his real love: being an ice cream man. He tried college again—this time at Skidmore, where he studied pottery and jewelry making—but, in spite of his course selections, still didn’t like it.

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

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Selecting a Form of Business Ownership
- Reading: Sole Proprietorship and Partnerships
- Self Check: Forms of Business Ownership
Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Selecting a Form of Business Ownership: Factors to Consider

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

1. What are you willing to do to set up and operate your business? Do you want to minimize the costs of getting started? Do you hope to avoid complex government regulations and reporting requirements?

2. How much control would you like? Do you want to own the company yourself, or do you want to share ownership with other people? Are you willing to share responsibility for running the business?

3. Do you want to be the sole benefactor of your efforts or are you willing to share profits with other people? Do you want to be in charge of deciding how much of the company's profits will be retained in the business?

4. Do you want to avoid special taxes? Do you want to avoid paying “business” income taxes on your business and then paying “personal” income taxes on profits earned by the
business?
5. Do you have all the skills needed to run the business? Do you possess the talent and skills to run the business yourself, or would the business benefit from a diverse group of owners? Are you likely to get along with co-owners over an extended period of time?
6. Should it be possible for the business to continue without you? Is it important to you that the business survive you? Do you want to know that other owners can take over if you die or become disabled? Do you want to make it easy for ownership to change hands?
7. What are your financing needs? How do you plan to finance your company? Will you need a lot of money to start, operate, and grow your business? Can you furnish the money yourself, or will you need some investment from other people? Will you need bank loans? If so, will you have difficulty getting them yourself?
8. How much liability exposure are you willing to accept? Are you willing to risk your personal assets—your bank account, your car, maybe even your home—for your business? Are you prepared to pay business debts out of your personal funds? Do you feel uneasy about accepting personal liability for the actions of fellow owners?

No single form of ownership will give you everything you desire. You'll have to make some trade-offs. Because each option has both advantages and disadvantages, your job is to decide which one offers the features that are most important to you. In the following sections we'll compare the three ownership options (sole proprietorship, partnership, corporation) on the eight dimensions that we identified previously: setup costs and government regulations control, profit sharing, income taxes, skills, continuity and transferability, ability to obtain financing, and liability exposure.
KEY TAKEAWAYS

• Some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business include the following:
  ◦ What are you willing to do to set up and operate your business?
  ◦ How much control do you want?
  ◦ Do you want to share profits with others?
  ◦ Do you want to avoid special taxes on your business?
  ◦ Do you have all the skills needed to run the business?
  ◦ Should it be possible for the business to continue without you?
  ◦ What are your financing needs?
  ◦ How much liability exposure are you willing to accept?

• No single form of ownership—sole proprietorship, partnership, or corporation—will give you everything you want. Each has advantages and disadvantages.

In this next section we will examine two very common forms of ownership: Sole Proprietorship and Partnerships.
Sole Proprietorship

A **sole proprietorship** is a business owned by only one person. The most common form of ownership, it accounts for about 72 percent of all U.S. businesses.\(^1\) It’s the easiest and cheapest type of business to form: if you’re using your own name as the name of your business, you just need a license to get started, and once you’re in business, you’re subject to few government regulations.

Advantages and Disadvantages of Sole Proprietorships

As sole owner, you have complete control over your business. You make all important decisions, and you’re generally responsible for all day-to-day activities. In exchange for assuming all this responsibility, you get all the income earned by the business. Profits:

2. .
earned are taxed as personal income, so you don’t have to pay any special federal and state income taxes.

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control, for example, is having to supply all the different talents that may be necessary to make the business a success. And if you die, the business dissolves. You also have to rely on your own resources for financing; in effect, you are the business, and any money borrowed by the business is loaned to you personally. Even more important, the sole proprietor bears unlimited liability for any losses incurred by the business. As you can see from Figure 1, the principle of unlimited personal liability means that if the company incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the owner is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.
Partnership

A **partnership (or general partnership)** is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships and though the vast majority are small, some are quite large. For example, the accounting firm Deloitte, Haskins and Sells is a partnership. In 2014 it had revenues of $34.2B and 210,000 employees.

Setting up a partnership is more complex than setting up a sole proprietorship, but it’s still relatively easy and inexpensive. The cost varies according to size and complexity. It’s possible to form a simple partnership without the help of a lawyer or an accountant, though it’s usually a good idea to get professional advice. Professionals can help you identify and resolve issues that may later create disputes among partners.


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The Partnership Agreement

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

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

Unlimited Liability and the Partnership

Figure 2 shows that a major problem with partnerships, as with sole proprietorships, is unlimited liability: each partner is personally liable not only for his or her own actions but also for the actions of all the partners. In a partnership, it may work according to the following scenario. Say that you're a partner in a dry cleaning business. One day, you return from lunch to find your establishment on fire. You're intercepted by your partner, who tells you that the fire started because he fell asleep while smoking. As you watch your livelihood go up in flames, your partner tells you something else: because he forgot to pay the bill, your fire insurance was canceled. When it's all over, you estimate the loss to the building and everything inside at $1.2 million. And here's the really bad news: if the business doesn't have the cash or other assets to cover losses, you can be personally sued for the amount owed. In other words,
any party who suffered a loss because of the fire can go after your personal assets.

**Figure 2. General Partnership and Unlimited Liability**

Limited partnerships

Many people are understandably reluctant to enter into partnerships because of unlimited liability. Individuals with substantial assets, for example, have a lot to lose if they get sued for a partnership obligation (and when people sue, they tend to start with the richest partner). To overcome this defect of partnerships, the law permits a limited partnership, which has two types of partners: a single general partner who runs the business and is responsible for its liabilities, and any number of limited partners.
who have limited involvement in the business and whose losses are limited to the amount of their investment.

Advantages and Disadvantages of Partnerships

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

Still, there are some negatives. First, as discussed earlier, partners are subject to unlimited liability. Second, being a partner means that you have to share decision making, and many people aren't comfortable with that situation. Not surprisingly, partners often have differences of opinion on how to run a business, and disagreements can escalate to the point of actual conflict; in fact, they can even jeopardize the continuance of the business. Third, in addition to sharing ideas, partners also share profits. This arrangement can work as long as all partners feel that they're being rewarded according to their efforts and accomplishments, but that isn't always the case.

While the partnership form of ownership is viewed negatively by some, it was particularly appealing to Ben Cohen and Jerry Greenfield. Starting their ice cream business as a partnership was inexpensive and let them combine their limited financial resources and use their diverse skills and talents. As friends they trusted each other and welcomed shared decision making and profit sharing. They were also not reluctant to be held personally liable for each other's actions.
KEY TAKEAWAYS

• A sole proprietorship is a business owned by only one person.
• It's the most common form of ownership and accounts for about 72 percent of all U.S. businesses.
• Advantages of a sole proprietorship include the following:
  ◦ Easy and inexpensive to form; few government regulations
  ◦ Complete control over your business
  ◦ Get all the profits earned by the business
  ◦ Don’t have to pay any special income taxes
• Disadvantages of a sole proprietorship include the following:
  ◦ Have to supply all the different talents needed to make the business a success
  ◦ If you die, the business dissolves
  ◦ Have to rely on your own resources for financing
  ◦ If the company incurs a debt or suffers a catastrophe, you are personally liable (you have unlimited liability)
• A general partnership is a business owned jointly by two or more people.
• About 10 percent of U.S. businesses are partnerships.
• The impact of disputes can be reduced if the partners have a partnership agreement that specifies everyone's rights and responsibilities.
• A partnership has several advantages over a sole proprietorship:
  ◦ It’s relatively inexpensive to set up and subject to few government regulations.
  ◦ Partners pay personal income taxes on their share of profits; the partnership doesn't pay any special taxes.
  ◦ It brings a diverse group of people together to share managerial responsibilities.
  ◦ Partners can agree legally to allow the partnership to survive if one or more partners die.
• It makes financing easier because the partnership can draw on resources from a number of partners.

• A partnership has several disadvantages over a sole proprietorship:
  ◦ Shared decision making can result in disagreements.
  ◦ Profits must be shared.
  ◦ Each partner is personally liable not only for his or her own actions but also for those of all partners—a principle called **unlimited liability**.

• A limited partnership has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

**Reflection Questions**

• Would you prefer to carry the full weight of a business, or to trust a partner?

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=160
135. Outcome: Types of Corporations

What you’ll learn to do: differentiate among the different types of corporations available to business owners (C, S, B)

When you hear the word corporation, what comes to mind? General Motors, Dell, Apple, Nike, WalMart? All of these organizations are in fact corporations, but not all corporations are big businesses, and in fact, not all of them even exist as “for-profit” companies. In this section we will examine three of the most common types of corporations: C Corps, the most common but most complex; S Corps, a small corporation with fewer than one hundred shareholders, and the B Corp or Benefit Corporation, a new form of corporation that allows owners to benefit both society and their shareholders.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Corporations
- Reading: Hybrid Forms of Organization
- Self Check: Types of Corporations

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Corporations

A corporation (sometimes called a regular or C-corporation) differs from a sole proprietorship and a partnership because it’s a legal entity that is entirely separate from the parties who own it. It can enter into binding contracts, buy and sell property, sue and be sued, be held responsible for its actions, and be taxed. As Figure 1 shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues. Most large well-known businesses are corporations, but so are many of the smaller firms with which you do business.


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Ownership and Stock

Corporations are owned by shareholders, who invest money in the business by buying shares of stock. The portion of the corporation they own depends on the percentage of stock they hold. For example, if a corporation has issued 100 shares of stock, and you own 30 shares, you own 30 percent of the company. The shareholders elect a board of directors, a group of people (primarily from outside the corporation) who are legally responsible for governing the corporation. The board oversees the major policies and decisions made by the corporation, sets goals, and holds management accountable for achieving them, and hires and evaluates the top executive, generally called the CEO (chief executive officer). The board also approves the distribution of income to shareholders in the form of cash payments called dividends.

Benefits of Incorporation

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

Limited Liability

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

**Financial Resources**

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

**Specialized Management**

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

**Continuity and Transferability**

Another advantage of incorporation is continuity. Because the corporation has a legal life separate from the lives of its owners, it can (at least in theory) exist forever. Transferring ownership of a corporation is easy: shareholders simply sell their stock to others.
Some founders, however, want to restrict the transferability of their stock and so choose to operate as a **privately held corporation**. The stock in these corporations is held by only a few individuals, who are not allowed to sell it to the general public. Companies with no such restrictions on stock sales are called **public corporations**; stock is available for sale to the general public.

**Drawbacks to Incorporation**

Like sole proprietorships and partnerships, corporations have both positive and negative properties. In sole proprietorships and partnerships, for instance, the individuals who own and manage a business are the same people. Corporate managers, however, don’t necessarily own stock, and shareholders don’t necessarily work for the company. This situation can be troublesome if the goals of the two groups differ significantly. Managers, for example, might be more interested in career advancement than the overall profitability of the company. Stockholders might care about profits without regard for the well-being of employees.

Another drawback to incorporation—one that often discourages small businesses from incorporating—is the fact that corporations are costly to set up. When you combine filing and licensing fees with accounting and attorney fees, incorporating a business could set you back by $1,000 to $6,000 or more depending on the size and scope of your business (4). Additionally, corporations are subject to levels of regulation and governmental oversight that can place a burden on small businesses. Finally, corporations are subject to what’s generally called “double taxation.” Corporations are taxed by the federal and state governments on their earnings. When these

earnings are distributed as dividends, the shareholders pay taxes on these dividends. Corporate profits are thus taxed twice—the corporation pays the taxes the first time and the shareholders pay the taxes the second time.

Five years after starting their ice cream business, Ben Cohen and Jerry Greenfield evaluated the pros and cons of the corporate form of ownership, and the “pros” won. The primary motivator was the need to raise funds to build a $2 million manufacturing facility. Not only did Ben and Jerry decide to switch from a partnership to a corporation, but they also decided to sell shares of stock to the public (and thus become a public corporation). Their sale of stock to the public was a bit unusual: Ben and Jerry wanted the community to own the company, so instead of offering the stock to anyone interested in buying a share, they offered stock to residents of Vermont only. Ben believed that “business has a responsibility to give back to the community from which it draws its support” (5) He wanted the company to be owned by those who lined up in the gas station to buy cones. The stock was so popular that one in every hundred Vermont families bought stock in the company (6) Eventually, as the company continued to expand, the stock was sold on a national level.

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

• S-corporations

Limited-liability companies

Cooperatives

Not-for-profit corporations

Hybrids: S-Corporations and Limited-Liability Companies

To understand the value of S-corporations and limited-liability companies, we'll begin by reviewing the major advantages and disadvantages of the three types of business ownership we've explored so far: sole proprietorship, partnership, and corporation. Identifying the attractive and unattractive features of these three types of business ownership will help us appreciate why S-corporations and limited-liability companies were created.

Attractive and Unattractive Features of Corporations

What feature of corporations do business owners find most attractive? The most attractive feature of a corporation is limited liability, which means that the shareholders (owners) cannot be held personally liable for the debts and obligations of the corporation. For example, if a corporation cannot pay its debts and goes bankrupt, the shareholders will not be required to pay the creditors with their own money. Shareholders cannot lose any more than the amount they have invested in the company.

What feature of corporations do business owners find least attractive? Most would agree that the least attractive feature of a corporation is “double taxation.” Double taxation occurs when the same earnings are taxed twice by the government. Let's use a simple example to show how this happens. You're the only shareholder in
a very small corporation. This past year it earned $10,000. It had to pay the government $3,000 corporate tax on the $10,000 earned. The remaining $7,000 was paid to you by the corporation in the form of a dividend. When you filed your personal income tax form, you had to pay personal taxes on the $7,000 dividend. So the $7,000 was taxed twice: the corporation paid the taxes the first time and you (the shareholder) paid the taxes the second time.

Attractive and Unattractive Features of Sole Proprietorships and Partnerships

Now let’s turn to the other two types of business ownership: sole proprietorship and partnership. What feature of these forms of business organization do owners find most attractive? The most attractive feature is that there is no “double taxation” with proprietorships and partnerships. Proprietorships and partnerships do not pay taxes on profits at the business level. The only taxes paid are at the personal level—this occurs when proprietors and partners pay taxes on their share of their company’s income. Here are two examples (one for a sole proprietorship and one for a partnership). First, let’s say you’re a sole proprietor and your business earns $20,000 this year. The sole proprietorship pays no taxes at the “business” level. You pay taxes on the $20,000 earnings on your personal tax return. Second, let’s say you’re a partner in a three-partner firm (in which each partner receives one-third of the partnership income). The firm earns $90,000 this year. It pays no taxes at the partnership level. Each partner, including you, pays taxes on one-third of the earnings, or $30,000 each. Notice that in both cases, there is no “double taxation.” Taxes were paid on the company earnings only once—at the personal level. So the total tax burden is less with sole proprietorships and partnerships than it is with corporations.

What feature of sole proprietorships and partnerships do
business owners find **least attractive**? And the answer is . . .

unlimited liability. This feature holds a business owner personally liable for all debts of his or her company. If you're a sole proprietorship and the debts of your business exceed its assets, creditors can seize your personal assets to cover the proprietorship’s outstanding business debt. For example, if your business is sued for $500,000 and it does not have enough money to cover its legal obligation, the injured party can seize your personal assets (cash, property, etc.) to cover the outstanding debt. Unlimited liability is even riskier in the case of a partnership. Each partner is personally liable not only for his or her own actions but also for the actions of all the partners. If, through mismanagement by one of your partners, the partnership is forced into bankruptcy, the creditors can go after you for all outstanding debts of the partnership.
Hybrid Forms of Organization

How would you like a legal form of organization that provides the attractive features of the three common forms of organization (corporation, sole proprietorship and partnership) and avoids the unattractive features of these three organization forms? It sounds very appealing. This is what was accomplished with the creation of two hybrid forms of organization: S-corporation and limited-liability company. These hybrid-organization forms provide business owners with limited liability (the attractive feature of corporations) and no “double taxation” (the attractive feature of sole proprietorships and partnerships). They avoid double taxation (the unattractive feature of corporations) and unlimited liability (the unattractive feature of sole proprietorships and partnerships). We’ll now look at these two hybrids in more detail.

S-Corporation

In 1970, Karen and Mike Tocci, avid go-kart racing fans, bought a parcel of land in New Hampshire so their son, Rob, and his son’s friends could drag race in a safe environment. The Tocci’s continued interest in racing resulted in their starting a family-run business called Shannon Dragway. Over time, the business expanded to include a speedway track and a go-kart track and was renamed New Hampshire Motorsports Complex. In selecting their organization form, the Tocci’s wanted to accomplish two main goals: (1) limit their
personal liability; and (2) avoid having their earnings taxed twice, first at the corporate level and again at the personal level. An S-corporation form of business achieved these goals. They found they were able to meet the following S-corporation eligibility criteria:

- The company has no more than 100 shareholders
- All shareholders are individuals, estates, or certain nonprofits or trusts
- All shareholders are U.S. citizens and permanent residents of the U.S.
- The business is not a bank or insurance company
- All shareholders concur with the decision to form an S-corporation

Deciding to operate as an S-corporation presented the Tocci's with some disadvantages: They had no flexibility in the way profits were divided among the owners. In an S-corporation, profits must be allocated based on percentage ownership. So if an owner/shareholder holds 25 percent of the stock in the S-corporation, 25 percent of the company profits are allocated to this shareholder regardless of the amount of effort he or she exerts in running the business. Additionally, the owners had to follow a number of formal procedures, such as electing a board of directors and holding annual meetings. Finally, they were subjected to heavy recordkeeping requirements. Despite these disadvantages, the Tocci's concluded that on balance the S-corporation was the best form of organization for their business.

Limited-Liability Company

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

In many ways, a limited-liability company looks a lot like an S-corporation. Its owners (called members rather than shareholders) are not personally liable for debts of the company, and its earnings are taxed only once, at the personal level (thereby eliminating double taxation). But there are important differences between the two forms of organizations. For example, an LLC:

1. Has fewer ownership restrictions. It can have as many members as it wants—it is not restricted to a maximum of 100 shareholders.
2. Its members don’t have to be U.S. residents or citizens.
3. Profits do not have to be allocated to owners based on percentage ownership. Members can distribute profits in any way they want.
4. Is easier to operate because it doesn’t have as many rules and restrictions as does an S-corporation. It doesn’t have to elect a board of directors, hold annual meetings, or contend with a heavy record-keeping burden.

As the approach used to allocate profits is very important (item 3 described previously), let’s spend a few minutes going over an example of how the profit allocation process works. Let’s say that you and a business partner started a small pet grooming business at the beginning of the year. Your business partner (who has more
money than you do) contributed $40,000 to start-up the business and you contributed $10,000 (so your partner’s percentage ownership in the business is 80 percent and yours is 20 percent). But your business partner has another job and so you did 90 percent of the work during the past year. Profit for the first year was $100,000. If your company was set up as a S-corporation, you would be required to allocate profits based on percentage ownership. Under this allocation scheme $80,000 of the profits would be allocated to your business partner and only $20,000 would be allocated to you. This hardly seems fair. Under the limited-liability form of organization you and your partner can decide what is a “fair” allocation of profits and split the profits accordingly. Perhaps you will decide that you should get 70 percent of the profits (or $70,000) and your business partner should get 30 percent (or $30,000).

Now, let’s look at the fourth item—ease of operation. It is true that S-corporations have to deal with more red tape and paperwork and abide by more rules (such as holding annual meetings) than do limited-liability companies. Plus they are more complex to set up. But this does not mean that setting up and operating a limited-liability company is a breeze and should be taken lightly. One essential task that should be carefully attended to is the preparation of an operating agreement. This document, which is completed when the company is formed (and can be revised later), is essential to the success of the business. It describes the rights and responsibilities of the LLC members and spells out how profits or losses will be allocated.

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

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

As personal loan guarantees are the most common circumstance under which an LLC member is held personally liable for the debts of his or her company, let's explore this topic some more by asking (and answering) two questions:

1. **What is a loan guarantee?** It is a legal agreement made between an individual and a bank that says, “If my company does not repay this loan, I will.” It is the same thing as co-signing a loan.

2. **Why would an LLC member give a bank a personal guarantee?** Because it is often the only way a business can get a loan. Bankers understand the concept of limited liability. They know that if the company goes out of business (and the loan is not guaranteed), the bank is stuck with an unpaid loan because the LLC members are not personally liable for the debts of the company. Consequently, banks are reluctant to give loans to companies (particularly those just starting up) unless the loans are guaranteed by an owner.

A final note about hybrid forms of organization. In this section, we have looked at two organization forms that offer business owners limited liability and tax benefits. There are others not covered here such as Professional Limited-Liability Companies (PLLCs), which are set up by doctors, lawyers, accountants, and so on who provide professional services. And it is evident that the variations of organization forms available to businesses will continue to expand in the future.
Cooperatives

A cooperative (also known as a co-op) is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members. If run correctly, cooperatives increase profits for its producer-members and lower costs for its consumer-members. Cooperatives are common in the agricultural community. For example, some 750 cranberry and grapefruit member growers market their cranberry sauce, fruit juices, and dried cranberries through the Ocean Spray Cooperative.¹ More than three hundred thousand farmers obtain products they need for production—feed, seed, fertilizer, farm supplies, fuel—through the Southern States Cooperative.² Co-ops also exist outside agriculture. For example, REI (Recreational Equipment Incorporated), which sells quality outdoor gear, is the largest consumer cooperative in the United States with more than three million active members. The company shares its financial success each year with its members, who get a refund each year based on their eligible purchases.³

Not-for-Profit Corporations

A not-for-profit corporation (sometimes called a nonprofit) is an

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

There are more than 1.5 million not-for-profit organizations in the United States (4) Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately $38 billion and has given away $25.36 billion since its inception (5) Others are nationally recognized, such as United Way, Goodwill Industries, Habitat for Humanity, and the Red Cross. The vast majority is neither rich nor famous but nevertheless makes significant contributions to society.

Benefit Corporations

More companies are registering as benefit corporations which can more freely divert profits to their community and the environment, instead of focusing on maximizing shareholder profits.

KEY TAKEAWAYS

- A corporation (sometimes called a regular or C-corporation) is a legal entity that’s separate from the parties who own it.
- Corporations are owned by shareholders who invest money in them by buying shares of stock.
- They elect a board of directors that's legally responsible for governing the corporation.
- A corporation has several advantages over a sole proprietorship and partnership:
  - An important advantage of incorporation is limited liability: Owners are not responsible for the obligations of
the corporation and can lose no more than the amount
that they have personally invested in the company.
◦ Incorporation also makes it easier to access financing.
◦ Because the corporation is a separate legal entity, it exists
  beyond the lives of its owners.
◦ Corporations are generally able to attract skilled and
talented employees.
• A corporation has several disadvantages over a sole
  proprietorship and partnership:
  ◦ The goals of corporate managers, who don’t necessarily
    own stock, and shareholders, who don’t necessarily work
    for the company, can differ.
  ◦ It’s costly to set up and subject to burdensome regulations
    and government oversight.
  ◦ It’s subject to “double taxation.” Corporations are taxed on
    their earnings. When these earnings are distributed as
    dividends, the shareholders pay taxes on these dividends.
• The S-corporation gives small business owners limited liability
  protection, but taxes company profits only once, when they
  are paid out as dividends. It can’t have more than one hundred
  stockholders.
• A limited-liability company (LLC) is similar to an S-
  corporation: its members are not personally liable for company
  debts and its earnings are taxed only once, when they’re paid
  out as dividends. But it has fewer rules and restrictions than
  does an S-corporation. For example, an LLC can have any
  number of members.
• A cooperative is a business owned and controlled by those who
  use its services. Individuals and firms who belong to the
  cooperative join together to market products, purchase
  supplies, and provide services for its members.
• A not-for-profit corporation is an organization formed to
  serve some public purpose rather than for financial gain. It
  enjoys favorable tax treatment.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=163
What you’ll learn to do: explain the concept of franchising and the associated risks and benefits to the franchisor and franchisee

For some people, coming up with a great business idea is a gratifying adventure. For most, however, it’s a daunting task. The key to coming up with a business idea is identifying something that customers want—or, perhaps more important, filling an unmet need. For those who are undecided about the “best” business, many of them elect to buy a franchise instead of starting from scratch.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Franchising
- Self Check: Franchising

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
If you want to be a small business owner but are averse to the risks of starting your own business, you might opt to buy a franchise.

Under this setup, a franchiser (the company that sells the franchise) grants the franchisee (the buyer—you) the right to use a brand name and to sell its goods or services. Franchises market products in a variety of industries, including food, retail, hotels, travel, real estate, business services, cleaning services, and even weight-loss centers and wedding services. There are thousands of franchises, many of which are quite familiar—SUBWAY, McDonald’s, 7-Eleven, Holiday Inn, Budget Car Rental, RadioShack, and Jiffy Lube.

As you can see from the figure “The Growth of Franchising, 1980–2007” below, franchising has become an extremely popular way to do business. A new franchise outlet opens once every eight minutes in the United States, where one in ten businesses is now a franchise. Franchises employ eight million people (13 percent of the workforce) and account for 17 percent of all sales in this country ($1.3 trillion) (“Census Bureau's First Release of Comprehensive Franchise Data Shows Franchises Make Up More Than 10 Percent of Employer Businesses,” U.S. Census Bureau, September 14, 2010,” U.S. Census Bureau, http://www.census.gov/newsroom/releases/archives/economic_census/cb10-141.html, accessed August 31, 2011).
In addition to the right to use a company's brand name and sell its products, the franchisee gets help in picking a location, starting and operating the business, and advertising. In effect, you've bought a prepackaged, ready-to-go business that's proven successful elsewhere. You also get ongoing support from the franchiser, which has a vested interest in your success.

Not surprisingly, these advantages don't come cheaply. Franchises can be very expensive, usually depending on the amount of business that a franchisee is expected to do. KFC franchises, for example, require a total investment of $1.3 million to $2.5 million each. This fee includes the cost of the property, equipment, training, start-up costs, and the franchise fee—a one-time charge for the right to operate as a KFC outlet. McDonald's is in the same price range ($1.1 million to $1.9 million). SUBWAY sandwich shops are more affordable, with expected total investment ranging from $84,000 to $258,000. If you'd prefer teaching dance and exercise classes, you could get a Jazzercise franchise for anywhere from $3,000 to $76,000. If you don't want to deal in food or dance, you might want to buy a dating service. The Right One® franchises go for an initial investment of $98,000 to $254,000, depending on location.

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

Why do would-be business owners like franchises? For one thing, buying a franchise lets you start up under fairly safe conditions, with a proven model for running a company and a permanent support team. You can profit from name recognition without having to develop your own image in the marketplace, and you can be your own boss (as long as you comply with the standards set by the franchiser).

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

Finally, franchisers don't always keep their promises. What do you do if the promised advertising or employee training doesn't materialize? What do you do if you're forced to make unnecessary and costly alterations to your premises, or the franchising company sets up a competing establishment nearby? What if the franchising company gets bad press, which, in turn, hurts your sales? You always have the option of suing the franchiser, but this is time-consuming and costly. As with any business venture, you need to do your homework before investing in a franchise.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=165
140. Outcome: Mergers and Acquisitions

What you’ll learn to do: explain how a business can expand market share and diversify through mergers and acquisitions

So, how do businesses grow once they have been established? If you are a franchisee, you could purchase more locations and own an entire chain of franchise businesses. If, however, you are a “home-grown” business, opening additional locations or going through the start-up process again can be a real barrier to expansion. One way that businesses both small and large can expand is through the process of mergers and acquisitions.

Consider the case of a small craft-beer company that has a very popular but distinct product line. If a large brand-name beer company wants to expand and begin selling a microbrew, it can just “acquire” the brand it wants instead of starting a microbrewery from scratch (which is expensive). But what about the small craft-beer company, with its popular and distinctive product line? Do all small businesses want to merge or be acquired, even though it might mean more money and growth? The following video gives you a glimpse into one such entrepreneur and his thoughts on the topic.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Mergers and Acquisitions
- Self Check: Mergers and Acquisitions

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Mergers and Acquisitions

The headlines read, “Wanted: More than 2,000 in Google Hiring Spree” and 1 The largest Web search engine in the world was disclosing its plans to grow internally and increase its workforce by more than 2,000 people, with half of the hires coming from the United States and the other half coming from other countries. The added employees will help the company expand into new markets and battle for global talent in the competitive Internet information providers industry. When properly executed, internal growth benefits the firm.

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

Mergers and Acquisitions

Though they are often used as if they're synonymous, the

terms *merger* and *acquisition* mean slightly different things. A merger occurs when two companies combine to form a new company. An acquisition is the purchase of one company by another with no new company being formed. An example of a *merger* is the merging in 2010 of United Airlines and Continental Airlines. The combined company, the largest carrier in the world, flies under the name United Airlines, but its planes display the Continental Airlines logo. The merger will combine the scale of United Airlines with the management culture of Continental. Another example of a fairly recent *acquisition* is the purchase of Reebok by Adidas for $3.8 billion (\(^{2}\) The deal was expected to give Adidas a stronger presence in North America and help the company compete with rival Nike. Though Adidas still sells shoes under the Reebok brand, Reebok as a company no longer exists.

**Motives behind Mergers and Acquisitions**

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

**Gain Complementary Products**

Do you think by acquiring Reebok, Adidas has had an impact on Nike’s command of the running shoe market?

Acquiring complementary products was the motivation behind Adidas’s acquisition of Reebok. As Adidas CEO Herbert Hainer stated in a conference call, “This is a once-in-a-lifetime opportunity. This

is a perfect fit for both companies, because the companies are so complementary....Adidas is grounded in sports performance with such products as a motorized running shoe and endorsement deals with such superstars as British soccer player David Beckham. Meanwhile, Reebok plays heavily to the melding of sports and entertainment with endorsement deals and products by Nelly, Jay-Z, and 50 Cent. The combination could be deadly to Nike” (3

Attain New Markets or Distribution Channels

Gaining new markets was a significant factor in the 2005 merger of US Airways and America West. US Airways is a major player on the East Coast, the Caribbean and Europe, while America West is strong in the West. The expectations were that combining the two carriers would create an airline that could reach more markets than either carrier could do on its own (4

Realize More Efficient Economies of Scale

The purchase of Pharmacia Corporation (a Swedish pharmaceutical company) by Pfizer (a research-based pharmaceutical company based in the United States) in 2003 created the world’s largest drug maker and the leading pharmaceutical company, by revenue, in every major market around the globe. The acquisition created an

industry giant with more than $48 billion in revenue and a research-and-development budget of more than $7 billion (5) Each day, almost forty million people around the globe are treated with Pfizer medicines (6) Its subsequent $68 billion purchase of rival drug maker Wyeth further increased its presence in the pharmaceutical market (7)

Hostile Takeover

What happens, though, if one company wants to acquire another company, but that company doesn't want to be acquired? You can end up with a very unfriendly situation. The outcome could be a hostile takeover—an act of assuming control that's resisted by the targeted company's management and its board of directors. Ben Cohen and Jerry Greenfield found themselves in one of these unfriendly situations: Unilever—a very large Dutch/British company that owns three ice cream brands—wanted to buy Ben & Jerry’s, against the founders' wishes. To make matters worse, most of the Ben & Jerry’s stockholders sided with Unilever. They had little confidence in the ability of Ben Cohen and Jerry Greenfield to continue managing the company and were frustrated with the firm's social-mission focus. The stockholders liked Unilever's offer to buy

their Ben & Jerry’s stock at almost twice its current market price and wanted to take their profits and run. In the end, Unilever won; Ben & Jerry’s was acquired by Unilever in a hostile takeover. Despite fears that the company’s social mission would end, this didn’t happen. Though neither Ben Cohen nor Jerry Greenfield are involved in the current management of the company, they have returned to their social activism roots and are heavily involved in numerous social initiatives sponsored by the company.

KEY TAKEAWAYS

• A **merger** occurs when two companies combine to form a new company.
• An **acquisition** is the purchase of one company by another with no new company being formed.
• Companies merge or acquire other companies to gain complementary products, attain new markets or distribution channels, and realize more-efficient economies of scale.
• A hostile takeover is an act of assuming control that is resisted by the targeted company’s management and its board of directors.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=167
142. Outcome: Assistance in Starting a Business

What you’ll learn to do: identify sources of assistance available to individuals to start a business

So far in this module so far we’ve looked at the various legal structures a business can assume, some of the risks and rewards associated with each, as well as some options for starting from scratch. If you have an original idea or you’ve got a franchise in mind for a future business venture, how can you navigate the startup business waters safely without being eaten by the sharks? There is a wealth of resources out there designed to support both startup and ongoing business ventures. The best part about these resources is that the vast majority of them are provided as a free service by government and service agencies around the country. In this next section, you will discover the Small Business Administration (SBA) and just some of the resources it provides to support business and entrepreneurship in the U.S.

LEARNING ACTIVITIES

The learning activities for this section include:

- Video: An Introduction to the SBA
- Video: Business Resources for Veterans
- Self Check: Assistance in Starting a Business
Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
An Introduction to the SBA

The Small Business Administration (SBA) was officially founded in 1953, but it grew out of the harsh economic times of the Great Depression and World War II. President Hoover believed that the government could step in and provide assistance to small businesses that were struggling as a result of the war and a weak economy, so it formed the RFC (Reconstruction Finance Corporation). Some twenty years later, Hoover’s agency was transformed into the SBA. Since then, it has provided assistance to millions of American business owners. The video that follows will give you an introduction to the SBA.
A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=169
Business Resources for Veterans

The mission of the Office of Veterans Business Development (OVBD) is to maximize the availability, applicability, and usability of small business programs for Veterans, Service-Disabled Veterans, Reserve Component Members, and their dependents or survivors. OVBD is SBA’s liaison with the veterans business community; it provides policy analysis and reporting; and it functions as an ombudsman for veteran entrepreneurs. OVBD has a number of programs and services to assist aspiring and existing veteran entrepreneurs. These services include training, counseling and mentorship, and oversight of federal procurement programs for Veteran-Owned and Service-Disabled Veteran-Owned Small Businesses.

https://www.youtube.com/watch?v=w4WOIw8e8_0

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=170
Summary

In this module you learned about the various legal forms for a business, as well as some options for starting up your own business—namely, franchising and mergers and acquisitions. We finished up the module with resources to assist business owners (both aspiring and existing) in the operation of their business. The following are key takeaways from this module:

Forms of Business Ownership

Sole proprietorship, partnerships, corporations, and hybrids (LLC, LLP) are all possible options for the legal formation of a business. Each structure carries risks and rewards, costs and benefits. Which form of business ownership is best for an individual depends not only upon the nature of the business opportunity but also the level of personal exposure to risk the owner is willing to accept.

Types of Corporations

Corporations, although the most common form of business ownership, are the most complex structure to start and maintain. Fortunately there are options within the corporate structure that enable the business owner to take advantage of the limited personal
liability and benefits of corporate organization. Which type of corporation an owner selects will largely be determined by the size, objectives, and vision for the business.

Franchising

For aspiring business owners who do not have the time, vision, or resources to “start from scratch,” franchising is a viable alternative for business ownership. Everyone is familiar with franchises—many industries such as fast food are almost wholly comprised of franchises. As appealing as this may seem, there are still risks to franchising for both the franchisor and franchisee.

Mergers and Acquisitions

One of the quickest ways for a business to expand into other markets or products lines is either to merge or acquire/purchase another company. Although this is common in today’s business environment, there are still many complex factors to consider before deciding whether a merger or acquisition is the optimal solution.

Assistance in Starting a Business

Starting, running, and/or expanding a business can be a daunting task, as there are legal, financial, social, environmental, and personal implications for nearly every decision. Fortunately for businesses, there are organizations and agencies such as the Small Business
Administration and its sub-agencies such as the Office for Veterans Business Development to provide reliable, free assistance.

Synthesis

Now that you have come to the end of this module, you should understand that there is a range of possibilities for structuring, starting, and growing a business. Each choice has its advantages and disadvantages, and there is no single set of choices that will accommodate all businesses. Fortunately a number of organizations and agencies exist for the sole purpose of supporting new and existing businesses. Just knowing that there are choices to be made and a variety of possible paths is critical to the success of any business venture—large or small.

Additional Resources

U.S. Small Business Association (SBA) website
PART IX
MODULE 8: MANAGING PROCESSES
Why explain how operations management contributes to organizational success in business?

Operations management is just what it sounds like: managing the operations of the business. The role of an operations manager is broad and encompasses multiple operational areas. While other employees can focus on a specialized area of operation (for example, finance and marketing), an operations manager wears several hats and does a bit of everything. While the term may be unfamiliar, you have probably already seen operations management in action—it even played a role in creating the beautiful turkey dinner in the photo below.

What does it take to make Thanksgiving dinner happen? Planning, scheduling, technology, logistics, supply chain management, quality assurance—all the aspects of operations management! As an overview to this module, let’s take Turkey Day as an example:
• **Planning.** Turkey dinner for fifteen people doesn't just happen. It takes careful planning and possibly the delegation of tasks and duties to others. Who sets the table? Who brings the green bean casserole? What time should everyone arrive?

• **Scheduling.** A turkey can take up to six hours to cook, and if you have only one oven, you'll need to schedule what time bird goes in and comes out so the rolls and sweet potatoes get a turn in the oven.

• **Technology.** Obviously you'll need an oven (or maybe a high-tech turkey fryer) and any number of cooking gadgets. Even the humble thermometer counts as technology. Unless you're preparing a raw, paleo Thanksgiving dinner, technology will be essential.

• **Logistics.** Fifteen people won't all fit around your current table. What should you do? Seat the children at a card table? Rent a larger table? And where should Uncle Stanley sit so he can't pick a fight with your spouse or your dad? Logistics, logistics.

• **Supply Chain Management.** Aunt Sue is bringing pies, Bob is responsible for rolls, Margaret is bringing the green beans. The host has to secure a fresh turkey before they sell out at the grocery store. If you live in the South, then you'll want to call the local fisherman and reserve some oysters for the oyster dressing. All are important components of the supply chain—leave one out and you'll miss a dish.

• **Quality Assurance.** Anyone who cooks knows you need to taste, season, and taste again to make sure the food is up to snuff. Quality assurance might also include asking Jean to bring drinks and flowers, since she's a terrible cook.

Any undertaking that involves the coordination of effort, tasks, and resources can be considered operations management. In this module you'll learn how operations management works in manufacturing and service industries—in short, you'll see how others get their turkey on the table.
Learning Outcomes

• Define operations management in manufacturing and production businesses
• Describe four major types of facility layouts: process, product, cellular, and fixed position
• Identify existing and emerging technologies that are changing the way goods are produced and delivered
• Define operations management in service businesses
• Explain the scheduling tools (Gantt and PERT) used to increase operations efficiency
• Explain the importance of logistics and supply-chain management
• Identify the techniques that are available to ensure high-quality goods and services (Six Sigma, TQM, SPC) and describe the costs of poor quality
**147. Outcome: Operations Management**

**What you’ll learn to do: define operations management in manufacturing and production**

The best way to understand operations management in manufacturing or production is to consider the things you use on a daily basis: they were all produced or manufactured by someone, somewhere, and a great deal of thought and planning were needed to make them available.

Watch this video on the manufacturing of the amazing Peep. It will serve as a point of reference as you work through this module because it features all the different parts of operations management.

https://youtu.be/O37anI5iFDc?t=1s

**LEARNING ACTIVITIES**

The learning activities for this section include:

- Reading: Operations Management in Manufacturing and Production
- Self Check: Operations Management
Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
The Challenge: Producing Quality Jetboards

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

get to being Superman on the water. With 40 hp under your toes, the 100-pound board literally flies. You supply the cape.²

Montgomery and his team at PowerSki enjoyed taking their well-deserved bows for the job they did designing the product. But having a product was only the beginning for the company. The next step was developing a system that would produce high-quality Jetboards at reasonable prices. Before putting this system in place, PowerSki managers had to address several questions: What kind of production process should they use to make the Jetboards? How large should their production facilities be, and where should they be located? How should the plant be laid out? Should every component be made in-house, or should some be furnished by subcontractors? Where should they buy the materials they needed to build Jetboards? What systems would they need to ensure that production was as efficient as possible and that quality standards were maintained? Answering these questions helped PowerSki set up a manufacturing system through which it could accomplish the most important task that it had set for itself: efficiently producing quality Jetboards.

Like PowerSki, every organization—whether it produces goods or

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

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

### Operations Management in Manufacturing

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

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

Let’s take a closer look at each of these responsibilities.
Planning the Production Process

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

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

Production-Method Decisions

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

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

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

Make-to-Order

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

Mass Production

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

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

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

The list of companies devoting at least a portion of their operations to mass customization is growing steadily. One of the best-known mass customizer is Nike, which has achieved success by allowing customers to configure their own athletic shoes, apparel, and equipment through Nike's iD program. The Web has a lot to do with the growth of mass customization. Levi's, for instance, lets a woman find a pair of perfect fitting jeans by going through an online fitting process that first identifies her “curve” type: slight (straight figure), demi (evenly proportioned), bold (curvy figure, which experiences waist gapping in the back), and supreme (curviest shape, which needs a higher rise in the back). Oakley offers customized sunglasses, goggles, watches, and backpacks, while

684 | Reading: Operations Management in Manufacturing and Production
Mars, Inc. can make M&M’s in any color the customer wants (say, school colors) as well as add text and pictures to the candy.\(^3\)

Naturally, mass customization doesn’t work for all types of goods. Most people don’t care about customized detergents or paper products (although a customized Kleenex tissue box with your picture on it and a statement that says, “go ahead . . . cry over me!” might come in handy after a relationship breakup with your significant other.\(^5\) And while many of us like the idea of customized clothes, footwear, or sunglasses from Levi’s, Nike, or Oakley, we often aren’t willing to pay the higher prices they command.

**Facilities Decisions**

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

3. See these websites for examples of customized products: \(^4\)
5. \(^6\)
Site Selection

In choosing a location, managers must consider the following factors:

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

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

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

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

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

KEY TAKEAWAYS

- The job of operations management is to oversee the process of transforming resources into goods and services.
- The role of operations managers in the manufacturing sector includes production planning, production control, and quality control.
• During production planning, managers determine how goods will be produced (production process), where production will take place (site selection), and how manufacturing facilities will be laid out (layout planning).

• In selecting the appropriate production process, managers compare three basic methods: make-to-order strategy (goods are made to customer specifications), mass production or make-to-stock strategy (high volumes of goods are made and held in inventory for later sale), and mass customization (high volumes of customized goods are made).

• In choosing the site for a company's manufacturing operations, managers look for locations that minimize shipping costs, have an ample supply of skilled workers, provide a favorable community for workers and their families, offer resources at low cost, and have a favorable business climate.

• Managers estimate the quantity of products to be produced by forecasting demand for their product and then calculating the capacity requirements of the production facility—the maximum number of goods that it can produce over a given period under normal working conditions.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=175
149. Outcome: Facility Layouts

What you’ll learn to do: describe four major types of facility layouts: process, product, cellular, and fixed position

Decisions regarding facility layouts are driven by what is produced and how it is produced—in other words, by the process. When you looked at the Just Born facility, it was clear that the way the plant was laid out supported the mass production and mostly automated system for manufacturing pink marshmallow bunnies and yellow marshmallow chicks. This layout is not appropriate for all production processes, but in this module you will learn about the four most common layouts: process, product, cellular, and fixed position.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Facility Layouts
- Self Check: Facility Layouts

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Facility Layouts

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

Process Layout

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

For a more colorful “Online Mini-Tour” of this process, log on to the Vermont Teddy Bear Web site.
Product Layout

Remember our Peeps at the start of the module? They were an example of a product layout. In a product layout, high-volume goods are produced efficiently by people, equipment, or departments arranged in an assembly line—that is, a series of workstations at which already-made parts are assembled. Just Born, a candy maker located in Bethlehem, Pennsylvania, makes a product called Marshmallow Peeps on an assembly line. First, the ingredients are combined and whipped in huge kettles. Then, sugar is added for color. At the next workstation, the mixture—colored warm marshmallow—is poured into baby-chick-shaped molds carried on conveyor belts. The conveyor-belt parade of candy pieces then moves forward to stations where workers add eyes or other details. When the finished candy reaches the packaging area, it's wrapped for shipment to stores around the world.

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

Arranging work by function, however, isn’t always efficient. Production lines can back up, inventories can build up, workers can get bored with repetitive jobs, and time can be wasted in transporting goods from one workstation to another. To counter some of these problems, many manufacturers have adopted a cellular layout, in which small teams of workers handle all aspects of building a component, a “family” of components, or even a finished product. Each team works in a small area, or cell, equipped with everything that it needs to function as a self-contained unit. Machines are sometimes configured in a U-shape, with people working inside the U. Because team members often share duties, they’re trained to perform several different jobs. Teams monitor both the quantity and the quality of their own output. This arrangement often results in faster completion time, lower inventory levels, improved quality, and better employee morale.

Cellular manufacturing is used by large manufacturers, such as Boeing, Raytheon, and Pratt & Whitney, as well as by small companies, such as Little Enterprise, which makes components for robots.¹ Figure 1, “Cellular Layout,” above, illustrates a typical cellular layout.

1. “

Reading: Facility Layouts | 693
Fixed Position

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
151. Outcome: Technology and Production of Goods

What you’ll learn to do: identify existing and emerging technologies that are changing the way goods are produced.

Do you even recognize these? These were the first flash drives for computers, in a way. Actually they are 3.5” floppy disks that people used to transport their data from one computer to another. No flash drives, no cloud computing, no USB ports—just a hard plastic disk that held a whopping 1.44 MB of data. Today you can purchase a DataTraveler HyperX Predator 3.0 Flash Drive with 1 TB of storage space. In the old days you’d need 728,178 floppy disks to hold all that data.

Emerging technologies are changing the way we conduct our lives and business. Now let’s look at some of the ways in which those technologies are transforming the production and delivery of goods and services to customers.
LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: The Technology of Goods Production
• Self Check: Technology and Production of Goods

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
The Technology of Goods Production

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

Computer-Aided Design

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

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

Computer-Aided Manufacturing

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

Watch the following video as a CNC carving machine uses a computer program to create an amazing woodcarving.

https://www.youtube.com/watch?v=OX_Pw8XPYMs

Computer-Integrated Manufacturing

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

Flexible Manufacturing Systems

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

3D Printing

3D printing (or additive manufacturing, AM) is any of various processes used to make a three-dimensional object. In 3D printing, additive processes are used, in which successive layers of material are laid down under computer control. These objects can be of almost any shape or geometry, and are produced from a 3D model or other electronic data source. A 3D printer is a type of industrial robot. Several different 3D printing processes have been invented since the late 1970s. The printers were originally large, expensive, and highly limited in what they could produce.
A large number of additive processes are now available. The main differences between processes are in the way layers are deposited to create parts and in the materials that are used. Some methods melt or soften material to produce the layers, while others cure liquid materials using different sophisticated technologies. With laminated object manufacturing (LOM), thin layers are cut to shape and joined together (e.g. paper, polymer, metal). Each method has its own advantages and drawbacks, which is why some companies consequently offer a choice between the material used to build the object. Other companies sometimes use standard, off-the-shelf business paper as the build material to produce a durable prototype. The main considerations in choosing a machine are generally speed, cost of the 3D printer, cost of the printed prototype, cost and choice of materials, and color
capabilities. Printers that work directly with metals are expensive. In some cases, however, less expensive printers can be used to make a mould, which is then used to make metal parts.

KEY TAKEAWAYS

• In addition to creating high-quality products, companies must produce and deliver goods and services in an efficient, cost-effective manner.
• Sophisticated software systems, including computer-aided design (CAD), computer-aided manufacturing (CAM), computer-integrated manufacturing (CIM), and flexible manufacturing systems (FMS), are becoming increasingly important in this area.
• Computer-aided design software (CAD) is used to create models representing the design of a product.
• Many companies link CAD systems to the manufacturing process through computer-integrated manufacturing (CIM) systems that not only determine the steps needed to produce components but also instruct machines to do the necessary work.
• A CAD/CAM system can be expanded by means of computer-integrated manufacturing (CIM), which integrates various operations (from design through production) with functional activities ranging from order taking to shipping.
• A CIM system is a common element in a flexible manufacturing system (FMS), in which computer-controlled equipment can easily be adapted to produce a variety of goods.
• 3D printing is a form of computer-aided design (CAD) that builds a 3-dimensional object by adding layers of material, one upon the other until an object is created according to the CAD design.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here: https://library.achievingthedream.org/baycollegeintrobusiness/?p=179
153. Outcome: Operations Management in Service Businesses

What you’ll learn to do: describe operations management in service businesses

Service providers don’t produce tangible goods in a factory as we saw with the JetBoards and Peeps, but operations management is every bit as critical for this sector as it is for manufacturing.

Consider the Izmailovo Hotel in Moscow shown in the photograph above. Built to house athletes during the 1980 Olympics, the complex has 7,500 guest rooms and is currently the largest hotel in the world. Think about cleaning all those rooms—in four thirty-story-high towers—or checking in the thousands of guests. No small operation! Although the Izmailovo doesn’t produce a tangible good, it relies on many of the same operations management principles used in manufacturing to keep itself running (and profitable).

LEARNING ACTIVITIES

The learning activities for this section include:
• Reading: Operations Management for Service Providers
• Self Check: Operations Management in Service Businesses

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
As the U.S. economy has changed from a goods producer to a service provider, the predominance of the manufacturing sector has declined substantially over the last sixty years. Today, only about 9 percent of U.S. workers are employed in manufacturing, in contrast to 30 percent in 1950. Most of us now hold jobs in the service sector, which accounts for 77 percent of U.S. gross domestic product. Wal-Mart is now America’s largest employer, followed by IBM, United Parcel Service (UPS), McDonald’s, and Target. Not until we drop down to the seventh-largest employer—Hewlett Packard—do we find a company with even a manufacturing component.

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

- **Intangibility.** Manufacturers produce tangible products—things that can be touched or handled, such as automobiles and appliances. Service companies provide intangible products, such as banking, entertainment, or education.
- **Customization.** Manufactured goods are generally standardized; one twelve-ounce bottle of Pepsi is the same as any other twelve-ounce bottle of Pepsi. Services, by contrast, are often customized to satisfy the specific needs of a
customer. When you go to the barber or the hairdresser, you ask for a haircut that looks good on you because of the shape of your face and the texture of your hair. When you go to the dentist, you ask him or her to fill or pull the tooth that’s bothering you.

- **Customer contact.** You could spend your entire working life assembling cars in Detroit and never meet a customer who bought a car that you helped to make. But if you were a waitress, you’d interact with customers every day. In fact, their satisfaction with your product would be determined in part by the service that you provided. Unlike manufactured goods, many services are bought and consumed at the same time.

Not surprisingly, operational efficiency is just as important in service industries as it is in manufacturing. To get a better idea of the role of operations management in the service sector, we’ll look closely at Burger King (BK), home of the Whopper, and the world’s second-largest restaurant chain.\(^1\) BK has grown substantially since selling the first Whopper (for $0.37) almost half a century ago. The instant success of the fire-grilled burger encouraged the Miami founders of the company to expand by selling franchises. Today, there are 12,200 BK company- and independently-owned franchised restaurants in seventy-three countries (seven thousand of which are in the United States), and

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they employ almost forty thousand people. More than eleven million customers visit BK each day.

**Operations Planning**

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

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

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

Operations Processes

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

Service providers that produce goods can, like manufacturers, adopt either a make-to-order or a make-to-stock approach to manufacturing them. BK, which encourages patrons to customize burgers and other menu items, uses a make-to-order approach. BK can customize products because it builds sandwiches one at a time rather than batch-process them. Meat patties, for example, go from the grill to a steamer for holding until an order comes in. Then the patty is pulled from the steamer and requested condiments are added. Finally, the completed sandwich chutes to a counter worker, who gives it to the customer. In contrast, many of BK’s competitors, including McDonald’s, rely on a make-to-stock approach in which a number of sandwiches are made at the same time with the same condiments. If a customer wants, say, a hamburger without onions, he or she has to wait for a new batch of patties to be grilled. The procedure could take up to five minutes, whereas BK can process a special order in thirty seconds.

Like manufacturers, service providers must continuously look for ways to improve operational efficiency. Throughout its sixty-year history, BK has introduced a number of innovations that have helped make the company (as well as the fast-food industry itself) more
efficient. BK, for example, was the first to offer drive-through service (which now accounts for 70 percent of its sales\(^7\)).

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

Facilities

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


\(^8\)
Site Selection

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

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

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

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

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

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

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

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

Capacity Planning

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

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

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

Managing Operations

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

Scheduling

In manufacturing, managers focus on scheduling the activities needed to transform raw materials into finished goods. In service organizations, they focus on scheduling workers so that they’re available to handle fluctuating customer demand. Each week, therefore, every BK store manager schedules employees to cover not only the peak periods of breakfast, lunch, and dinner, but also the slower periods in between. If he or she staffs too many people, labor cost per sales dollar will be too high. If there aren’t enough employees, customers have to wait in lines. Some get discouraged, and even leave, and many may never come back.
Scheduling is made easier by information provided by a point-of-sale device built into every BK cash register. The register keeps track of every sandwich, beverage, and side order sold by the hour, every hour of the day, every day of the week. Thus, to determine how many people will be needed for next Thursday’s lunch hour, the manager reviews last Thursday’s data, using sales revenue and a specific BK formula to determine the appropriate staffing level. Each manager can adjust this forecast to account for other factors, such as current marketing promotions or a local sporting event that will increase customer traffic.

Inventory Control

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

KEY TAKEAWAYS

• Though the primary function of both manufacturers and
service providers is to satisfy customer needs, there are several important differences between the two types of operations.

- While manufacturers produce tangible, generally standardized products, service firms provide intangible products that are often customized to satisfy specific needs. Unlike manufactured goods, many services are bought and consumed at the same time.

- Operational efficiency is just as important in service industries as it is in manufacturing.

- Operations managers in the service sector make many decisions that are similar to those made by manufacturers: they decide which services to offer, how to provide these services, where to locate their businesses, what their facilities will look like, and what the demand will be for their services.

- Service providers that produce goods can, like manufacturers, adopt either a make-to-order approach (in which products are made to customer satisfaction) or make-to-stock approach (in which products are made for inventory) to manufacturing them.

- Estimating capacity needs for a service business is more difficult than for a manufacturer. Service providers can't store their services for later use: services must be delivered on an as-needed basis.

- Overseeing a service organization puts special demands on managers, especially services requiring a high degree of contact with customers.

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

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=181


155. Outcome: Scheduling Tools

What you’ll learn to do: explain the scheduling tools (Gantt and PERT) used to increase operations efficiency

If you're in college, you've probably got a course schedule, and if you're working toward a degree, you've probably looked at a college curriculum plan and figured out the degree and graduation requirements. Some courses have prerequisites—you have to take Chem I before you can take Chem II, for instance—others are offered only in the spring or fall, and you can only take so many credits/courses per term. Given all these variables and constraints, how do you put together your academic plan, making sure that you're using your time most efficiently and following the best path toward graduation?

The answer is that you can use a Gantt or PERT chart. As you will
see, both are fancy terms for scheduling tools that get used all the time to make operations (even college planning!) more efficient.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Graphical Tools: Gantt and PERT Charts
• Self Check: Scheduling Tools

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Gantt and PERT Charts

Because they need to control the timing of all operations, managers set up schedules: They select jobs to be performed during the production process, assign tasks to work groups, set timetables for the completion of tasks, and make sure that resources will be available when and where they're needed. There are a number of scheduling techniques. We’ll focus on two of the most common: Gantt and PERT charts.
A Gantt chart—named after the designer Henry Gantt—is an easy-to-use graphical tool that helps operations managers determine the status of projects. Let’s say that you’re in charge of making the “hiking bear” that we ordered earlier from the Vermont Teddy Bear Company. Figure 1, “Gantt Chart for Vermont Teddy Bear,” below, is a Gantt chart for the production of one hundred of these bears. As you can see, it shows that several activities must be completed before the bears are dressed: the fur has to be cut, stuffed, and sewn; and the clothes and accessories must be made. Our Gantt chart tells us that by day six, all accessories and clothing have been made. The stuffing and sewing, however (which must be finished
before the bears are dressed), isn't scheduled for completion until the end of day eight. As operations manager, you'll have to pay close attention to the progress of the stuffing and sewing operations to ensure that finished products are ready for shipment by their scheduled date.

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Lot size: 100 bears

All activities are scheduled to begin at their earliest start time.

- Completed work
- Work to be completed

*Figure 1. Gantt Chart for Vermont Teddy Bear*

### PERT Charts

Gantt charts are useful when the production process is fairly simple and the activities aren't interrelated. For more complex schedules, operations managers may use PERT charts. PERT (which stands for *Program Evaluation and Review Technique*) is designed to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence. It also identifies a critical path: the
Figure 2, “PERT Chart for Vermont Teddy Bear,” below, is a PERT diagram showing the same process for producing one “hiker” bear at Vermont Teddy Bear.

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

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

KEY TAKEAWAYS

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

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=183
157. Outcome: Logistics and Supply Chain Management

What you’ll learn to do: explain the importance of logistics and supply-chain management

In this section you’ll learn about the role of logistics and supply-chain management in the production of goods, services, and products. Before you begin the learning activity below, watch the following video about the supply-chain management of BYU ice cream.

A YouTube element has been excluded from this version of the text. You can view it online here:
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Supply Chain Management
- Self Check: Logistics and Supply Chain Management

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Supply Chain Management

Supply chain management is the management of the network of interconnected steps involved in the provision of product and service packages. The following video provides an overview of the importance of supply chain management, logistics, and some of the careers in this field.

A YouTube element has been excluded from this version of the text. You can view it online here: https://library.achievingthedream.org/baycollegeintrobusiness/?p=185
Supply chain management (SCM) is the management of a network of interconnected businesses involved in the provision of product and service packages required by the end customers in a supply chain. Supply chain management spans all movement and storage of raw materials, work-in-process inventory, and finished goods from point of origin to point of consumption.

Another definition is provided by the APICS Dictionary, when it defines SCM as the “design, planning, execution, control, and monitoring of supply chain activities with the objective of creating net value, building a competitive infrastructure, leveraging worldwide logistics, synchronizing supply with demand and measuring performance globally.”

Supply chain management must address the following problems:

- Distribution network configuration: number, location and network missions of suppliers, production facilities, distribution centers, warehouses, cross-docks and customers.
- Distribution strategy: questions of operating control (centralized, decentralized or shared); delivery scheme (e.g., direct shipment, pool point shipping, or cross docking), DSD (direct store delivery), closed loop shipping; mode of transportation (e.g., motor carrier, including truckload, LTL, or parcel); railroad; intermodal transport, including TOFC (trailer on flatcar), and COFC (container on flatcar); ocean freight; airfreight; replenishment strategy (e.g., pull, push or hybrid); and transportation control (e.g., owner-operated, private carrier, common carrier, contract carrier, or 3PL).

**Trade-offs in logistical activities:** The above activities must be well coordinated in order to achieve the lowest total logistics cost. Trade-offs may increase the total cost if only one of the activities is optimized. For example, full truckload (FTL) rates are more economical on a cost per pallet basis than less than truckload (LTL) shipments. If, however, a full truckload of a product is ordered to reduce transportation costs, there will be an increase in inventory.
holding costs, which may increase total logistics costs. It is, therefore, imperative to take a systems approach when planning logistical activities. These trade offs are key to developing the most efficient and effective Logistics and SCM strategy.

- Information: Integration of processes through the supply chain to share valuable information, including demand signals, forecasts, inventory, transportation, potential collaboration, etc.
- Inventory management: Quantity and location of inventory, including raw materials, work-in-process (WIP), and finished goods.
- Cash-flow: Arranging the payment terms and methodologies for exchanging funds across entities within the supply chain.
- Supply chain execution means managing and coordinating the movement of materials, information, and funds across the supply chain. The flow is bi-directional.

Figure 1. Supply Chain: A supply and demand network
KEY TAKEAWAYS

• Supply chain management spans all movement and storage of raw materials, work-in-process inventory, and finished goods from point of origin to point of consumption.
• Distribution Network Configuration: number, location, and network missions of suppliers; production facilities; distribution centers; warehouses; cross-docks; and customers.
• Supply chain management addresses the following issues: distribution network configuration, distribution strategy, logistical activities, information, and cash flow.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=185
159. Outcome: Quality of Goods and Services

What you’ll learn to do: identify the techniques that are available to ensure high-quality goods and services (Six Sigma, TQM, and SPC) and describe the costs of poor quality

At some point you may have found yourself in the situation pictured above—and it definitely was not what you expected or wanted. When consumers purchase a product, good, or service, there's a certain expectation of quality. When things are defective, don’t function properly or “as advertised,” or wear out too quickly, the consumer’s disappointment can mean lost revenues, bad publicity, and, in some cases, lawsuits. For example, by the end of 2014, recalls of General Motors automobiles cost the company $4.1 BILLION. The recalls also cost in terms of brand loyalty, consumer confidence, investor relations, and government scrutiny. In both production and service businesses there are techniques and
processes that can be utilized to ensure high-quality goods and services. In this module you'll learn about some of these, including Six Sigma, TQM, and SPC.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Producing for Quality
• Reading: Outsourcing
• Self Check: Quality of Goods and Services

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

But what is quality? According to the American Society for Quality, quality refers to “the characteristics of a product or service that bear on its ability to satisfy stated or implied needs.”¹ When you buy a DVD player, you expect it to play DVDs. When it doesn't, you question its quality. When you go to a drive-through window, you expect to be served in a reasonable amount of time. If you're forced to wait, you conclude that you're the victim of poor-quality service.

Quality Management

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

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

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

Customer Satisfaction

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

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

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

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

Continuous Improvement

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

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

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

Benchmarking

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

International Quality Standards

As a consumer, wouldn't you like to know which companies ensure that their products meet quality specifications? Some of us would like to know which companies take steps to protect the environment. Some consumers want to know which companies continuously improve their performance in both of these areas—that is, practice both quality management and environmental management. By the same token, if you were a company doing a good job in these areas, wouldn't you want potential customers to know? It might be worth your while to find out whether your suppliers were also being conscientious in these areas—and even your suppliers’ suppliers.

ISO 9000 and ISO 14000

Through the International Organization for Standardization (ISO), a nongovernmental agency based in Switzerland, it’s possible to find this kind of information. The resources of this organization will enable you to identify those organizations that have people and processes in place for delivering products that satisfy customers’ quality requirements. You can also find out which organizations work to reduce the negative impact of their activities on the

³

environment. Working with representatives from various countries, the organization has established the ISO 9000 family of international standards for quality management and the ISO 14000 family of international standards for environmental management. ISO standards focus on the way a company does its work, not on its output (though there’s certainly a strong correlation between the way in which a business functions and the quality of its products). Compliance with ISO standards is voluntary, and the certification process is time-consuming and complex. Even so, hundreds of thousands of organizations around the world are ISO 9000 and ISO 14000 certified. ISO certification has become an internationally recognized symbol of quality management and is almost essential to be competitive in the global marketplace.

Six Sigma

Another approach to quality management in the United States was formulated at Motorola in 1986 and was named Six Sigma (6σ). The Six Sigma practices were based on W. Edwards Deming’s work, TQM, and others and had similarities regarding continuous efforts at improvement involving everyone at the company. It emphasized a clear focus on achieving quantifiable financial returns from any Six Sigma project. To determine the financial return on a quality initiative, the cost of quality (COQ) must be determined. The cost of quality has two parts: the cost of prevention and the cost of failure (or nonconformance). The cost of quality is the sum of the cost of


prevention and the cost of failure. If spending more on prevention reduces the cost of failure by an even greater amount, the total cost of quality is reduced.

- **Cost of prevention**
  - *Cost of conformance*. Cost to improve quality
  - *Cost of appraisal*. Cost to measure and evaluate quality
- **Cost of failure**
  - *Internal costs*. Repairing bad parts before shipment or retooling a manufacturing line to reduce failures
  - *External costs*. Managing returns, lawsuits, product recalls

Six Sigma identified individuals as experts in quality and awarded titles like Champion and Master Black Belt. The name Six Sigma refers to a process that has six standard deviations from the mean to either control limit that would ensure virtually zero defects. (In practice, the Six Sigma approach allows for a 1.5 sigma drift, so it is really a 4.5 sigma standard that allows approximately 3.4 defects per million products.) This approach was adopted by Jack Welch at General Electric with great success. By the late 1990s, about two-thirds of the top five hundred companies in the United States had begun Six Sigma projects, including Ford, which had allowed its quality programs to slip. To provide encouragement and a consistent standard, the U.S. government created the Malcolm Baldrige National Quality Award in 1987 to encourage companies to improve quality; the award was named for Malcolm Baldrige who
was the U.S. secretary of commerce from 1981 to 1987. The criteria used to determine award winners are as follows:

1. Leadership of senior executives
2. Strategic planning
3. Customer and market focus
4. Measurement, analysis, and knowledge management
5. Workforce focus
6. Process management
7. Results

Outsourcing and Quality

PowerSki’s Web site states that “PowerSki International has been founded to bring a new watercraft, the PowerSki Jetboard, and the engine technology behind it, to market.” That goal was reached in May 2003, when the firm emerged from a lengthy design period. Having already garnered praise for its innovative product, PowerSki was ready to begin mass-producing Jetboards. At this juncture, the management team made a strategic decision that’s not uncommon in manufacturing today.

Rather than producing Jetboards in-house, they opted for outsourcing: having outside vendors manufacture the engines, fiberglass hulls, and associated parts. Assembly of the final product took place in a manufacturing facility owned by All American Power Sports in Moses Lake, Washington. This decision does not mean that the company relinquished control over quality; in fact, every component that goes into the PowerSki Jetboard is manufactured to exact specifications set by PowerSki.

One advantage of outsourcing its production function is that the management team can thereby devote its attention to refining its product design and designing future products. However, as processes or pieces of a process are outsourced companies have legitimate concerns about quality standards being met and maintained at the outsourced location. The decision whether or not

1. [About PowerSki International](https://www.powerskijetboard.com/about)

to outsource often comes down to identifying organizations that can meet and maintain the standards set by the company and the customer.

Outsourcing in the Manufacturing Sector

Understandably, outsourcing is becoming an increasingly popular option among manufacturers. For one thing, few companies have either the expertise or the inclination to produce everything needed to make a product. Today, more firms, like PowerSki, want to specialize in the processes that they perform best—and outsource the rest. Like PowerSki, they also want to take advantage of...
outsourcing by linking up with suppliers located in regions with lower labor costs.

Outsourcing in the Service Sector

Outsourcing is by no means limited to the manufacturing sector. Service companies also outsource many of their noncore functions. Your school, for instance, probably outsources such functions as food services, maintenance, bookstore sales, printing, groundskeeping, security, information-technology (IT) support, and even residence operations.

KEY TAKEAWAYS

• Today, companies that compete in both the manufacturing and service sectors must deliver quality goods and services that satisfy customers’ needs. Many companies achieve this goal by adhering to principles of total quality management (TQM).
• Companies using a TQM approach focus on customer satisfaction, engage all members of the organization in quality efforts, and strive for continuous improvement in the design, production, and delivery of goods and services. They also benchmark other companies to find ways to improve their own performance.
• To identify areas for improvement, companies can use a technique called statistical process control (SPC), which monitors quality by testing to see whether a sample of output is being made to predetermined specifications.
• The Deming award is given by Japan to companies doing business in Japan for high-quality standards. Similarly, the Baldrige National Quality Award is given to U.S. companies and
• Six Sigma identifies specialists within the organization and assigns titles like Master Black Belt. Each quality project must evaluate the cost of quality to gain approval.
• The International Standards Institute devises guidelines for establishing practices. The ISO 9000 group are guidelines for establishing practices that are likely to create quality products.
• The cost of quality has two parts: the cost of prevention and the cost of failure. The cost of prevention includes costs to establish quality practices and the costs to verify them. The cost of failure includes internal costs before the product is sold, such as waste and fixing products, while external costs include those that occur after the product is sold, such as returns and lawsuits.
• Another cost-saving approach is outsourcing—having outside vendors manufacture components or even entire products or provide services, such as information-technology support or service center operations.
• Outsourcing is an appealing option for companies without the expertise in producing everything needed to make a product or those that want to take advantage of low labor costs in developing countries.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:

https://library.achievingthedream.org/
baycollegeintrobusiness/?p=188
162. Putting It Together: Managing Processes

Summary

In this module you learned about how operations management contributes to organizational success in business. Below is a summary of the key points covered.

Operations Management in Manufacturing and Production

Operations management is responsible for all the activities involved in transforming a concept into a finished product. Included in these activities are planning and controlling the systems that produce these goods and services.

Facility Layouts

The layout of a facility is most often determined by the product being manufactured. The four types of facility layouts are process, product, cellular, and fixed position.
Technology and Production of Goods

Just as technology has revolutionized the average home, it has also transformed the way products are manufactured. Using technologies such as CAD (computer-aided design), CAM (computer-aided manufacturing), CIM (computer-integrated manufacturing), flexible manufacturing and 3D printing companies are able to manufacture products faster and more efficiently.

Operations Management in Service Businesses

Even though service companies do not produce a tangible good, they require operations managers to help ensure that the services delivered are high-quality, timely, and cost-effective.

Scheduling Tools

A major part of operations planning is scheduling the various activities that go into the production process. Two tools that are used by operations managers to ensure that projects and tasks are completed on time are the Gantt and PERT charting methods.

Logistics and Supply Chain Management

Supply chain management refers to the management activities that maximize customer value and allow the company to gain a competitive advantage. It represents a conscious effort among firms to work in the most efficient ways possible. Supply chain activities
cover everything from product development, sourcing of materials, actual production, and transportation logistics.

Quality of Goods and Services

The cost of poor quality can range from a small refund to a single, dissatisfied customer to global product recalls. In order to insure that their products, goods, and services meet consumer quality standards, companies can employ quality-control techniques such as Six Sigma, TQM, and SPC.

Synthesis

In this module you were given an overview of and some insight into the world of operations management and the key role it plays in delivering high-quality goods and services to customers. We can sum up operations management by saying that it's the functional area within organizations that makes sure that the right customer gets the right product at the right time for the right price in a form that meets the customers' quality expectations. It's a pretty tall order, and it requires operations managers to be involved in every facet of the business process.

Regardless of how much marketplace demand there is for a given product, good, or service, if the organization cannot consistently deliver it, then consumers will either find a substitute or simply do without. Consider the following examples, and you'll begin to register the impact of poor operations management:

Have you ever . . .

- Left a restaurant because the wait was too long or the service too slow?
• Returned an item to the store because it was defective or broke shortly after you bought it?
• Stayed in a hotel and vowed never to go there again because the hot water didn’t work or the room wasn’t clean?
• Attended a Thanksgiving dinner where the turkey was bone dry and the sweet potato pie was crunchy?

As you can see, breakdowns in operations management can be very disappointing to the consumer and costly to the organization!
PART X

MODULE 9: TEAMWORK AND COMMUNICATION
Why It Matters: Teamwork and Communication

Why demonstrate the importance of teamwork and effective communication in a business environment?

Why do businesses stress teamwork and communication? Why have you been subjected to the dreaded “group project” in some of your classes? We think of ourselves as individuals, each hired or chosen for our individual expertise, talents, and experience, and yet we are often asked to work with others on assignments and projects. Why? Because, as the video below demonstrates, we are capable of so much more when we work together. In this module you will learn about teams, why businesses use them, why they succeed and why they fail. As part of our examination of teamwork, we’ll also look at the critical role played by communication. You'll discover that even a team of star players is doomed to fail if it can't communicate effectively.
Learning Outcomes

- Differentiate between a group and a team, the characteristics of a team, and why organizations use teams
- Identify the stages of team development and the characteristics of each stage
- Identify factors that contribute to team success
- Explain the importance of effective communications within an organization
- Distinguish what is appropriate and inappropriate in business communications
- Identify communication flows, channels, and networks within
an organization

- Identify common barriers to communication in organizations
164. Outcome: Groups and Teams

What you’ll learn to do: differentiate between a group and a team, the characteristics of a team, and why organizations use teams

Not every group of people is a team! Teams within organizations have unique characteristics and are often created for specific purposes. What type of teams an organization builds is determined by its goals and objectives—there may be multiple teams with very different structures. In this section you'll learn to differentiate between groups and teams, understand different team structures, and learn why companies choose to formalize group activities within a more formal team structure.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Team and the Organization
- Self Check: Groups and Teams

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
165. Reading: The Team and the Organization

What Is a Team? How Does Teamwork Work?

A team (or a work team) is a group of people with complementary skills who work together to achieve a specific goal. In the case of Motorola’s RAZR team, the specific goal was to develop (and ultimately bring to market) an ultrathin cell phone that would help restore the company’s reputation as a designer of stylistically appealing, high-function phones. The team achieved its goal by integrating specialized but complementary skills in engineering and design and by making the most of its authority to make its own decisions and manage its own operations.

Teams vs. Groups

“A group,” suggests Bonnie Edelstein, a consultant in organizational development, “is a bunch of people in an elevator. A team is also a bunch of people in an elevator, but the elevator is broken.” This distinction may be a little oversimplified, but as our tale of teamwork at Motorola reminds us, a team is clearly something more than a mere group of individuals. In particular, members of a group—or, more accurately, a working group—go about their jobs independently and meet primarily to share information. A group of department-store managers, for example, might meet monthly to discuss their progress in cutting plant costs, but each manager is focused on the goals of his or her department because each is held accountable for meeting only those goals. Teams, by contrast,
are responsible for achieving specific common goals, and they're generally empowered to make the decisions needed to complete their authorized tasks.

Some Key Characteristics of Teams

To keep matters in perspective, the following lists five key characteristics of work teams:

1. **Teams are accountable for achieving specific common goals.** Members are collectively responsible for achieving team goals, and if they succeed, they're rewarded collectively.
2. **Teams function interdependently.** Members cannot achieve goals independently and must rely on each other for information, input, and expertise.
3. **Teams are stable.** Teams remain intact long enough to finish their assigned tasks, and each member remains on board long enough to get to know every other member.
4. **Teams have authority.** Teams possess the decision-making power to pursue their goals and to manage the activities through which they complete their assignments.
5. **Teams operate in a social context.** Teams are assembled to do specific work for larger organizations and have the advantage of access to resources available from other areas of their organizations.

Why Organizations Build Teams

Why do major organizations now rely more and more on teams to improve operations? Executives at Xerox have reported that team-based operations are 30 percent more productive than conventional
operations. General Mills says that factories organized around team activities are 40 percent more productive than traditionally organized factories. According to in-house studies at Shenandoah Life Insurance, teams have cut case-handling time from twenty-seven to two days and virtually eliminated service complaints. FedEx says that teams reduced service errors (lost packages, incorrect bills) by 13 percent in the first year.¹

Today it seems obvious that teams can address a variety of challenges in the world of corporate activity. Before we go any further, however, we should remind ourselves that data like those we’ve just cited aren’t necessarily definitive. For one thing, they may not be objective—companies are more likely to report successes than failures. As a matter of fact, teams don’t always work. Indeed, according to one study, team-based projects fail 50 to 70 percent of the time.²


The Effect of Teams on Performance

Research shows that companies build and support teams because of their effect on overall workplace performance, both organizational and individual. If we examine the impact of team-based operations according to a wide range of relevant criteria—including product quality, worker satisfaction, and quality of work life, among others—we find that overall organizational performance improves. Below, Table 1 lists several areas in which we can analyze workplace performance and indicates the percentage of companies that have reported improvements in each area.

Table 1. Effect of Teams on Workplace Performance

<table>
<thead>
<tr>
<th>Area of Performance</th>
<th>Percent of Firms Reporting Improvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product and service quality</td>
<td>70</td>
</tr>
<tr>
<td>Customer service</td>
<td>67</td>
</tr>
<tr>
<td>Worker satisfaction</td>
<td>66</td>
</tr>
<tr>
<td>Quality of work life</td>
<td>63</td>
</tr>
<tr>
<td>Productivity</td>
<td>61</td>
</tr>
<tr>
<td>Competitiveness</td>
<td>50</td>
</tr>
<tr>
<td>Profitability</td>
<td>45</td>
</tr>
<tr>
<td>Absenteeism/turnover</td>
<td>23</td>
</tr>
</tbody>
</table>

Types of Teams

Teams, then, can improve company and individual performance in a number of areas. Not all teams, however, are formed to achieve the same goals or charged with the same responsibilities. Nor are they organized in the same way. Some, for instance, are more autonomous than others—less accountable to those higher up in the organization. Some depend on a team leader who’s responsible for defining the team’s goals and making sure that its activities are performed effectively. Others are more or less self-governing: though a leader lays out overall goals and strategies, the team itself chooses and manages the methods by which it pursues its goals and implements its strategies. Teams also vary according to their membership. Let’s look at several categories of teams.

Manager-Led Teams

As its name implies, in the manager-led team the manager is the team leader and is in charge of setting team goals, assigning tasks, and monitoring the team’s performance. The individual team members have relatively little autonomy. For example, the key employees of a professional football team (a manager-led team) are highly trained (and highly paid) athletes, but their activities on the field are tightly controlled by a head coach. As team manager, the coach is responsible both for developing the strategies by which the team pursues its goal of winning games and for the final outcome of each game (not to mention the season). He’s also solely responsible

for interacting with managers above him in the organization. The players are responsible only for executing plays.  

Self-Managing Teams

Self-managing teams (also known as self-directed or self-regulating teams) have considerable autonomy. They are usually small and often absorb activities that were once performed by traditional supervisors. A manager or team leader may determine overall goals, but the members of the self-managing team control the activities needed to achieve the goals, such as planning and scheduling work, sharing tasks, meeting quality standards, and handling day-to-day operations.

Self-managing teams are the organizational hallmark of Whole Foods Market, the largest natural-foods grocer in the United States. Each store is run by ten teams (produce, prepared foods, and so forth), and virtually every store employee is a member of a team. Each team has a designated leader and its own performance targets. (Team leaders also belong to a store team, and store-team leaders belong to a regional team.) To do its job, every team has access to the kind of information—including sales and even salary figures—that most companies reserve for the eyes of traditional managers.


Needless to say, not every self-managed team enjoys the same degree of autonomy. Companies vary widely in choosing which tasks teams are allowed to manage and which ones are best left to upper-level management only. As you can see below in Figure 1, for example, self-managing teams are often allowed to schedule assignments, but they are rarely allowed to fire coworkers.

Figure 1. What Teams Do (and Don’t) Manage

Cross-Functional Teams

Many companies use cross-functional teams—teams that, as the name suggests, cut across an organization’s functional areas (operations, marketing, finance, and so on). A cross-functional team is designed to take advantage of the special expertise of members drawn from different functional areas of the company. When the Internal Revenue Service, for example, wanted to study the effects on employees of a major change in information systems, it created a cross-functional team composed of people from a wide range of departments. The final study reflected expertise in such areas as job
analysis, training, change management, industrial psychology, and even ergonomics.\(^7\)

Cross-functional teams figure prominently in the product-development process at Nike, where they take advantage of expertise from both inside and outside the company. Typically, team members include not only product designers, marketing specialists, and accountants but also sports-research experts, coaches, athletes, and even consumers. Likewise, Motorola's RAZR team was a cross-functional team: Responsibility for developing the new product wasn't passed along from the design team to the engineering team but rather was entrusted to a special team composed of both designers and engineers.

We can also classify the RAZR team as a \textit{product-development} or \textit{project team}. Committees and \textit{task forces}, both of which are dedicated to specific issues or tasks, are often cross-functional teams. \textit{Problem-solving teams}, which are created to study such issues as improving quality or reducing waste, may be either intradepartmental or cross-functional.\(^8\)

\section*{Virtual Teams}

“Teamwork,” said someone (we're not sure who), “doesn’t tolerate the inconvenience of distance.” Indeed, technology now makes it

possible for teams to function not only across such organizational boundaries as functional areas, departments, and divisions but also across time and space, as well. Working in virtual teams, geographically dispersed members interact electronically in the process of pursuing a common goal. Such technologies as videoconferencing, instant messaging, and electronic meetings, which allow people to interact simultaneously and in real time, offer a number of advantages in conducting the business of a virtual team. Among other things, members can participate from any location or at any time of day, and teams can “meet” for as long as it takes to achieve a goal or solve a problem—a few days, a few weeks, or a few months.

Nor does team size seem to be an obstacle when it comes to calling virtual-team meetings: In building the F-35 Strike Fighter, U.S. defense contractor Lockheed Martin staked the $225 billion project on a virtual product-team of unprecedented global dimension, drawing on designers and engineers from the ranks of eight international partners ranging from Canada and the United Kingdom to Norway and Turkey.

KEY TAKEAWAYS

• Teamwork brings diverse areas of expertise to bear on organizational problems and projects.
• Reaching teamwork goals requires skills in negotiating trade-offs, and teamwork brings these skills into play at almost every step in the process.
• To be successful, teams need a certain amount of autonomy and authority in making and implementing their decisions.
• A team (or a work team) is a group of people with complementary skills who work together to achieve a specific goal. Members of a working group work independently and meet primarily to share information.
• Work teams have five key characteristics:
  ◦ They are accountable for achieving specific common goals.
  ◦ They function interdependently.
  ◦ They are stable.
  ◦ They have authority.
  ◦ They operate in a social context.
• Companies build and support teams because of their effect on overall workplace performance, both organizational and individual.
• Work teams may be of several types:
  ◦ In the traditional manager-led team, the leader defines the team's goals and activities and is responsible for its achieving its assigned goals.
  ◦ The leader of a self-managing team may determine overall goals, but employees control the activities needed to meet them.
  ◦ A cross-functional team is designed to take advantage of the special expertise of members drawn from different functional areas of the company.
  ◦ On virtual teams, geographically dispersed members interact electronically in the process of pursuing a
common goal.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=193
166. Outcome: Team Development

What you’ll learn to do: identify the stages of team development and the characteristics of each stage

When a team is created it goes through a process of transitioning from a group of people to a cohesive team with a shared purpose and set of goals. In this section you will learn about the stages of team development.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Stages of Team Development
- Self Check: Team Development
Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Stages of Team Development

Teams move through a series of stages, beginning when they are formed and ending when they are disbanded. Bruce Tuckman identified four distinct phases of team development: forming, storming, norming, and performing. Each has a primary purpose and a common set of interpersonal dynamics among team members. Tuckman proposed that all are inevitable and even necessary parts of a successful team’s evolution.
The Forming Stage

The first step in a team’s life is bringing together a group of individuals. Individuals focus on defining and assigning tasks, establishing a schedule, organizing the team’s work, and other startup matters. In addition to focusing on the scope of the team’s purpose and how to approach it, individuals in the formation stage are also gathering information and impressions about each other. Since people generally want to be accepted by others, during this period they usually avoid conflict and disagreement. Team members may begin to work on their tasks independently, not yet focused on their relationships with fellow team members.

The Storming Stage

Once their efforts are under way, team members need clarity about their activities and goals, as well as explicit guidance about how they will work independently and collectively. This leads to a period known as storming—because it can involve brainstorming ideas and also because it usually causes disruption. During the storming stage members begin to share ideas about what to do and how to do it that compete for consideration. Team members start to open up to each other and confront one another’s ideas and perspectives.

Because storming can be contentious, members who are averse to conflict will find it unpleasant or even painful. This can decrease motivation and effort by drawing attention away from tasks. In some cases storming (i.e., disagreements) can be resolved quickly. Other times a team never leaves this stage and becomes stuck and unable to do its work. Patience and consideration toward team members and their views go a long way toward avoiding this.
The Norming Stage

Successfully moving through the storming stage means that a team has clarified its purpose and strategy for achieving its goals. It now transitions to a period focused on developing shared values about how team members will work together. These norms of collaboration can address issues ranging from when to use certain modes of communication, such as e-mail versus telephone, to how team meetings will be run and what to do when conflicts arise. Norms become a way of simplifying choices and facilitating collaboration, since members have shared expectations about how work will get done.

The Performing Stage

Once norms are established and the team is functioning as a unit, it enters the performing stage. By now team members work together easily on interdependent tasks and are able to communicate and coordinate effectively. There are fewer time-consuming distractions based on interpersonal and group dynamics. For this reason, motivation is usually high and team members have confidence in their ability to attain goals.

While these four stages—forming, storming, norming, and performing—are distinct and generally sequential, they often blend into one another and even overlap. A team may pass through one phase only to return to it. For example, if a new member joins the team there may be a second brief period of formation while that person is integrated. A team may also need to return to an earlier stage if its performance declines. Team-building exercises are often done to help a team through its development process.
KEY TAKEAWAYS

• Teams move through a series of four phases—from when they are formed to when their work is complete.
• During the forming stage, the team discusses its purpose, defines and assigns tasks, establishes timelines, and begins forming personal relationships.
• The often-contentious storming stage is the period when team members clarify their goals and the strategy for achieving them.
• The norming stage is when the team establishes its values for how individuals will interact and collaborate.
• Performing is the stage of team development when team members have productive relationships and are able to communicate and coordinate effectively and efficiently.
• While teams move through the four stages in sequence, the phases may overlap or be repeated.

GLOSSARY

Performing:
The stage of group development when team members have productive relationships and are able to communicate and coordinate effectively and efficiently.

Norming:
The stage of group development when the team establishes its values for how individuals will interact and collaborate.

Forming:
The stage of group development when the team discusses its purpose, defines and assigns tasks, establishes timelines, and begins forming personal relationships.
**Storming:**

The stage of group development when the team clarifies its goals and its strategy for achieving them.

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**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

[An interactive or media element has been excluded from this version of the text. You can view it online here: https://library.achievingthedream.org/baycollegeintrobusiness/?p=195]
What you’ll learn to do: identify factors that contribute to team success

Why do some teams succeed where others do not? In this section of the module you will learn about the factors that contribute to team success. As you read through this material, think of a winning team you were a member of and see if you recognize some of the same attributes.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Why Teamwork Works
• Self Check: Team Success

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Factors in Effective Teamwork

Now that we know a little bit about how teams work, we need to ask ourselves why they work. Not surprisingly, this is a fairly complex issue. In this section, we’ll answer these closely related questions: Why are teams often effective? Why are they sometimes ineffective?

First, let’s begin by identifying several factors that, in practice, tend to contribute to effective teamwork. Generally speaking, teams are effective when the following factors are met:\(^1\)

- **Members depend on each other.** When team members rely on each other to get the job done, team productivity and efficiency are high.
- **Members trust one another.** Teamwork is more effective when members trust each other.
- **Members work better together than individually.** When team members perform better as a group than alone, collective performance exceeds individual performance.
- **Members become boosters.** When each member is encouraged by other team members to do his or her best, collective results improve.

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• Team members enjoy being on the team. The more that team members derive satisfaction from being on the team, the more committed they become.
• Leadership rotates. Teams function effectively when leadership responsibility is shared over time.

Most of these explanations probably make pretty clear intuitive sense. Unfortunately, because such issues are rarely as clear-cut as they may seem at first glance, we need to examine the issue of group effectiveness from another perspective—one that considers the effects of factors that aren’t quite so straightforward.

Group Cohesiveness

The idea of group cohesiveness refers to the attractiveness of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it’s low in cohesiveness, members are unhappy with it and may even try to leave it. The principle of group cohesiveness, in other words, is based on the simple idea that groups are most effective when their members like being members of the group.²

What Makes a Team Cohesive?

Numerous factors may contribute to team cohesiveness, but in this section, we'll focus on five of the most important:

1. **Size**. The bigger the team, the less satisfied members tend to be. When teams get too large, members find it harder to interact closely with other members; a few members tend to dominate team activities, and conflict becomes more likely.

2. **Similarity**. People usually get along better with people like themselves, and teams are generally more cohesive when members perceive fellow members as people who share their own attitudes and experience.

3. **Success**. When teams are successful, members are satisfied, and other people are more likely to be attracted to their teams.

4. **Exclusiveness**. The harder it is to get into a group, the happier the people who are already in it. Status (the extent to which outsiders look up to a team, as well as the perks that come with membership) also increases members’ satisfaction.

5. **Competition**. Members value membership more highly when they’re motivated to achieve common goals—especially when those goals mean outperforming other teams.

There’s such a thing as too much cohesiveness. When, for instance, members are highly motivated to collaborate in performing the team’s activities, the team is more likely to be effective in achieving its goals. Clearly, when those goals are aligned with the goals of the larger organization, the organization, too, will be happy. If, however, its members get too wrapped up in more immediate team goals, the whole team may lose sight of the larger organizational goals toward which it’s supposed to be working.
Groupthink

Likewise, it’s easier for leaders to direct members toward team goals when members are all on the same page—when there’s a basic willingness to conform to the team’s rules and guidelines. When there’s too much conformity, however, the group can become ineffective: It may resist change and fresh ideas and, what’s worse, may end up adopting its own dysfunctional tendencies as its way of doing things. Such tendencies may also encourage a phenomenon known as groupthink—the tendency to conform to group pressure in making decisions, while failing to think critically or to consider outside influences. Groupthink is often cited as a factor in the explosion of the space shuttle Challenger in January 1986: Engineers from a supplier of components for the rocket booster warned that the launch might be risky because of the weather but were persuaded to reverse their recommendation by NASA officials who wanted the launch to proceed as scheduled.³

Why Teams Fail

Teams don’t always work. To learn why, let’s take a quick look at four common obstacles to success in introducing teams into an organization:⁴

• **Unwillingness to cooperate.** Failure to cooperate can occur when members don’t or won’t commit to a common goal or set of activities. What if, for example, half the members of a product-development team want to create a brand-new product and half want to improve an existing product? The entire team may get stuck on this point of contention for weeks or even months.

• **Lack of managerial support.** Every team requires organizational resources to achieve its goals, and if management isn't willing to commit the needed resources—say, funding or key personnel—a team will probably fall short of those goals.

• **Failure of managers to delegate authority.** Team leaders are often chosen from the ranks of successful supervisors—first-line managers who give instructions on a day-to-day basis and expect to have them carried out. This approach to workplace activities may not work very well in leading a team—a position in which success depends on building a consensus and letting people make their own decisions.

• **Failure of teams to cooperate.** If you’re on a workplace team, your employer probably depends on teams to perform much of the organization’s work and meet many of its goals. In other words, it is, to some extent, a team-based organization, and as such, reaching its overall goals requires a high level of cooperation among teams. When teams can’t agree on mutual goals (or when they duplicate efforts), neither the teams nor the organization is likely to meet with much success.

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Motivation and Frustration

Finally, remember that teams are composed of people, and whatever the roles they happen to be playing at a given time, people are subject to psychological ups and downs. As members of workplace teams, they need motivation; when motivation is down, so are effectiveness and productivity. As you can see below in Figure 1, “Sources of Frustration,” the difficulty of maintaining a high level of motivation is the chief cause of frustration among members of teams. As such, it’s also a chief cause of ineffective teamwork, and that’s one reason why more employers now look for the ability to develop and sustain motivation when they’re hiring new managers.  

KEY TAKEAWAYS

- Generally speaking, teams are effective when the following are true:
  - Members are interdependent.
  - Members work better together than individually.
  - Teams work well enough to satisfy members.
  - Leadership rotates.
  - Members help one another.
  - Members become boosters.
  - Members trust one another.

- Group cohesiveness refers to the attractiveness of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it.

- Common obstacles to team success include the following:
  - Unwillingness to cooperate
  - Lack of managerial support
  - Failure of managers to delegate authority
  - Failure of teams to cooperate

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=197
What you’ll learn to do: explain the importance of effective communications within an organization

When you were a child you may have played a game called “telephone,” in which one person whispers a phrase into the ear of the person sitting next to her, and she, in turn, whispers the message to the next person, and so on, until the message travels around to the very last person, who announces to everyone what she heard. After traveling through the “telephone,” what may have started as “Joni likes going to the beach” has become “Your knee likes groaning tuna—eek!” It’s a fun game . . . but it also points out a very real challenge that all businesses face: how to avoid the distortions of the telephone game and maintain effective communication.
communication within the organization. In this section you'll learn some of the communication practices businesses use for doing just that.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Effective Communications in Business
• Self Check: Effective Communication

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Effective Communication in Business

Consider the following:

- A text message
- A voicemail
- A passing comment
- A Facebook post
- An unreturned phone call

Have you ever had one of these communications be misinterpreted? You meant one thing, but your friend thought you meant something else? Sometimes the miscommunication can result in confusion about a meeting time or place. Or worse, it can be entirely misunderstood and have a negative impact on your relationship.

Communication, the exchange of information or ideas between sender and receiver, can be challenging in one's personal life, at school, and especially in business. Today, it's even more complex because business is conducted on a global basis 24/7, often using different languages and different communication methods. In this constant, high-speed business environment, communication blunders can cost more than you might think. Did you ever hear the saying “You only have one chance to make a good first impression”? It couldn't be truer when it comes to communication: The first two seconds of communication are so important that it takes another four minutes to add 50 percent more information to an impression—positive or negative—within that
Communication has often been referred to as a soft skill, which includes other competencies such as social graces, personality traits, language abilities, and the ability to work with other people. Soft skills also encompass emotional intelligence, which Adele B. Lynn, in her book *The EQ Interview: Finding Employees with High Emotional Intelligence*, defines as “a person’s ability to manage herself as well as her relationship with others so she can live her intentions.” But in today’s business world, communication has become part of the new “hard skills” category, a technical job requirement, because of the critical role that it plays in business. According to Peter Post, great-grandson of the late Emily Post, “Your skills can get you in the door; your people skills are what can seal the deal.”

**Misunderstood = Miscommunicated**

It is almost impossible to be in business without developing relationships inside your organization and with your customers. Your relationship skills build trust, allow you to be a true partner,

4. The Emily Post Institute, (accessed July 13, 2009).
and help solve your customers' problems; both internal trust and external communication are keys to your ability to deliver on your promises. How are these qualities intrinsically related? The way in which you communicate can determine the level of trust that your colleagues or customers have in you.⁵

In the same way that relationships are the cornerstone of trust, communication is the foundation of relationships. But it’s difficult to establish and develop relationships; it takes work and a lot of clear communication. You might think that sounds simple, but consider this: Nearly 75 percent of communications that are received are interpreted incorrectly. At the same time, interestingly, many people consider themselves good communicators. The telling disconnect occurs because people tend to assume that they know what other people mean, or people assume that others know what they mean. This is compounded by the fact that people tend to hear what they want to hear—that is, a person may interpret elements of a conversation in such a way that the taken meanings contribute to his already established beliefs. When you put these assumptions together, communication can easily become “miscommunication.”⁶

The Communication Model

The standard model of communication has evolved based on two

parties—the sender and the receiver—exchanging information or ideas. The model includes major processes and functions categorized as encoding, decoding, response, and feedback. In addition, the model accounts for noise, which symbolizes anything that might disrupt the sending or receiving of a message. The communication model is shown below in Figure 1, “Traditional Communication Process”:

![Figure 1. Traditional Communication Process. Adapted from Michael R. Solomon, Greg W. Marshall, and Elnora W. Stewart, Marketing: Real People, Real Choices, 5th ed. (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 378.](image)

The model helps describe exactly how communication takes place. For example, if you send a text message to your friend to ask him if he wants to go a movie, you are the source, or sender, of the message. You translated or encoded your message into text characters. A personal digital assistant (PDA) such as a BlackBerry, iPhone, or cell phone is the channel, or the method by which you communicated your message. Chances are, if your friend does not

have his PDA or cell phone with him, your message will not reach him, and you might miss the movie. So in this example, the PDA or cell phone is the channel. When your friend, the receiver, reads the message, he decodes it or determines what you meant to communicate, and then he responds. If he was talking to another friend while he was reading your text message and didn’t see the time the movie started, that conversation would be considered noise because it would be interfering with the communication of your message. Noise interferes with communication or causes distraction, whether it is heard or seen. When your friend responds to you by saying that he wants to go see the movie, he is providing feedback (or a response to your message). Figure 2 below shows this example applied to the communication model.

The same thing can happen in business situations. For example, if you call a prospect to set up a meeting, you are the sender. The message is the meeting information (e.g., date, time, and place) that you encode into words. The channel is the telephone, and the receiver is the prospect. It sounds easy enough. Assume, however, that the prospect responds to you and agrees to the meeting. But because he was checking his e-mails while he was talking to you (which is noise), he puts the wrong time on his calendar. When you come for the appointment, he’s out of the office, and your sales
call doesn't take place. Now you have to start the communication process all over again. This is an example of simply setting up a meeting. Now imagine the challenges if you started explaining the features and benefits of a complex product or negotiating a contract. You can see why understanding the communication process is so important in selling.

Did You Know . . . ?

• Positive e-mail messages are likely to be interpreted as neutral.
• Neutral e-mail messages are likely to be perceived as negative.
• People who send e-mails overrate their ability to communicate feelings.
• There is a gap between how a sender feels when he writes the e-mail and the way the emotional content is communicated, which can cause an error in decoding on the part of the receiver.
• One simple e-mail can lead to a communication debacle if the e-mail is not clearly written and well thought out from the recipient's point of view.8

Effective Communication

How do you avoid the pitfalls of poor communication and build productive business relationships? It's best to always communicate in a timely manner and in the method that your customer prefers. That may be easier said than done. Here are six tips that can help

you increase your chances of making your communications effective.

Tip 1: Empathy Is Essential

One of the key elements of being a good communicator is having empathy. That means thinking about your communication from the receiver's point of view. It's focusing on what she wants to learn as a result of your communication, not what you want to tell her. Empathy is about demonstrating that you care about the other person's situation. Think about when you received your acceptance letter from your college; the letter probably mentioned what an exciting time it is in your life. The author of the letter demonstrated empathy because she focused on the situation from your perspective. A purely factual letter, without empathy, might have said that you were accepted and that now the school can make their budget since they met their enrollment goal. That would be quite a different letter and would make you feel very different (and probably not very welcome). Although it's always best to be candid, you should deliver information from the receiver's point of view and address her concerns.9

Empathy is an integral part of emotional connections. It is especially important to have an emotional connection and empathy when apologizing to customers. Chances are the customer is already angry, or at least disappointed, when you are not able to deliver as expected. You can express empathy in your communications by saying or writing, “You have every right to be upset. I understand how you must feel. I apologize for the late delivery. Let's work on a new process that will help prevent it from

happening again.” Some of the best brands have disappointed their customers but showed empathy when they apologized.

Tip 2: Think Before You Communicate

Quick responses, whether verbal or via electronic methods, can be less effective than those that are considered. Although a timely response is critical, it's worth a few minutes to think about exactly what you want to say before you say it (or type it).

Tip 3: Be Clear

It seems obvious, but not everyone is clear in his communications. Sometimes, people are trying to avoid “bad news” or trying to avoid taking a stand on a topic. It’s always best to avoid confusion and clearly say what you mean by framing your message in a way that is easily understood by all receivers. It’s also a good idea to avoid buzz words (or jargon)—those words, phrases, or acronyms that are used only in your company. If they can't be avoided, explain them in the same communication terms. You should also avoid jargon on your résumé and cover letter—help your reader see your brand story at a glance without needing a decoder ring.

Tip 4: Be Brief

Business communication should be short and to the point. Your customers are busy and need information—whether it’s a proposal, report, or follow-up to a question—in a clear, concise way. It’s best to avoid being verbose, especially in any business plans, proposals, or other significant documents.11

Tip 5: Be Specific

If you go to dinner at Cheesecake Factory and there is a wait to get a table, the hostess will hand you a portable pager and tell you that the wait will be twenty to twenty-five minutes. Perfect. You have just enough time to run a quick errand at a nearby store at the mall and be back in time to get your table. If, on the other hand, she told you that you will be seated shortly, you might have an expectation of being seated in five to ten minutes. Meanwhile, “shortly” might mean twenty to twenty-five minutes for her. You would probably forgo running your errand because you think you are going to be seated soon but end up waiting for twenty-five minutes and being frustrated. Being specific in your communication not only gives clarity to your message but also helps set your customer's expectations. In other words, your customer won't expect something you can't deliver if you are clear about what exactly you can deliver and when. The same is true for prices. For example, if you order from the menu at the Cheesecake Factory, you know precisely what you will get to eat and how much it will cost.

However, if there is a menu special that you heard about tableside, but you weren't told how much the dish was, you might be surprised (and disappointed) when you receive the check. Specificity avoids surprises and sets expectations. Below, in Table 1, “General vs. Specific Statements,” are some examples of general statements that can be communicated more effectively when turned into specific statements:

<table>
<thead>
<tr>
<th>General Statement</th>
<th>Specific Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>I'll get back to you shortly.</td>
<td>I'll get back to you by Tuesday.</td>
</tr>
<tr>
<td>It will only take a few minutes.</td>
<td>It will take less than 5 minutes.</td>
</tr>
<tr>
<td>It will cost about $5,000 plus installation.</td>
<td>The cost is $4,800 plus $200 for installation.</td>
</tr>
<tr>
<td>Everything is included.</td>
<td>It includes your choice of entrée, vegetable, dessert, and coffee.</td>
</tr>
</tbody>
</table>

Tip 6: Be Timely

Timing is everything in life and most certainly in selling. It’s best to be proactive with communication, and if you owe someone a response, do it sooner rather than later. If you are slow to respond to questions and communication, it will be difficult to develop trust, as prolonged responses may seem to imply that you are taking action without informing the customer what it is you are doing. Timing is especially important when you are communicating a negative response or bad news. Don’t put it off; do it as soon as possible and give your customer the benefit of complete information.
Rules of Engagement

At the beginning of each business relationship, ask your customer how she prefers to communicate. Getting the answers to the following simple questions will save time and confusion throughout your relationship and help ensure good communication:

- How do you prefer to receive regular communication (e-mail, text, phone, in person, hard copy)?
- What can I expect as a standard turnaround time for response to questions and issues?
- How do you prefer to receive urgent communication (e-mail, text, phone)?
- Who else (if anyone) in the organization would you like to also receive communication from me?
- When is the best time to touch base with you (early morning, midday, or later in the afternoon)?
- How frequently would you like a status update and in what format (e-mail, phone, in person)?

Listen Up

While you may think you are ready to communicate, it’s a good idea to stop and listen first. Creating your message is only half of communication; listening is the other half. But it’s difficult to listen because we listen faster than we speak—that is, based on what the other person is saying, we are already constructing responses in our minds before they have even finished. As a result, many people are guilty of “listening too fast.”12 Cicero once said that it is good thing

12. Jeffrey J. Denning, “How to Improve Your Listening Skills,
that humans were given one mouth and two ears, in light of the way we use them.\textsuperscript{13}

Listening, in fact, is so important that companies like Starbucks believe that it may directly improve profits. According to Alan Gulick, a Starbucks Corporation spokesperson, if every Starbucks employee misheard one $10 order each day, it would cost the company one billion dollars in a year. That’s why Starbucks has a process to teach their employees how to listen. Although listening may seem passive, it is actively linked to success: One study conducted in the insurance industry found that better listeners held higher positions and got promoted more than those who did not have developed listening skills.\textsuperscript{14} So it’s worth it to hone your listening skills now so that when you get into the business world you can be successful. The following are a few tips:

- **Use active listening.** Confirm that you heard the sender correctly by saying something like, “Just to be sure I understand, we are going to move forward with twelve cases for your initial order, then revisit your inventory in five days.” Review the communication model above and take notice of the importance of decoding. If you decode a message from your customer incorrectly, the communication is ineffective and


could even be costly. In the example above, the customer might have said in response, “I meant that the initial order should be five cases, and we’ll revisit the inventory in twelve days.” That’s a big difference.

- **Ask questions.** Questions are a way to gather more information and learn about your customer and their business. They are also an excellent way to demonstrate that you are communicating by listening. Asking the right questions is critical to being successful. Focus on listening and asking the right questions, and you'll be rewarded with great information.

- **Focus.** Although multitasking has seemingly become a modern virtue, focus actually helps create more effective communication. Stop and focus on your customer when he is speaking. This is a sign of respect, and this concentration allows you to absorb more information. Take notes to remember exactly what you discussed. There’s nothing more important than what your customer has to say.15

- **Take notes.** While it may seem like you will remember everything that is said at a meeting or during a conversation, taking notes signals that you are listening, and it provides you with an accurate record of what was said. “The palest ink is better than the best memory.”16

There’s More to Communication Than Meets the Eye . . . or Ear

It’s important to remember that you will be communicating with many different people about many different topics in selling. Sometimes, you will be communicating one-on-one and sometimes you will be communicating with a group. Just as people have varying social styles, it’s important to know that people also absorb information differently. Research conducted in the 1970s indicates that people comprehend information in the following four distinct ways:

- **Why.** They want to know the reasons for doing something.
- **What.** They want to know the facts about it.
- **How.** They want to know only the information they need to get it done.
- **What if.** They want to know the consequences of doing it.

This can be a helpful road map of the elements you will want to include in your communications, especially if you are communicating with a group, since you may not know everyone’s best method of absorbing information. It’s been proven that if people don’t receive the type of communication they prefer, they tend to tune out or reject the information.

You’ve probably noticed that both people and brands communicate the same message multiple times and usually in multiple ways. Creative repetition is key to successful communication. Think about the advertising Pepsi ran when it launched its new logo in early 2009; you most likely saw the television commercial during the Super Bowl, noticed a billboard in a high-traffic area of a major city, received an e-mail, saw banner ads on the Internet, reviewed the commercial on YouTube, and saw the new logo on the packaging. Pepsi’s ad campaign illustrates the “three-times convincer” concept, which claims that 80 percent of
people need to be exposed a message three times to buy into it, 15 percent need to be exposed to it five times, and 5 percent need to be exposed to it up to twenty-five times. You may have seen the message so many times that it’s hard to remember what the old logo even looked like.

**Types of Communication**

It is important to use multiple types of communication so that repetition does not become boring like a broken record. There are three types of communication: verbal, which involves speaking to one or many people to convey a message; nonverbal, which includes body language and other observations about people; and written, which includes a message that is read in hard copy, e-mail, text message, instant message, Facebook, Twitter, blog, or other Internet-based written communication. Varying the usage of these mediums can help ensure your customer’s attention, but you must carefully develop each skill separately to communicate effectively.

**Verbal Communication**

An introduction, a presentation, a telephone conversation, a videoconference call: these are all examples of verbal communication because information is transmitted orally. Despite the ubiquitous use of technology in the business world, verbal communication is the most common method of exchanging

information and ideas. Verbal communication is powerful, fast, and natural and includes voice inflections that help senders and receivers understand the message more clearly. The downside to verbal communication is that once it is spoken, the words are essentially gone; they are preserved only in the memory of those present, and sometimes the memories of the specific words spoken vary dramatically. The he-said-she-said argument is an example of this. No one really knows who said what unless the words are recorded. Recall is rarely exactly the same between two or more people.

Voice inflection, the verbal emphasis you put on certain words, can have a significant impact on the meaning of what you say. In fact, the same words can take on completely different meaning based on the inflection you use. For example, if you say the sentence “I borrowed your book” with an inflection on a different word each time, the sentence communicates something completely different each time.

Verbal communication may take place face-to-face, such as an in-person conversation or group meeting, speech, or presentation. It could also take place by phone in an individual conversation, a conference call, or even a voice mail. Other forms of verbal communication include video conferences, podcasts, and Webinars, which are increasingly common in business. All these methods allow you to use inflection to communicate effectively. Face-to-face meetings also provide the opportunity to use and interpret other visual cues to increase the effectiveness of your communication.

Verbal communication is especially important throughout the steps of the selling process. Your choice of words can make the difference in someone’s decision to first hear your sales presentation, and your presentation can determine whether that person will purchase your product or service.
Nonverbal Communication

Imagine that you are in a retail store buying a suit for an interview. When the salesperson approaches you, she smiles, makes eye contact, and shakes your hand. You respond positively. You notice that she is dressed professionally, so she makes you feel as if you will receive good fashion advice from her. When you make your choice, the tailor comes over wearing a tape measure around his neck. You know he is a professional and you can trust him to alter your new suit properly. On the other hand, if the salesperson waits on you only after you interrupt her personal phone call, doesn’t make eye contact or shake your hand, acts as if she is bored being at work, and is dressed in worn jeans and flip-flops, it’s unlikely that you trust her to help you choose your suit.

You have, no doubt, used and noticed nonverbal communication in virtually every personal encounter you have had. Think about it: A gesture, a smile, a nod, eye contact, what you are wearing, the fact that you are frequently checking your cell phone for text messages, and how close you stand to someone are all examples of nonverbal communication.

Nonverbal communication is extremely powerful. In fact, some studies indicate that the influence from nonverbal communication such as tone and visuals can have a greater impact than the spoken words. Dr. Albert Mehrabian, a famed psychologist and professor emeritus of psychology at University of California, Los Angeles, is considered a pioneer in the area of body language and nonverbal communication. His research includes an equation, called the Mehrabian formula, 18 that is frequently used to define the relative impact of verbal and nonverbal messages based on


Reading: Effective Communication in Business | 805
experiments of communication of feelings and attitudes. Dr. Mehrabian developed the formula shown below, in Figure 3, to define how communication takes place:

\[
\text{Total liking} = 7\% \text{ verbal liking} + 38\% \text{ vocal liking} + 55\% \text{ facial liking}
\]

Figure 3. The Mehrabian Formula

The Mehrabian formula is used to explain situations in which verbal communication and nonverbal communication do not match. In other words, when facial expressions contradict words, people tend to believe the facial expressions. 19

Types of Nonverbal Communication

• Handshake
• Body language
• Gestures
• Nodding or shaking your head
• Eye contact (or lack of eye contact)
• Eye roll
• Facial expressions
• Touch
• Space or proximity
• Dress
• Multitasking (e.g., texting while listening to someone,

earphones in ears while working)

**Your Handshake Says It All**

In some countries, you might bow when you meet someone; in others you might kiss; but when you meet someone for a business meeting in the United States, it’s best to shake hands.\(^{20}\) Although fist bumps and high fives may be trendy as friendly greetings, neither is appropriate in a business setting.

The exact history of the handshake is unknown; however, at one time it was used as method to prove that you had no weapons in your hands.\(^{21}\) A good handshake is essential in business; it is the first nonverbal cue that you give to the person with whom you are meeting. It’s so important to have a good handshake that a recent study conducted at the University of Iowa showed that during mock interviews, those students who scored as having a better handshake were also considered more hirable by interviewers. According to Greg Stewart, a business professor who conducted the study said, “We found that the first impression begins with a handshake and sets the tone for the rest of the interview.”\(^ {22}\)

Do you think you have a good handshake? Believe it or not, it’s worth practicing your handshake. Here are five tips for a good handshake:

1. Extend your right hand when you are approximately three feet away from the person with whom you want to shake hands.\(^ {23}\)

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2. Keep your wrist straight and lock hands connecting your hand with the same part of the other person's hand.\textsuperscript{24} Apply appropriate pressure; don't crush the person's hand.

3. Shake up and down three or four times.\textsuperscript{25}

4. Avoid the “wet fish” handshake.\textsuperscript{26} This is where practice is really important. The more you shake hands, the less nervous you will be.

5. Smile and make eye contact.\textsuperscript{27} This is your opportunity to use multiple types of nonverbal communication to get your meeting or interview off to a good start.

**Body Language**

Do you use your hands when you talk? If so, you are using body language to help make your point. But body language includes more than talking with your hands. Body language is what we say without words; nonverbal communication using your body includes elements such as gestures, facial expressions, eye contact, a head tilt, a nod, and even where and how you sit. Body language can indicate an unspoken emotion or sentiment that a person might be feeling either consciously or subconsciously. Body language can indicate if you are listening to someone and are engaged in what he is saying, disagreeing with him, or getting bored. (You might

\textsuperscript{25} “Good Handshake Key to Interview Success,” BC Jobs, (accessed July 12, 2009).
\textsuperscript{26} “Good Handshake Key to Interview Success,” BC Jobs, (accessed July 12, 2009).
\textsuperscript{27} “Good Handshake Key to Interview Success,” BC Jobs, (accessed July 12, 2009).
want to think twice about the body language you are using in class.) It's important that you are aware of what you communicate with your body language and to understand and respond to the cues you are getting from someone else's body language.

- Crossed arms: discomfort
- Spreading fingers: territorial display
- Mirroring (i.e., mimicking your body position to another's): comfort
- Drumming or tapping fingers: frustration
- Hands on hips: there is an issue
- Hands behind the back: “leave me alone”
- Hands clasped, thumbs up: positive
- Thumbs down: don't like
- Hands clasped with fingers forming a steeple: confidence
- Touch neck: insecurity
- Crossed legs: comfort
- Glancing at watch: concerned about time or bored

Body language is not just an interesting topic to consider; it's a proven science that can help you improve your communication. If you would like to see how body language is used in everyday life, watch the following video featuring Tonya Reiman, national television commentator and author of *The Power of Body Language*:
Here are some tips to remember about your body language to be sure you are sending the right nonverbal message to your customer or interviewer.

- **Make eye contact** with the person to whom you are speaking. Eye contact avoidance can be distracting and can prevent you from establishing a relationship as shown in this video.

- **Smile** when you meet someone and throughout the conversation. A smile is a positive response to another person and has a significant impact on how people perceive you. A smile can break the ice and help you start a conversation.

- **Dress for success** at all times, which means always dressing appropriately for the situation. But it’s best to keep in mind
that even after you get the job you want, it's a good idea to
dress a little better than the position. Even in very casual work
environments, what you wear is a nonverbal communication
about who you are. If you don't dress for the next promotion,
chances are you won't be considered for it. Be aware of the
company policy and dress code, and if in doubt, dress more
conservatively.

Written Communication

Although verbal and nonverbal communications usually take place
in real time, written communication has a longer consideration
period. The sender must encode the message in words to be
communicated on paper or a screen. Business reports, proposals,
memos, e-mails, text messages, Web sites, blogs, wikis, and more
are all examples of written communication. Each of them is created
over a period of time and can include collaboration from multiple
people. Collaboration is especially important for communicating,
planning, and creating documents so many people use tools such
as wikis to share documents.

Written communication is preferred to verbal communication
when careful consideration is important or the information needs
to be permanent, such as a company policy, sales presentation, or
proposal. Written communication can also take place when verbal
communication isn't an option, like when you need to respond to an
e-mail or text message at 1:00 a.m.

Although verbal communication is faster and more natural than
written communication, each has its pros and cons. Generally,
written communication is better at conveying facts, while verbal
communication is better at conveying feelings. Verbal
communication has another significant drawback: consider the fact
that humans listen much faster than they speak. For example, the
average public speaker speaks at about 125 words per minute.
Although this sounds natural, the average person can listen at 400 to 500 words per minute. That means that listeners' minds have time and space to wander, which can impact the effectiveness of verbal communication. (You may have noticed your mind wandering during a class lecture—even if you found the topic interesting.)

Written communication requires a good command of the English language, including the rules of grammar and spelling. If you think that business exists solely on quick instant messages and text messages, you might be surprised to learn that they are only a portion of the communication within a company and between the company's vendors and other partners. Because the nature of written communication is such that it allows time for consideration and composition, the standards for writing are much higher than for a casual conversation. Customers and colleagues alike expect clear, concise written communications with proper grammar and spelling. And because written communication is long lasting—whether on paper or on the Internet—errors or misstatements exist for an irritatingly long time. So whether you are writing a proposal, a presentation, a report, a meeting recap, or a follow-up e-mail, it's best to take the time to think about your communication and craft it so that it is effective. Consider using the following tips:

• **Be short and sweet.** Shorter is always better when it comes to business correspondence. It's best to include all pertinent facts with concise information. If you write your communication with the receiver in mind, it will be easier to make it shorter and more effective.

• **Grammar, please.** Sentences should be structured correctly and use proper grammar, including a subject and a verb in each sentence. Business correspondence should always include uppercase and lowercase letters and correct punctuation.

28. Patricia M. Buhler, “Managing in the New Millennium: Six Tips to More Effective Communication,” *Supervision* 70,
writing is not your strong suit, visit your campus student services office or learning center to provide information about upcoming writing clinics and access to other tools that can help improve your writing skills.

- **Check spelling.** Use the spell-check tool on your computer. There is no excuse for a misspelled word. Text abbreviations are not acceptable in business correspondence.

- **Read before you send.** Reread your document or electronic communication before it goes out. Is everything complete? Is it clear? Is it something you will be proud of days or weeks later? Take the extra time to review before you send. It's difficult to revise a communication as revisions cause confusion.

- **Just the facts.** Stick to the facts to maximize the impact of your written communications; leave the emotional topics for verbal dialogue. For example, send an e-mail to confirm meeting time, date, and location; use a verbal communication for the content of the meeting to be discussed, such as a negotiation.

### Which Is Best?

Although verbal, nonverbal, and written communication all play a role in your communication with your customers, you might be wondering which one is best. It depends on your customer and on the situation. Some customers want to work day to day using all the latest technology tools, including text messaging, social networking, Web conferences, wikis, and more. Other customers prefer more traditional face-to-face meetings, phone calls, and some e-mail correspondence. Adapt to the method of communication that your customer prefers and not the other way around. In some situations,
a face-to-face meeting is best—for instance, if you wish to discuss a complex issue, negotiate, or meet some additional members of the team. Sometimes, a face-to-face meeting isn't feasible, so other verbal communication methods such as a videoconference, phone call, or conference call can be efficient and effective if used properly.

Chances are you will use a combination of communication types with each customer tailored to his particular preferences and situation. Be guided by the fact that you want to keep your communication personal in meaning and professional in content. Think about it from the receiver's point of view, and deliver bad news verbally whenever possible.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:

https://library.achievingthedream.org/baycollegeintrobusiness/?p=199
172. Outcome: Appropriate Communication in Business

What you’ll learn to do: distinguish what is appropriate and inappropriate in business communications

In this age of social media, instant messaging, tweeting, and blogging, it’s more important than ever for individuals to understand what forms and styles of communication are appropriate in a business environment. In this section you will learn some of the “rules” of the communication game in business when it comes to emails, meetings, telephone conversations, company memos, and other digital communications.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Appropriate Business Communications
• Self Check: Appropriate Communication in Business

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
You probably learned about table manners, thank-you notes, and other forms of etiquette when you were younger. The way you conduct yourself says a lot about who you are in life and, by extension, in business. Although many companies have a casual dress code, don't be quick to assume that protocol and established practices aren't important. It would be easy to misinterpret lack of formality as lack of professionalism.

Letters and Memos

Despite the use of electronic devices in business, formal written communication such as letters, memos, proposals, reports, and presentations are still major methods of communication in selling. These more official methods of communication reflect factual statements that you are making on behalf of the company. Here are some tips for writing business communications:

Use company letterhead where appropriate. For example, letters are always written on letterhead, whether in hard copy or in an electronic format that can be sent via e-mail.

Use the formal elements of a business letter shown below in Figure 1, “Business Letter Format”:
August 28, 2009

Ms. Janice Lee
Buyer
Universal Parts, Inc.
101 Corporate Drive
Deerfield, IL 60511

Dear Ms. Lee,

Productivity and cost savings are even more critical today than ever before. But you can’t afford
to give up customer service for reduced costs. You deserve impeccable service from a supplier
who also keeps costs among the lowest in the industry.

Based on the research I have done on Universal Parts, it appears that switching to Moore
Manufacturing could save you as much as 12% on your annual purchases. In addition, you would
have a dedicated customer service expert available to you 24/7 for any questions or issues you
may have.

I’d like the opportunity to meet with you and learn more about your priorities and business
challenges. I will call you on Tuesday to set up a time that is convenient for you.

In the meantime, you might find it interesting to review the attached audit that was conducted
on your current offering. It reflects where you can potentially realize savings.

Sincerely,

Rachel Grossman
Account Manager

Attachment

Figure 1. Business Letter Format

For a company memo, use the company format. Most companies
have a set format for hard copy and electronic memos. See an
example of a company memo below in Figure 2, “Company Memo
Example”: 
Spell-check and proofread your document carefully before you send it. Be sure it is complete and factually correct and does not include any grammar or spelling errors.

Use CC to indicate the names of other people who should also receive a copy of the letter or memo. The term “CC” is short for “carbon copy,” which dates back to the days of typewriters when carbon paper was used to make multiple copies of a document. It can also mean “courtesy copy”: an additional copy provided to someone as a courtesy.¹

Conversations, Meetings, and Presentations

Although common sense should prevail in all business communications, here are some tips that will help make your conversations, meetings, and presentations more effective forms of communication:

• Be prepared; don't waste anyone's time or focus.
• Prepare a written agenda and hand it out at the start of the meeting to keep the group focused on the desired topics.
• Speak clearly and at a volume that is easy to hear, but not too loud so as to be distracting.
• Be professional and respectful; don't interrupt when others are speaking.
• Use eye contact.
• At the end, recap your key points and identify next steps.
• In business, time is money so conducting effective and efficient meetings is critical to your success.

High Tech, High Touch

The year was 1982, and the world was just beginning to realize the amazing potential of computer technology. John Naisbitt wrote a book called Megatrends: Ten New Directions Transforming Our Lives, in which he coined the term “high tech, high touch,” which he defined as the contradictory state in which people are driven by technology yet long for human interaction. In his 1999 book,

High Tech/High Touch, he wrote about how the United States has been transformed from being comfortable with technology to being intoxicated with technology, a state he calls the “Technologically Intoxicated Zone.” You probably can’t imagine living without your cell phone or personal digital assistant (PDA), iPod, computer, or other electronic devices. In fact, it’s likely you can’t even remember what communication was like before the Internet.

Technology, with all of its efficiency and benefits, cannot, however, become a substitute for old-fashioned human efforts. “Technology makes tasks easier, but it does not make our lives easier,” July Shapiro said in an article in Advertising Age.³ Shapiro’s observation is true, especially as it relates to business; sometimes, the crush of technology takes precedence over business etiquette. However, people have begun to rethink the lack of personal interaction and its corresponding etiquette in the workplace. Yes, “there’s even an app for that”; a firm named Etiquette Avenue has recently launched an iPod app for business etiquette. The fact is, technology isn't personal and can't behave in the right way at the right time with your customer or on an interview; that’s completely up to you.

Now, we’re seeing a bit of a reverse movement: Technology is so pervasive people are actually pushing back on their managers and asking them for more face time and less gadget time.

Being Connected vs. Being Addicted

In a recent pitch to a potential client, a marketing executive in

Manhattan thought it was strange that his potential customer was so engaged with his iPhone that he hardly looked up from it during the meeting. After ninety minutes, someone peeked over the customer’s shoulder and saw that he was playing a racing game on his iPhone. This was disappointing, but not shocking according to the marketing firm that was doing the presentation; they continued with their pitch because they wanted the business. Some are not as tolerant. Billionaire Tom Golisano, a power broker in New York politics, recently announced that he wants to have State Senate majority leader Malcolm A. Smith removed from office because Smith was focused on his iPhone during a budget meeting with him. Recently, in Dallas, Texas, a student lost his opportunity for an internship at a hedge fund when he checked his phone to check a fact during an interview and took an extra minute to check his text messages at the same time. 4 According to Maggie Jackson, author of Distracted: The Erosion of Attention and the Coming Dark Age, we are living in “an institutionalized culture of interruption, where our time and attention is being fragmented by a never-ending stream of phone calls, e-mails, instant messages, text messages, and tweets.”5

The need to be connected should not overwhelm respect for colleagues and customers. Although texting has become a national pastime, especially among teenagers, it’s important to know the appropriate etiquette for the use of handheld electronic devices in the business environment.

First, it’s best to turn off your electronic devices before you enter every meeting. If you think you can’t live without checking your text messages, think about how you would feel if you went on a job interview and the person with whom you were meeting was

checking his electronic device during your interview. Just because some people demonstrate bad behavior and check their electronic devices for messages during a meeting doesn't make it appropriate. In fact, it will help you stand out as a good listener.

Telephone, Cell Phone, Voice Mail, and Conference Calls

Sometimes, however, the use of technology is entirely necessary to conduct business when personal interaction is impossible. It’s important that verbal communication that is not face-to-face is effective and professional. Because you don't have the benefit of using or seeing the receiver’s nonverbal communication, the challenges for effective and appropriate communication are even greater.

Here are some dos and don’ts of telephone etiquette:

- Do be aware of the volume of your voice when you are speaking on the phone in the office or on a cell phone.  
- Do, when using a speakerphone, conduct the call in an enclosed or isolated area such as a conference room or office to avoid disturbing others in the area.
- Do, when leaving a voice mail message, speak slowly, enunciate, spell your name, and leave your number (this makes it much easier for the recipient to hear your message the first time).

• Do, when you leave a voice mail message, be specific about what you want: make it easier for the caller to get back to you and include what time you will be available for a callback to avoid playing telephone tag.  


• Do customize your voice mail message: create a different message for each of your customers or prospective customers so the message is personal and relevant.


• Do speak with enthusiasm: it’s best to convey a smile in your voice, especially if it is the first time you are calling or leaving a message for someone.


• Don’t take another phone call during a meeting.


• Don’t discuss confidential or personal issues during business calls.


• Don’t discuss confidential issues in public areas—you never know who might overhear a conversation in the hallway, on a train, or in other public areas.


• Don’t leave a long, rambling voice mail message: be prepared with a message that is no longer than sixty seconds.
• Don't multitask during a long phone call or conference call—give the other person or people the courtesy of your full attention.

E-mails, Text Messages, Instant Messages, and Social Networks

Written communication has evolved to include multiple methods, all of which have appropriate places in selling. Notice the operative word here is appropriate. E-mail has become an accepted method of communication in most businesses, whereas text messages, instant messages, and social networks are commonplace for only some companies. That’s why etiquette is especially important when using any of these methods of communication, and you should take time to choose your method carefully. Letters, memos, proposals, and other written communication are considered formal, whether they are sent on paper or transmitted via e-mail. However, text messages, instant messages, and social networking are considered informal methods of communication and should be used only to communicate less formal information, such as a meeting time when schedules have been adjusted during a factory tour. Text and instant messages should never be used to communicate company policies, proposals, pricing, or other information that is important to conduct business with customers. It’s also worth noting that in all these methods your communication is permanent, so it’s a good idea to know the following dos and don’ts of electronic communication:

• Do use an e-mail subject line that clearly tells the recipient about the content of the e-mail.
• Do create a short, concise message that uses proper grammar and spelling—use spell-check to be sure all words are spelled correctly.
• Do, in all electronic communications, use uppercase and lowercase letters as grammar dictates.\(^{15}\)

• Do use e-mail, text messages, and instant messages when appropriate, according to your company’s practices, and with your customers to communicate factual information such as to confirm meeting date, time, and location.\(^ {16}\)

• Do use social networking sites to join the conversation and add value—you can build your personal brand by creating a blog or joining a professional conversation on social networking sites such as Twitter or Facebook.\(^ {17}\)

• Don’t use all capital letters in an e-mail; it appears that you are shouting or angry.\(^ {18}\)

• Don’t use “Reply to All” unless it’s absolutely necessary that all the recipients see your response—be selective to avoid mailbox overload.

• Don’t send an e-mail, text message, or instant message when you are angry: take the time to think about what you send because you can’t take it back after it’s sent.\(^ {19}\)

\(^{14}\) “Shouting and Other E-mail Faux Pas,” BusinessLine, April 20, 2009.

\(^{15}\) “Shouting and Other E-mail Faux Pas,” BusinessLine, April 20, 2009.

\(^{16}\) Patricia M. Buhler, “Managing in the New Millennium: Six Tips to More Effective Communication,” Supervision 70, no. 7 (July 2009), 19.


\(^{18}\) “Shouting and Other E-mail Faux Pas,” BusinessLine, April 20, 2009.

• Don’t use abbreviations like “ur,” “2b,” and others—this is not appropriate business communication.20
• Don’t use company e-mail, text message, or instant message accounts to send personal correspondence, and don’t check your personal accounts or pages during company time, as all communication that takes place on company hardware and servers is property of the company.
• Don’t use electronic communication to transmit bad news: talk to the person first, and if follow-up is necessary, reiterate the information in written form.
• Don’t use text messages, instant messages, or social networks to communicate information such as pricing, proposals, reports, service agreements, and other company information that should be sent using a more formal method.

Music to Your Ears

When is an iPod or other MP3 player or a handheld gaming device appropriate at work? Only when it is used for business purposes. “You’re isolating yourself,” says Dale Chapman Webb, founder of The Protocol Centre in Coral Gables, Florida. “You are sending a message that my music is more important than the work at hand.”

Check Your Understanding

Answer the question(s) below to see how well you understand the

topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:

https://library.achievingthedream.org/
baycollegeintrobusiness/?p=201
174. Outcome: Communication Flow

What you’ll learn to do: identify communication flows, channels, and networks within an organization

Within every organizations there are channels through which communications flow. In this section you will learn about the way that communication flows and the types of channels used to convey information. You will also read and learn about the communication networks, both formal and less formal, that exist within an organization.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Communication Channels
- Self Check: Communication Flow

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
What Is Organizational Communication?

Clearly, the task of preparing and submitting a finished sales report doesn’t require the same kinds of communication skills as talking on the phone with a classmate. No matter what your “workstation” happens to be—whether your workplace office or your kitchen table—you’re performing the task of preparing that sales report in an organizational setting. You’re still a sender transferring information to a receiver, but the organizational context of the task requires you to consider different factors for success in communicating effectively (including barriers to success). A report, for example, must be targeted for someone in a specific position and must contain the information necessary to make a specific set of decisions.¹

Communication Flows

Here’s another way of thinking about communication in an organizational setting. Let’s assume that you and the classmate you called on the phone are on roughly equal footing—you’re both

juniors, your grades in the class are about the same, and so forth. Your phone conversation, therefore, is “lateral”: You belong to the same group (your accounting class), and your group activities take place on the same level.

Communication may also flow laterally in organizational settings (as it does between you and your classmate), but more often it flows up or down. Take a look at Figure 1, “Formal Communication Flows,” below, which shows the three directions in which communications can flow in a typical organization. ²

- As the term suggests, downward communication flows from higher organizational levels (supervisors) to lower organizational levels (subordinates).
- Upward communication flows from lower to higher organizational levels.
- Lateral (or horizontal) communication flows across the organization, among personnel on the same level.

Your boss’s request for a sales report is an instance of downward communication, and when you’ve finished and submitted it, you will have completed a task of upward communication.

² This section is based on Jerald Greenberg and Robert A. Baron, Behavior in Organizations, 9th ed. (Upper Saddle River, NJ: Pearson Education, 2008), 351–53.
Figure 1. Formal Communication Flows

Advantages of Communication Flows

Naturally, each of these different directional flows has its functions and advantages. Downward communication, for example, is appropriate for giving instructions or directions—telling people what to do. (As a goal of communication, by the way, giving orders isn’t as one-sided as it may seem. One of the things that employees—the receivers—most want to know is: What, exactly, does my job entail?)\(^3\) Like a sales report, upward communication usually provides managers with information that they need for making decisions, but it’s also the vehicle for new ideas, suggestions,

and complaints. Horizontal communication supports efforts to coordinate tasks and otherwise help people work together.

Disadvantages of Communication Flows

And, of course, each type of flow has its disadvantages. As information seeps downward, for instance, it tends to lose some of its original clarity and often becomes distorted or downright wrong. (This is especially true when it’s delivered orally.) In addition, unlike Donald Trump, most people who are responsible for using downward communication don’t like delivering bad news (such as “You’re fired” or, more commonly, “Your job is being phased out”); as a result, bad news—including bad news that happens to be important news—is often ignored or disguised. The same thing may happen when bad news—say, a negative status report—must be sent upward.

Finally, while horizontal flows are valuable for promoting cooperation, they can also be used to engage in conflict—for instance, between two departments competing for the same organizational resources. The problem is especially bad when such horizontal communications breach official upward or downward lines of communication, thus bypassing managers who might be able to resolve the conflict.

Channels of Communication

Figure 2, “Channels of Communication,” summarizes two additional sets of characteristics of organizational communication—internal
and external channels and formal and informal channels.\textsuperscript{4} Internal communication is shared by people at all levels within a company. External communication occurs between parties inside a company and parties outside the company, such as suppliers, customers, and investors. Both internal and external forms of communication include everything from formal e-mail and official reports to face-to-face conversations and casual phone calls. External communication also takes such forms as customer and supplier Web sites, news releases, and advertising.

Figure 2. Channels of Communication

<table>
<thead>
<tr>
<th>Internal</th>
<th>External</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Formal</strong></td>
<td><strong>Informal</strong></td>
</tr>
<tr>
<td>Internal communications following the company’s chain of command among people inside the organization—email, memos, conference calls, reports, presentations, executive blogs</td>
<td>Casually communicated among employees that do not follow the chain of command—email, instant messages, phone calls, face-to-face conversations, team blogs</td>
</tr>
<tr>
<td>Informal</td>
<td>External</td>
</tr>
</tbody>
</table>

Note that Figure 2, “Channels of Communication,” takes the form of a grid, thus creating four dimensions in which communication can take place. Informal communication, for example, can take place either among people within the company (internally) or between insiders and outsiders (externally). By and large, though you can use the same set of tools (memos, reports, phone calls) to communicate

in any of these four situations, some tools (team blogs, news releases, supplier Web sites) are useful only in one or two.

The Formal Communication Network

An organization's formal communication network consists of all communications that flow along its official lines of authority. Look again at Figure 1, “Formal Communication Flows.” Because it incorporates the organization chart for the company Notes-4-You, it also shows the company’s lines of authority—what we call its reporting relationships. Here we can see that the reporting relationships in question consist of upward communication from subordinates to superiors. In reporting to the operations manager, for example, the notetakers’ supervisor communicates upward. Conversely, when the notetakers’ manager needs to give direction to notetakers, she will use downward communication. If the notetakers’ manager and the copiers’ manager must get together to prepare a joint report for the operations manager, they’ll engage in lateral communication. In short, an organization’s formal communication network is basically the same thing as its network of reporting relationships and lines of authority. 5

The Informal Communication Network

Every company also has an informal communication network (or grapevine), which goes to work whenever two or more employees

get together and start talking about the company and their jobs. Informal communication can take place just about anywhere (in one person's cubicle, in the cafeteria, on the golf course) and by just about any means (phone, e-mail, instant messaging, face-to-face conversation).

Though it's sometimes called the grapevine, an informal network is an extremely important communication channel. Why? For the simple reason that it's typically widespread and can rarely be prevented, even if it's not officially sanctioned by the company—indeed, even when the company tries to discourage or bypass it. Unofficial information crosses virtually every boundary drawn by a firm's organization chart, reaching out and touching everyone in the organization, and what's more, it travels a lot faster than official information.

Problems with the Flow of Information through Informal Channels

The downside of “unofficial” information should be obvious. Because much of it is communicated orally, it's likely to get distorted and often degenerates into outright misinformation. Say, for example, that a rumor about layoffs gets started in your workplace. As more than one manager will verify, such rumors can do more damage than the reality. Morale may plummet and productivity won't be far behind. Valuable employees may abandon ship (needlessly, if the rumors are false).

And imagine what can happen if informal information gets outside the organization. In the 1970s, Chicago-area McDonald's outlets

found themselves fighting rumors about worms in their hamburgers. Over the years, Coca-Cola has had to fight rumors about terrorists joining its organization, subversive messages concealed in its label, and hyperacidity (false rumors that Coke causes osteoporosis and makes a good pesticide and an equally good spermicide). ⑦

What to Do about Informal Information Flows

On the upside, savvy managers can tap into the informal network, either to find out what sort of information is influencing employee activities or to circulate more meaningful information, including new ideas as well as corrective information. In any case, managers have to deal with the grapevine, and one manager has compiled a list of suggestions for doing so effectively: ⑧

- **Learn to live with it.** It’s here to stay.
- **Tune into it.** Pay attention to the information that’s circulating and try to learn something from it. Remember: The more you know about grapevine information, the better you can interact with employees (who, in turn, will probably come to regard you as someone who keeps in touch with the things that concern


them).

- **Don’t participate in rumors.** Resist the temptation to add your two cents’ worth, and don’t make matters worse.
- **Check out what you hear.** Because it’s your job to replace bad information with good information, you need to find out what’s really going on.
- **Take advantage of the grapevine.** Its only function is to carry information, so there’s no reason why you can’t pump some useful information through it.

Perhaps most important, when alert managers notice that the grapevine is particularly active, they tend to reach a sensible twofold conclusion:

1. The organization’s formal lines of communication aren’t working as well as they should be.
2. The best way to minimize informal communication and its potential damage is to provide better formal communication from the outset—or, failing that, to provide whatever formal communication will counteract misinformation as thoroughly as possible.

Let’s go back to our example of a workplace overwhelmed by layoff rumors. In a practical sense, what can a manager—say, the leader of a long-term product-development team—do to provide better communication? One manager suggests at least three specific responses:

1. Go to your supervisor or another senior manager and try to

find out as much as you can about the organization’s real plans.
2. Ask a senior manager or a human resources representative to meet with your team and address members’ concerns with accurate feedback.
3. Make it a priority to keep channels open—both between yourself and your team members and between team members and the human resources department.

Because actions of this sort send a message, they can legitimately be characterized as a form of formal communication. They also reflect good leadership: Even though the information in this case relates only indirectly to immediate team tasks, you’re sharing information with people who need it, and you’re demonstrating integrity (you’re being honest, and you’re following through on a commitment to the team).

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/
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176. Outcome: Barriers to Communication

What you’ll learn to do: identify common barriers to communication in organizations

How many times have you heard any of the following?

- Do you understand what I am saying?
- Do you know what I mean?
- Can you see what I am talking about?

Why are these such common phrases? In this section you’ll get some answers. There are barriers to effective communication that we may not even know exist. Once we understand such roadblocks, we can devise ways of getting around them or at least reducing their impact. Within organizations, where clear communication is critical (sometimes even life-threatening), understanding barriers such as filtering and bias will help you become a more effective communicator.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Communication Barriers
- Self Check: Barriers to Communication

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
177. Reading: Communication Barriers

Barriers to Effective Communication

Communicating can be more of a challenge than you think, when you realize the many things that can stand in the way of effective communication. These include filtering, selective perception, information overload, emotional disconnects, lack of source familiarity or credibility, workplace gossip, semantics, gender differences, differences in meaning between sender and receiver, and biased language. Let’s examine each of these barriers.

Filtering

Filtering is the distortion or withholding of information to manage a person’s reactions. Some examples of filtering include a manager who keeps her division’s poor sales figures from her boss, the vice president, fearing that the bad news will make him angry. The old saying, “Don’t shoot the messenger!” illustrates the tendency of receivers (in this case, the vice president) to vent their negative response to unwanted messages on the sender. A gatekeeper (the vice president’s assistant, perhaps) who doesn’t pass along a complete message is also filtering. The vice president may delete the e-mail announcing the quarter’s sales figures before reading it, blocking the message before it arrives.

As you can see, filtering prevents members of an organization from getting a complete picture of the way things are. To maximize your chances of sending and receiving effective communications,
it’s helpful to deliver a message in multiple ways and to seek information from multiple sources. In this way, the effect of any one person’s filtering the message will be diminished.

Since people tend to filter bad news more during upward communication, it is also helpful to remember that those below you in an organization may be wary of sharing bad news. One way to defuse the tendency to filter is to reward employees who clearly convey information upward, regardless of whether the news is good and bad.

The following lists some of the criteria that individuals may use when deciding whether to filter a message or pass it on as is:

- Past experience: Was the sender rewarded for passing along news of this kind in the past, or was she criticized?
- Knowledge, perception of the speaker: Has the receiver’s direct superior made it clear that “no news is good news?”
- Emotional state, involvement with the topic, level of attention: Does the sender’s fear of failure or criticism prevent him from conveying the message? Is the topic within his realm of expertise, increasing his confidence in his ability to decode it, or is he out of his comfort zone when it comes to evaluating the message’s significance? Are personal concerns impacting his ability to judge the message’s value?

Once again, filtering can lead to miscommunications in business. Each sender translates the message into his or her own words, creating his or her own version of what was said.

Selective Perception

Selective perception refers to filtering what we see and hear to suit our own needs. This process is often unconscious. Small things can command our attention when we’re visiting a new place—a new
city or a new company. Over time, however, we begin to make assumptions about the way things are on the basis of our past experience. Often, much of this process is unconscious. “We simply are bombarded with too much stimuli every day to pay equal attention to everything so we pick and choose according to our own needs.” Selective perception is a time-saver, a necessary tool in a complex culture. But it can also lead to mistakes.

Think back to the earlier example conversation between Bill, who was asked to order more toner cartridges, and his boss. Since Bill found his boss’s to-do list to be unreasonably demanding, he assumed the request could wait. (How else could he do everything else on the list?) The boss, assuming that Bill had heard the urgency in her request, assumed that Bill would place the order before returning to the other tasks on her list.

Both members of this organization were using selective perception to evaluate the communication. Bill's perception was that the task of ordering could wait. The boss's perception was that her time frame was clear, though unstated. When two selective perceptions collide, a misunderstanding occurs.

Information Overload

Information overload can be defined as “occurring when the information processing demands on an individual’s time to perform interactions and internal calculations exceed the supply or capacity of time available for such processing.” Messages reach us in countless ways every day. Some are societal—advertisements that we may hear or see in the course of our day. Others are professional—e-mails, and memos, voice mails, and conversations from our colleagues. Others are personal—messages and conversations from our loved ones and friends.

Add these together and it’s easy to see how we may be receiving more information than we can take in. This state of imbalance is
known as information overload. Experts note that information overload is “A symptom of the high-tech age, which is too much information for one human being to absorb in an expanding world of people and technology. It comes from all sources including TV, newspapers, and magazines as well as wanted and unwanted regular mail, e-mail and faxes. It has been exacerbated enormously because of the formidable number of results obtained from Web search engines.” Other research shows that working in such fragmented fashion has a significant negative effect on efficiency, creativity, and mental acuity.

Going back to our example of Bill. Let's say he's in his cubicle on the phone with a supplier. While he's talking, he hears the chime of e-mail alerting him to an important message from his boss. He's scanning through it quickly, while still on the phone, when a coworker pokes his head around the cubicle corner to remind Bill that he's late for a staff meeting. The supplier on the other end of the phone line has just given Bill a choice among the products and delivery dates he requested. Bill realizes he missed hearing the first two options, but he doesn't have time to ask the supplier to repeat them all or to try reconnecting to place the order at a later time. He chooses the third option—at least he heard that one, he reasons, and it seemed fair. How good was Bill's decision amid all the information he was processing at the same time?

Emotional disconnects

Emotional disconnects happen when the sender or the receiver is upset, whether about the subject at hand or about some unrelated incident that may have happened earlier. An effective communication requires a sender and a receiver who are open to speaking and listening to one another, despite possible differences in opinion or personality. One or both parties may have to put their emotions aside to achieve the goal of communicating clearly.
A receiver who is emotionally upset tends to ignore or distort what the sender is saying. A sender who is emotionally upset may be unable to present ideas or feelings effectively.

Lack of Source Credibility

Lack of source familiarity or credibility can derail communications, especially when humor is involved. Have you ever told a joke that fell flat? You and the receiver lacked the common context that could have made it funny. (Or yes, it could have just been a lousy joke.) Sarcasm and irony are subtle, and potentially hurtful, commodities in business. It's best to keep these types of communications out of the workplace as their benefits are limited, and their potential dangers are great. Lack of familiarity with the sender can lead to misinterpreting humor, especially in less-rich information channels like e-mail. For example, an e-mail from Jill that ends with, “Men, like hens, should boil in vats of oil,” could be interpreted as anti-male if the receiver didn’t know that Jill has a penchant for rhyme and likes to entertain coworkers by making up amusing sayings.

Similarly, if the sender lacks credibility or is untrustworthy, the message will not get through. Receivers may be suspicious of the sender’s motivations (“Why am I being told this?”). Likewise, if the sender has communicated erroneous information in the past, or has created false emergencies, his current message may be filtered.

Workplace gossip

Workplace gossip, also known as the grapevine, is a lifeline for many employees seeking information about their company. Employees trust their peers as a source of messages, but the grapevine’s informal structure can be a barrier to effective
communication from the managerial point of view. Its grassroots structure gives it greater credibility in the minds of employees than information delivered through official channels, even when that information is false.

Some downsides of the office grapevine are that gossip offers politically minded insiders a powerful tool for disseminating communication (and self-promoting miscommunications) within an organization. In addition, the grapevine lacks a specific sender, which can create a sense of distrust among employees—who is at the root of the gossip network? When the news is volatile, suspicions may arise as to the person or persons behind the message. Managers who understand the grapevine’s power can use it to send and receive messages of their own. They also decrease the grapevine’s power by sending official messages quickly and accurately, should big news arise.

Semantics

Semantics is the study of meaning in communication. Words can mean different things to different people, or they might not mean anything to another person. For example, companies often have their own acronyms and buzzwords (called business jargon) that are clear to them but impenetrable to outsiders. For example, at IBM, GBS is focusing on BPTS, using expertise acquired from the PwC purchase (which had to be sold to avoid conflicts of interest in light of SOX) to fend off other BPO providers and inroads by the Bangalore tiger. Does this make sense to you? If not, here’s the translation: IBM’s Global Business Services (GBS) division is focusing on offering companies Business Process Transformation Services (BPTS), using the expertise it acquired from purchasing the management consulting and technology services arm of PricewaterhouseCoopers (PwC), which had to sell the division because of the Sarbanes-Oxley Act (SOX, enacted in response to the major accounting scandals like
the Enron). The added management expertise puts it above business process outsourcing (BPO) vendors who focus more on automating processes rather than transforming and improving them. Chief among these BPO competitors is Wipro, often called the “Bangalore tiger” because of its geographic origin and aggressive growth.

Given the amount of messages we send and receive every day, it makes sense that humans try to find shortcuts—a way to communicate things in code. In business, this code is known as jargon. Jargon is the language of specialized terms used by a group or profession. It is common shorthand among experts and if used sensibly can be a quick and efficient way of communicating. Most jargon consists of unfamiliar terms, abstract words, nonexistent words, acronyms, and abbreviations, with an occasional euphemism thrown in for good measure. Every profession, trade, and organization has its own specialized terms. At first glance, jargon seems like a good thing—a quicker way to send an effective communication, the way text message abbreviations can send common messages in a shorter, yet understandable way. But that’s not always how things happen. Jargon can be an obstacle to effective communication, causing listeners to tune out or fostering ill-feeling between partners in a conversation. When jargon rules the day, the message can get obscured.

A key question to ask before using jargon is, “Who is the receiver of my message?” If you are a specialist speaking to another specialist in your area, jargon may be the best way to send a message while forging a professional bond—similar to the way best friends can communicate in code. For example, an information technology (IT) systems analyst communicating with another IT employee may use jargon as a way of sharing information in a way that reinforces the pair’s shared knowledge. But that same conversation should be held in standard English, free of jargon, when communicating with staff members outside the IT group.
A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=205

LINK IT UP

Here is a website containing eighty buzz words in business and a discussion of why slang is a problem.

Gender Differences

Gender differences in communication have been documented by a number of experts, including linguistics professor Deborah Tannen in her best-selling book *You Just Don’t Understand: Women and Men*
in Conversation. Men and women work together every day. But their different styles of communication can sometimes work against them. Generally speaking, women like to ask questions before starting a project, while men tend to “jump right in.” A male manager who's unaware of how many women communicate their readiness to work may misperceive a ready employee as not ready.

Another difference that has been noticed is that men often speak in sports metaphors, while many women use their home as a starting place for analogies. Women who believe men are “only talking about the game” may be missing out on a chance to participate in a division’s strategy and opportunities for teamwork and “rallying the troops” for success.

“It is important to promote the best possible communication between men and women in the workplace,” notes gender policy adviser Dee Norton, who provided the above example. “As we move between the male and female cultures, we sometimes have to change how we behave (speak the language of the other gender) to gain the best results from the situation. Clearly, successful organizations of the future are going to have leaders and team members who understand, respect and apply the rules of gender culture appropriately.

Being aware of these gender differences can be the first step in learning to work with them, as opposed to around them. For example, keep in mind that men tend to focus more on competition, data, and orders in their communications, while women tend to focus more on cooperation, intuition, and requests. Both styles can be effective in the right situations, but understanding the differences is a first step in avoiding misunderstandings based on them.
Differences in meaning between sender and receiver

Differences in meaning often exist between the sender and receiver. “Mean what you say, and say what you mean.” It's an easy thing to say. But in business, what do those words mean? Different words mean different things to different people. Age, education, and cultural background are all factors that influence how a person interprets words. The less we consider our audience, the greater our chances of miscommunication will be. When communication occurs in the cross-cultural context, extra caution is needed given that different words will be interpreted differently across cultures and different cultures have different norms regarding nonverbal communication. Eliminating jargon is one way of ensuring that our words will convey real-world concepts to others. Speaking to our audience, as opposed to about ourselves, is another. Nonverbal messages can also have different meanings.
| Figure 1 | 1. “V” for victory. Use this gesture with caution! While in North America it signs victory or peace, in England and Australia it means something closer to “take this!” |
| Figure 2 | 2. The “OK” gesture. While in North America it means things are going well, in France it means a person is thought to be worthless, in Japan it refers to money, and in Brazil, Russia, and Germany it means something really not appropriate for the workplace. |
Table 1. Gestures Around the Globe

Figure 3

3. The “thumbs up” means one in Germany, five in Japan, but a good job in North America. This can lead to confusion.

Figure 4

4. “Hook ’em horns.” This University of Texas rallying call looks like the horns of a bull. However, in Italy it means you are being tricked, while in Brazil and Venezuela it means you are warding off evil.

Figure 5

5. Waving your hand. In much of Europe waving your hand indicates a disagreement. However, in North America it is routinely used as a way to signal greetings or to get someone’s attention.
Managers who speak about “long-term goals and profits” to a staff that has received scant raises may find their core message (“You’re doing a great job—and that benefits the folks in charge!”) has infuriated the group they hoped to inspire. Instead, managers who recognize the “contributions” of their staff and confirm that this work is contributing to company goals in ways “that will benefit the source of our success—our employees as well as executives,” will find their core message (“You’re doing a great job—we really value your work”) is received as opposed to being misinterpreted.

**Biased Language**

Biased language can offend or stereotype others on the basis of their personal or group affiliation. The figure below provides a list of words that have the potential to be offensive in the left-hand column. The right-hand column provides more neutral words that you can use instead.

<table>
<thead>
<tr>
<th>Avoid</th>
<th>Consider Using</th>
</tr>
</thead>
<tbody>
<tr>
<td>Black attorney</td>
<td>attorney</td>
</tr>
<tr>
<td>businessman</td>
<td>business person</td>
</tr>
<tr>
<td>chairman</td>
<td>chair or chairperson</td>
</tr>
<tr>
<td>cleaning lady</td>
<td>cleaner or maintenance worker</td>
</tr>
<tr>
<td>male nurse</td>
<td>nurse</td>
</tr>
<tr>
<td>manpower</td>
<td>staff or personnel</td>
</tr>
<tr>
<td>secretary</td>
<td>assistant or associate</td>
</tr>
</tbody>
</table>
Effective communication is clear, factual, and goal-oriented. It is also respectful. Referring to a person by one adjective (a brain, a diabetic, an invalid) reduces that person to that one characteristic. Language that belittles or stereotypes a person poisons the communication process. Language that insults an individual or group based on age, ethnicity, sexual preference, or political beliefs violates public and private standards of decency, ranging from civil rights to corporate regulations.

The effort to create a neutral set of terms to refer to heritage and preferences has resulted in a debate over the nature of “political correctness.” Proponents of political correctness see it as a way to defuse the volatile nature of words that stereotyped groups and individuals in the past. Critics of political correctness see its vocabulary as stilted and needlessly cautious.

Many companies offer new employees written guides on standards of speech and conduct. These guides, augmented by common sense and courtesy, are solid starting points for effective, respectful workplace communication. Tips for appropriate workplace speech include but are not limited to the following:

• Alternating the use of “he” and “she” when referring to people in general.
• Relying on human resources–generated guidelines.
• Remembering that terms that feel respectful or comfortable to us may not be comfortable or respectful to others.

Poor Listening and Active Listening

Former Chrysler CEO Lee Iacocca lamented, “I only wish I could find an institute that teaches people how to listen. After all, a good manager needs to listen at least as much as he needs to talk.” A sender may strive to deliver a message clearly. But the receiver’s ability to listen effectively is equally vital to effective
communication. The average worker spends 55% of her workdays listening. Managers listen up to 70% each day. But listening doesn’t lead to understanding in every case. Listening takes practice, skill, and concentration.

According to University of San Diego professor Phillip Hunsaker, “The consequences of poor listening are lower employee productivity, missed sales, unhappy customers, and billions of dollars of increased cost and lost profits. Poor listening is a factor in low employee morale and increased turnover because employees do not feel their managers listen to their needs, suggestions, or complaints.” Clearly, if you hope to have a successful career in management, it behooves you to learn to be a good listener.

Alan Gulick, a Starbucks spokesperson, puts better listening to work in pursuit of better profits. If every Starbucks employee misheard one $10 order each day, he calculates, their errors would cost the company a billion dollars annually. To teach its employees to listen, Starbucks created a code that helps employees taking orders hear the size, flavor, and use of milk or decaf coffee. The person making the drink echoes the order aloud.

How can you improve your listening skills? The Roman philosopher Cicero said, “Silence is one of the great arts of conversation.” How often have we been in conversation with someone else where we are not really listening but itching to convey our portion? This behavior is known as “rehearsing.” It suggests the receiver has no intention of considering the sender’s message and intends to respond to an earlier point instead. Clearly, rehearsing is an impediment to the communication process. Effective communication relies on another kind of listening: active listening.

Active listening can be defined as giving full attention to what other people are saying, taking time to understand the points being made, asking questions as appropriate, and not interrupting at
inappropriate times.\(^1\) Active listening creates a real-time relationship between the sender and the receiver by acknowledging the content and receipt of a message. As we've seen in the Starbucks example, repeating and confirming a message's content offers a way to confirm that the correct content is flowing between colleagues. The process creates a bond between coworkers while increasing the flow and accuracy of messaging.

Carl Rogers, founder of the “person-centered” approach to psychology, formulated the following five rules for active listening:

1. Listen for message content
2. Listen for feelings
3. Respond to feelings
4. Note all cues
5. Paraphrase and restate

The good news is that listening is a skill that can be learned. The first step is to decide that we want to listen. Casting aside distractions, such as by reducing background or internal noise, is critical. The receiver takes in the sender's message silently, without speaking. Second, throughout the conversation, show the speaker that you're listening. You can do this nonverbally by nodding your head and keeping your attention focused on the speaker. You can also do it verbally, by saying things like, “Yes,” “That’s interesting,” or other such verbal cues. As you're listening, pay attention to the sender's body language for additional cues about how they're feeling. Interestingly, silence plays a major role in active listening. During active listening, we are trying to understand what has been said, and in silence, we can consider the implications. We can't consider information and reply to it at the same time. That's where the power of silence comes into play. Finally, if anything is not clear to you,
ask questions. Confirm that you’ve heard the message accurately, by repeating back a crucial piece like, “Great, I’ll see you at 2 p.m. in my office.” At the end of the conversation, a “thank-you” from both parties is an optional but highly effective way of acknowledging each other’s teamwork.

In summary, active listening creates a more dynamic relationship between a receiver and a sender. It strengthens personal investment in the information being shared. It also forges healthy working relationships among colleagues by making speakers and listeners equally valued members of the communication process.

KEY TAKEAWAYS

Many barriers to effective communication exist. Examples include filtering, selective perception, information overload, emotional disconnects, lack of source familiarity or credibility, workplace gossip, semantics, gender differences, differences in meaning between sender and receiver, and biased language. The receiver can enhance the probability of effective communication by engaging in active listening, which involves (1) giving one’s full attention to the sender and (2) checking for understanding by repeating the essence of the message back to the sender.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.
Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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baycollegeintrobusiness/?p=205
178. Putting It Together: Teamwork and Communication

Summary

In this module you learned about the importance of teamwork and communication in business. Below is a summary of the key points that were covered.

Groups and Teams

Teams are groups of individuals with complementary skills who come together to achieve a specific goal. Teams can be manager-led, self-directed, cross-functional, or even virtual. Companies use teams because they are an effective means of achieving objectives, and they bring increased efficiency to operations.

Team Development

When teams are formed they evolve from individuals into a cohesive unit. The stages of team development are: forming, storming, norming, and performing.
Team Success

What differentiates a successful team from an unsuccessful one? Some of the hallmarks of successful teams are the following: the members trust one another, the members become “boosters” for one another, members enjoy the team activities, and leadership is shared.

Effective Communication

Effective communications are based on empathy, and they are thoughtful, clear, specific, brief, and timely. Effective communicators are aware that only a portion of their message is verbally conveyed, so they are careful about tone, diction, and body language. Finally, in order to communicate effectively one must be an active and engaged listener.

Appropriate Communication in Business

Knowing how to appropriately communicate in a business setting has been complicated by the introduction and use of mobile technology and social media. In addition, some workplaces have adopted a more casual dress code, making it appear that casual communication methods are appropriate. Understanding when and how each form of communication should be used depends on the sender, receiver, and message involved.
Communication Flow

Communications flow like a river through a variety of channels, both formal and informal. In addition, communication channels are both external and internal to the organization. Each channel has advantages and disadvantages and must be managed in order to ensure that the appropriate message is being conveyed to the appropriate parties.

Barriers to Communication

“Getting one's message across” can be tricky and challenging due to barriers that impede communication. Among the barriers to effective communication are filtering, selective perspective, information overload, lack of source credibility, emotional disconnects, semantics, gender differences, and poor listening skills.

Synthesis
What did it take for these eight people to jump out of a perfectly good airplane and join hands to form a figure eight? Yes, nerves of steel and a measure of pure insanity. But it also took something else—the very thing you learned about in this module: teamwork and communication. As for these skydivers, the consequences of poor teamwork and faulty communication can be serious and even deadly. Defective parts can wind up in automobiles and airplanes, the wrong medications can be given to patients in a hospital, food can be contaminated . . . all as a result of poor teamwork and communication. Understanding the ways in which people communicate and learning to overcome potential barriers can help you be a more effective communicator and a better team member. Moreover, the skills you've learned in this module are not only important in business—they're useful in skydiving and life.
179. Why It Matters: Motivating Employees

Why explain the most common motivational theories and apply them to business?

What motivates you to do what you do? How do you motivate others to help you or to accomplish things on their own? You have already learned a lot about business and the role people play, both as managers and employees, in helping the organization reach its goals. As a manager you are expected to lead and manage people. As an employee you are given job specific duties and responsibilities you are expected to perform. Neither leading nor following will happen until people are motivated.

Since the 1920s researchers have studied human behavior and developed a variety of theories to explain the driving force behind motivation. These theories range from the need to provide a safe and secure environment for oneself and family to the compelling desire not to experience negative consequences from action or inaction. Understanding the basis for motivation and learning how motivational approaches work in the business environment can be helpful to your professional and organizational success.

Before you begin this module ask yourself the following questions:
• What motivates me?
• How have others tried to motivate me?
• Which motivational approaches have been the most and least successful?
• When have I been successful in motivating others?
• How can I use this information to be successful in my personal and professional life?

Learning Outcomes

• Explain the theory of scientific management
• Describe the “Hawthorne effect” and its significance in managing employees
• Explain need-based theories of worker motivation, including Maslow’s hierarchy of needs and Herzberg’s two-factor theory
• Explain process-based theories of motivation, including expectancy and equity theories
• Compare and contrast Theory X and Theory Y managers
• Identify ways in which managers can use the varying motivation theories to motivate individual employees in an increasingly diverse workplace
180. Outcome: Scientific Management

What you’ll learn to do: explain the theory of scientific management

Just over one hundred years ago Frederick Taylor published *Principles of Scientific Management*, a work that forever changed the way the organizations view their workers and their organization. At the time of Taylor's publication, managers believed that workers were lazy and worked slowly and inefficiently in order to protect their jobs. Taylor identified a revolutionary solution:

The remedy for this inefficiency lies in systematic management, rather than in searching for some unusual or extraordinary man.

You might think that a century-old theory wouldn't have any application in today's fast-paced, technology-driven world. You'd be wrong, though! In fact much of what you've already learned in this course is based on Taylor's work, and plenty of what you'll experience in the workplace will be indebted to him, too. If you recognize any of the following, you have already seen his principles of scientific management in action: organizational charts, performance evaluations, quality measurements and metrics, and sales and/or production goals.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Introduction to Motivational Theory
- Reading: Fredrick Taylor’s Scientific Management
- Self Check: Scientific Management

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Introduction to Motivational Theory

Motivation is defined as “the intention of achieving a goal, leading to goal-directed behavior” (1). When we say that someone is motivated, we mean that the person is trying hard to accomplish a certain task. Motivation is clearly important in order for someone to perform well. However, motivation alone is not sufficient. Ability—having the skills and knowledge required to perform the job—is also important, and is sometimes key to being effective. Finally, environmental factors—having the resources, information, and support one needs to perform well—are also critical to reaching one’s goals.

What makes employees willing to “go the extra mile” to provide excellent service, market a company’s products effectively, or achieve the goals set for them? Answering such questions can help us understand and manage the work of peers, subordinates, and even supervisors. As with many questions involving human behavior, though, the answers are anything but uniform or simple. Instead, you’ll find a number of theories that explore the concept of motivation and attempt to explain its source.

The following video on the motivational strategies used by Zappos is a good place to begin our discussion of motivation in business:

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=210
Fredrick Taylor’s Scientific Management

In 1913, Frederick Taylor published *Principles of Scientific Management*, ushering in a completely new way of understanding the modern organization. Frederick Taylor was trained as an engineer and played a prominent role in the idea of scientific management. Scientific management is a management-oriented and production-centered perspective of organizational communication.

Taylor believed that the reason most organizations failed was because they lacked successful systematic management. He wrote that “the best management is true science resting upon clearly defined laws, rules, and principles, as a foundation.” He further noted that “under scientific management, arbitrary power, arbitrary dictation ceases, and every single subject,

3. 
large and small, becomes a question for scientific investigation, for reduction to law."{5} Taylor believed that any job could be performed better if it were investigated scientifically. Taylor developed time and motion studies that helped improve organizational efficiency.

Working as a foreman for the Bethlehem Steel Works in the 1900s, Taylor observed how workers could do more with less time. He analyzed coal shoveling at the factory and noticed that several workers brought different sizes of shovels from home. Workers who brought small shovels could do more but it took them longer, and workers who brought big shovels could do less but it was faster. He observed that the best size shovel was one weighing about twenty pounds. As a result, he directed the organization to provide all the workers with the same size shovel. He also provided pay incentives for workers who could shovel more coal. By making these changes, the organization dramatically increased its production.

Taylor believed that several steps must be taken in order to create a more productive organization. First, one must examine the job or task. Second, one needs to determine the best way to complete the job or task. Third, one must choose the most appropriate person for the task while at the same time providing proper compensation. Last, one must be able to train the person to do the task efficiently. Taylor believed that by using these scientific steps organizations gain efficiencies.

Taylor’s idea of scientific management originated during a time when most worker training was based on apprenticeship models. In an apprenticeship, a person would be taught by a more skilled and experienced person, who would demonstrate the task so the inexperienced person could model the behavior. Taylor believed that this was a very ineffective way of training because he felt that workers would differ in terms of the tasks they performed, and the quality or efficiency of task completion would depend on the kind

5. Ibid., p 211
of training they received. Taylor argued that there should be only one way to explain the job and one way to execute the task. He didn’t think the training of apprentices should be left to individual “experts.”

Overall, Taylor felt that employees are lazy and need constant supervision. He posited that “the tendency of the average [employee] is toward working at a slow easy gait.” He called this tendency “natural soldiering” (“soldiering” is another word for “taking it easy”). One’s natural tendency to take it easy on the job can also be affected by “systematic soldiering,” which occurs when when employees decrease their work production based on input or communications from others or if they feel that working harder will not result in greater compensation. When employees are paid by the hour, there is an additional incentive to slow down—it’s better to “soldier” and show that tasks take longer than might really be necessary. On account of what he took to be workers’ inherent laziness, Taylor understood the impact of workers on production rates and the need for more efficient work practices.

Taylor is known for developing time and motion studies of work. These were methods for calculating production efficiency by recording outcomes and the time it takes to produce those outcomes. Taylor believed that if each task were scientifically designed and the workers could be trained, then production could be measured by timing the labor the workers performed. The idea was to create quantified benchmarks for work in order to improve efficiency and production outcomes. Taylor’s time and motion studies were furthered by Frank Gilbreth, who used film to capture workers in action to gain a better understanding of physical movements.  

In the following video, you can see the work of Frank


Reading: Fredrick Taylor’s Scientific Management | 875
Gilbreth, along with his wife Lilian, as they attempted to use time and motion techniques to make bricklaying more effective, productive, and profitable.

In the first half of the video, the initial configuration of the scaffolding required the bricklayers to do a lot of bending. The bending motion not only took more time but also increased the workers’ fatigue as the day wore on, making them less effective and productive. In the second half of the video, after the time and motion study, you saw the solution: a new scaffolding arrangement that no longer required bending over to pick up the bricks. It was time and motion studies like these that enabled researchers (and employers) to investigate the mechanics of doing work—which, in
many cases, led to genuine improvements in worker conditions and work techniques.

Taylor's mechanistic vision applied to organizations as a whole: ideally, work tasks would be clearcut and simple, and the sum total of employees efficiently performing their tasks would be a company that runs like a well-functioning machine.

Taylor's ideas do not leave much room for flexibility, creativity, or originality on the worker's part. In his view, there is a strong and necessary division between managers, who do the thinking, and workers, who do the laboring. Nor do Taylor's scientific principles address the messier, more human side of organizational management—things like interpersonal relationships, work motivation, and turbulence in organizations. Taylor didn’t think it was important to build rapport with workers. Managers ought to communicate in a straightforward manner; employees don't need to give input—they just need to know how to do their jobs.

Though Taylor's ideas were wildly popular in their day, they had detractors even then. As early as 1912, the U.S. Commission on Industrial Relations expressed skepticism about scientific management (what many were calling “Taylorism”):

To sum up, scientific management in practice generally tends to weaken the competitive power of the individual worker and thwarts the formation of shop groups and weakens group solidarity; moreover, generally scientific management is lacking in the arrangements and machinery necessary for the actual voicing of the workers ideas and complaints and for the democratic consideration and adjustment of grievances.7

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=211
Outcome: The Hawthorne Effect

What you’ll learn to do: describe the Hawthorne effect and its significance in managing employees

The Hawthorne effect refers to the phenomenon of people appearing to perform differently and usually better when they are observed. The phrase was an unexpected outcome of studies conducted at the Western Electric Hawthorne Works plant in the 1920s. The studies were conducted by Elton Mayo and his colleagues, who were attempting to test Frederick Taylor's scientific management theories in an actual work environment. As you read the following section, consider the dramatic effect these studies have had on management within organizations and our understanding of how different factors impact worker performance.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Hawthorne Studies
- Self Check: The Hawthorne Effect

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
184. Reading: The Hawthorne Studies

Results of the Hawthorne Studies

The Hawthorne studies were conducted on workers at the Hawthorne plant of the Western Electric Company by Elton Mayo and Fritz Roethlisberger in the 1920s. The Hawthorne studies were part of a refocus on managerial strategy incorporating the socio-psychological aspects of human behavior in organizations.

The following video from the AT&T archives contains interviews with individuals who participated in these studies. It provides additional insight into the way the studies were conducted and how they changed employers’ views on worker motivation.
The studies originally looked into whether workers were more responsive and worked more efficiently under certain environmental conditions, such as improved lighting. The results were surprising: Mayo and Roethlisberger found that workers were more responsive to social factors—such as the people they worked with on a team and the amount of interest their manager had in their work—than the factors (lighting, etc.) the researchers had gone in to inspect.

The Hawthorne studies discovered that workers were highly responsive to additional attention from their managers and the feeling that their managers actually cared about, and were interested in, their work. The studies also found that although financial motives are important, social issues are equally important factors in worker productivity.

There were a number of other experiments conducted in the Hawthorne studies, including one in which two women were chosen as test subjects and were then asked to choose four other workers to join the test group. Together, the women worked assembling telephone relays in a separate room over the course of five years (1927–1932). Their output was measured during this time—at first, in secret. It started two weeks before moving the women to an experiment room and continued throughout the study. In the experiment room, they had a supervisor who discussed changes with them and, at times, used the women's suggestions. The researchers then spent five years measuring how different variables impacted both the group's and the individuals' productivity. Some of the variables included giving two five-minute breaks (after a
discussion with the group on the best length of time), and then changing to two 10-minute breaks (not the preference of the group).

Intangible Motivators

Changing a variable usually increased productivity, even if the variable was just a change back to the original condition. Researchers concluded that the employees worked harder because they thought they were being monitored individually. Researchers hypothesized that choosing one’s own coworkers, working as a group, being treated as special (as evidenced by working in a separate room), and having a sympathetic supervisor were the real reasons for the productivity increase.

The Hawthorne studies showed that people’s work performance is dependent on social issues and job satisfaction, and that monetary incentives and good working conditions are generally less important in improving employee productivity than meeting individuals’ need and desire to belong to a group and be included in decision making and work.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=213
What you’ll learn to do: explain need-based theories of worker motivation, including Maslow’s hierarchy of needs and Herzberg’s two-factor theory

The earliest answer to motivation involved understanding individual needs. Specifically, early researchers thought that employees try hard and demonstrate goal-driven behavior to satisfy needs. For example, an employee who is always walking around the office talking to people may have a need for companionship, and his behavior may be a way of satisfying that need. There are four major theories in the need-based category: Maslow’s hierarchy of needs, ERG theory, Herzberg’s two-factor theory, and McClelland’s acquired-needs theory.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Need-Based Motivation Theories
- Self Check: Need-Based Theories

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Maslow’s Hierarchy of Needs

Abraham Maslow is among the most prominent psychologists of the twentieth century, and the hierarchy of needs, accompanied by the pyramid representing how human needs are ranked (see Figure 1, below), is an idea familiar to most business students and managers. Maslow’s theory is based on a simple premise: Human beings have needs that are hierarchically ranked. Some needs are basic to all human beings, and in their absence, nothing else matters. As we satisfy these basic needs, we start looking to satisfy higher-order needs. Once a lower-level need is satisfied, it no longer serves as a motivator.

The most basic of Maslow’s needs are physiological needs. Physiological needs refer to the need for air, food, and water. Imagine being very hungry. At that point, all your behavior will probably be directed at finding food. Once you eat, though, the search for food ceases and the promise of food no longer serves as a motivator. Once physiological needs are satisfied, people tend to become concerned about safety. Are they safe from danger, pain, or an uncertain future? One level up, social needs refer to the need to bond with other human beings, to be loved, and to form lasting attachments. In fact, having no attachments can negatively

affect health and well-being.\textsuperscript{2} The satisfaction of social needs makes esteem needs more salient. Esteem needs refer to the desire to be respected by one’s peers, feeling important, and being appreciated. Finally, at the highest level of the hierarchy, the need for self-actualization refers to “becoming all you are capable of becoming.” This need manifests itself by acquiring new skills, taking on new challenges, and behaving in a way that will lead to the satisfaction of one’s life goals.

Maslow’s hierarchy is a systematic way of thinking about the

different needs employees may have at any given point and explains different reactions they may have to similar treatment. An employee who is trying to satisfy her esteem needs may feel gratified when her supervisor praises her. However, another employee who is trying to satisfy his social needs may resent being praised by upper management in front of peers if the praise sets him apart from the rest of the group.

So, how can organizations satisfy their employees' various needs? By leveraging the various facets of the planning-organizing-leading-controlling (P-O-L-C) functions. In the long run, physiological needs may be satisfied by the person's paycheck, but it is important to remember that pay may satisfy other needs such as safety and esteem as well. Providing generous benefits, including health insurance and company-sponsored retirement plans, as well as offering a measure of job security, will help satisfy safety needs. Social needs may be satisfied by having a friendly environment, providing a workplace conducive to collaboration and communication with others. Company picnics and other social get-togethers may also be helpful if the majority of employees are motivated primarily by social needs (but may cause resentment if they are not and if they have to sacrifice a Sunday afternoon for a company picnic). Providing promotion opportunities at work, recognizing a person's accomplishments verbally or through more formal reward systems, job titles that communicate to the employee that one has achieved high status within the organization are among the ways of satisfying esteem needs. Finally, self-actualization needs may be satisfied by providing development and growth opportunities on or off the job, as well as by assigning interesting and challenging work. By making the effort to satisfy the different needs each employee may have at a given time, organizations may ensure a more highly motivated workforce.
ERG Theory

The ERG theory of Clayton Alderfer is a modification of Maslow's hierarchy of needs. Instead of the five needs that are hierarchically organized, Alderfer proposed that basic human needs may be grouped under three categories: Existence, Relatedness, and Growth (see Figure 2, below). Existence need corresponds to Maslow's physiological and safety needs, relatedness corresponds to social needs, and growth need refers to Maslow's esteem and self-actualization.

ERG theory’s main contribution to the literature is its relaxation of Maslow’s assumptions. For example, ERG theory does not rank needs in any particular order and explicitly recognizes that more than one need may operate at a given time. Moreover, the theory has a “frustration-regression” hypothesis, suggesting that individuals who are frustrated in their attempts to satisfy one need may regress to another one. For example, someone who is frustrated by the lack of growth opportunities in his job and slow progress toward career goals may regress to relatedness needs and start spending more time socializing with one’s coworkers. The
implication of this theory is that we need to recognize the multiple needs that may be driving an individual at a given point to understand his behavior and to motivate him.

Two-Factor Theory

Frederick Herzberg approached the question of motivation in a different way. By asking individuals what satisfies them on the job and what dissatisfies them, Herzberg came to the conclusion that aspects of the work environment that satisfy employees are very different from aspects that dissatisfy them. \(^4\) Herzberg labeled factors causing dissatisfaction of workers as “hygiene” factors because these factors were part of the context in which the job was performed, as opposed to the job itself. Hygiene factors included company policies, supervision, working conditions, salary, safety, and security on the job. To illustrate, imagine that you are working in an unpleasant work environment. Your office is too hot in the summer and too cold in the winter. You are being harassed and mistreated. You would certainly be miserable in such a work environment. However, if these problems were solved (your office temperature is just right and you are not harassed at all), would you be motivated? Most likely you would take the situation for granted. In fact, many factors in our work environment are things that we miss when they are absent but take for granted if they are present.

In contrast, motivators are factors that are intrinsic to the job, such as achievement, recognition, interesting work, increased

responsibilities, advancement, and growth opportunities. According to Herzberg's research, motivators are the conditions that truly encourage employees to try harder.

Herzberg's research, which is summarized in Figure 3, above, has received its share of criticism. One criticism relates to the classification of the factors as hygiene or motivator. For example, pay is viewed as a hygiene factor. However, pay is not necessarily a contextual factor and may have symbolic value by showing employees that they are being recognized for their contributions as well as communicating to them that they are advancing within the company. Similarly, quality of supervision or relationships employees form with their supervisors may determine whether they are assigned interesting work, whether they are recognized for their potential, and whether they take on more responsibilities. Despite its limitations, the two-factor theory can be a valuable aid to

managers because it points out that improving the environment in which the job is performed goes only so far in motivating employees.

**Acquired-Needs Theory**

Among the need-based approaches to motivation, Douglas McClelland’s acquired-needs theory is the one that has received the greatest amount of support. According to this theory, individuals acquire three types of needs as a result of their life experiences. These needs are need for achievement, need for affiliation, and need for power. All individuals possess a combination of these needs. Those who have a high need for achievement have a strong need to be successful. A worker who derives great satisfaction from meeting deadlines, coming up with brilliant ideas, and planning his or her next career move may be high in need for achievement. Individuals high on need for achievement are well suited to positions such as sales, where there are explicit goals, feedback is immediately available, and their effort often leads to success. Because of their success in lower-level jobs, those in high need for achievement are often promoted to higher-level positions.


However, a high need for achievement has important disadvantages in management. Management involves getting work done by motivating others. When a salesperson is promoted to be a sales manager, the job description changes from actively selling to recruiting, motivating, and training salespeople. Those who are high in need for achievement may view managerial activities such as coaching, communicating, and meeting with subordinates as a waste of time. Moreover, they enjoy doing things themselves and may find it difficult to delegate authority. They may become overbearing or micromanaging bosses, expecting everyone to be as dedicated to work as they are, and expecting subordinates to do things exactly the way they are used to doing.8

Individuals who have a high need for affiliation want to be liked and accepted by others. When given a choice, they prefer to interact with others and be with friends.9 Their emphasis on harmonious interpersonal relationships may be an advantage in jobs and occupations requiring frequent interpersonal interaction, such as social worker or teacher. In managerial positions, a high need for affiliation may again serve as a disadvantage because these individuals tend to be overly concerned about how they are perceived by others. Thus, they may find it difficult to perform some aspects of a manager’s job such as giving employees critical feedback or disciplining poor performers.

Finally, those with high need for power want to influence others and control their environment. Need for power may be destructive of one's relationships if it takes the form of seeking and using power for one's own good and prestige. However, when it manifests itself in more altruistic forms, such as changing the way things are done so that the work environment is more positive or negotiating more resources for one's department, it tends to lead to positive outcomes. In fact, need for power is viewed as important for effectiveness in managerial and leadership positions.¹⁰

McClelland’s theory of acquired needs has important implications for motivating employees. While someone who has high need for achievement may respond to goals, those with high need for affiliation may be motivated to gain the approval of their peers and supervisors, whereas those who have high need for power may value gaining influence over the supervisor or acquiring a position that has decision-making authority. And, when it comes to succeeding in managerial positions, individuals who are aware of the drawbacks of their need orientation can take steps to overcome these drawbacks.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=215
What you’ll learn to do: explain process-based theories of motivation

In contrast to the need-based theories we have covered so far, process-based theories view motivation as a rational process. Individuals analyze their environment, develop reactions and feelings, and react in certain ways. In this section we will review equity theory, expectancy theory, and reinforcement theory.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Process-Based Theories
- Self Check: Process-Based Theories

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Equity Theory

Imagine that your friend Marie is paid $10 an hour working as an office assistant. She has held this job for six months. She is very good at what she does, she comes up with creative ways to make things easier in the workplace, and she is a good colleague who is willing to help others. She stays late when necessary and is flexible if asked to rearrange her priorities or her work hours. Now imagine that Marie finds out her manager is hiring another employee, Spencer, who is going to work with her, who will hold the same job title and will perform the same type of tasks. Spencer has more advanced computer skills, but it is unclear whether these will be used on the job. The starting pay for Spencer will be $14 an hour. How would Marie feel? Would she be as motivated as before, going above and beyond her duties?

If your reaction to this scenario was along the lines of “Marie would think it’s unfair,” your feelings may be explained using equity theory. According to this theory, individuals are motivated by a sense of fairness in their interactions. Moreover, our sense of fairness is a result of the social comparisons we make. Specifically, we compare our inputs and outputs with someone else’s inputs and outputs. We perceive fairness if we believe that the input-to-output ratio we are bringing into the situation is similar to the input/output ratio of a comparison person, or a referent. Perceptions of inequity create tension within us and drive us to action that will
reduce perceived inequity. This process is illustrated in the Equity Formula.¹

What Are Inputs and Outputs?

Inputs are the contributions the person feels he or she is making to the environment. In the previous example, the hard work Marie was providing, loyalty to the organization, the number of months she has worked there, level of education, training, and her skills may have been relevant inputs. Outputs are the rewards the person feels he or she is receiving from the situation. The $10 an hour Marie is receiving was a salient output. There may be other outputs, such as the benefits received or the treatment one gets from the boss. In the prior example, Marie may reason as follows: “I have been working here for six months. I am loyal and I perform well (inputs). I am paid $10 an hour for this (outputs). The new guy, Spencer, does

not have any experience here (referent’s inputs) but will be paid $14 (referent’s outcomes). This situation is unfair.”

We should emphasize that equity perceptions develop as a result of a subjective process. Different people may look at exactly the same situation and perceive different levels of equity. For example, another person may look at the same scenario and decide that the situation is fair because Spencer has computer skills and the company is paying extra for these skills.

Who Is the Referent?

The referent other may be a specific person or an entire category of people. For example, Marie might look at want ads for entry-level clerical workers and see whether the pay offered is in the $10-per-hour range; in this case, the referent other is the category of entry-level clerical workers, including office assistants, in Marie’s local area. Referents should be comparable to us—otherwise the comparison is not meaningful. It would be illogical for Marie to compare herself to the CEO of the company, given the differences in the nature of inputs and outcomes. Instead, she would logically compare herself to those performing similar tasks within the same organization or a different organization.

Reactions to Unfairness

The theory outlines several potential reactions to perceived inequity, which are summarized in Table 1, “Potential Responses to Inequity.” Oftentimes, the situation may be dealt with perceptually, by distorting our perceptions of our own or referent’s inputs and outputs. For example, Marie may justify the situation by downplaying her own inputs (“I don’t really work very hard on this
job”), valuing the outputs more highly (“I am gaining valuable work experience, so the situation is not that bad”), distorting the other person’s inputs (“Spencer really is more competent than I am and deserves to be paid more”) or distorting the other person’s outputs (“Spencer gets $14 but will have to work with a lousy manager, so the situation is not unfair”).

<table>
<thead>
<tr>
<th>Reactions to Inequity</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distort perceptions</td>
<td>Changing one’s thinking to believe that the referent actually is more skilled than previously thought</td>
</tr>
<tr>
<td>Increase referent’s inputs</td>
<td>Encouraging the referent to work harder</td>
</tr>
<tr>
<td>Reduce own input</td>
<td>Deliberately putting forth less effort at work. Reducing the quality of one’s work</td>
</tr>
<tr>
<td>Increase own outcomes</td>
<td>Negotiating a raise for oneself or using unethical ways of increasing rewards such as stealing from the company</td>
</tr>
<tr>
<td>Change referent</td>
<td>Comparing oneself to someone who is worse off</td>
</tr>
<tr>
<td>Leave the situation</td>
<td>Quitting one’s job</td>
</tr>
<tr>
<td>Seek legal action</td>
<td>Suing the company or filing a complaint if the unfairness in question is under legal protection</td>
</tr>
</tbody>
</table>

Table 1. Potential Responses to Inequity

Another way of addressing perceived inequity is to reduce one’s own inputs or increase one’s own outputs. If Marie works less hard, perceived inequity would be reduced. And, indeed, research shows that people who perceive inequity tend to reduce their work performance or reduce the quality of their inputs. Increasing one’s outputs can be achieved through legitimate means such as negotiating a pay raise. At the same time, research shows that those feeling inequity sometimes resort to stealing to balance the scales. Other options include changing the comparison person (for example, Marie may learn that others doing similar work in different organizations are paid only minimum wage) and leaving the situation by quitting one’s job. We might even consider taking legal justice: Informational and interpersonal moderators of theft reactions to underpayment inequity. Organizational Behavior and Human Decision Processes, 54, 81–103; Schmidt, D. R., & Marwell, G. (1972). Withdrawal and reward reallocation as responses to inequity. Journal of Experimental Social Psychology, 8, 207–211.


5. Schmidt, D. R., & Marwell, G. (1972). Withdrawal and
action as a potential outcome of perceived inequity. For example, if Marie finds out that the main reason behind the pay gap is gender, she may react to the situation by taking legal action because sex discrimination in pay is illegal in the United States.

Overpayment Inequity

What would you do if you felt you were overrewarded? In other words, how would you feel if you were the new employee, Spencer (and you knew that your coworker Marie was being paid $4 per hour less than you)? Originally, equity theory proposed that overrewarded individuals would experience guilt and would increase their effort to restore perceptions of equity. However, research does not provide support for this argument. Instead, it seems that individuals experience less distress as a result of being overrewarded. It is not hard to imagine that individuals find perceptual ways to deal with a situation like this, such as believing that they have more skills and bring more to the situation compared with the referent person. Therefore, research does not support equity theory’s predictions with respect to people who are overpaid.

reward reallocation as responses to inequity. Journal of Experimental Social Psychology, 8, 207–211.
7. Evan, W. M., & Simmons, R. G. (1969). Organizational effects of inequitable rewards: Two experiments in
Individual Differences in Reactions to Inequity

So far, we have assumed that once people feel that the situation is inequitable, they will be motivated to react. However, does inequity disturb everyone equally? Researchers identified a personality trait that explains different reactions to inequity and named this trait equity sensitivity. Equity sensitive individuals experience distress when they feel they are overrewarded or underrewarded and expect to maintain equitable relationships. At the same time, there are some individuals who are benevolents who give without waiting to receive much in return and entitleds who expect to receive a lot without giving much in return. Thus, the theory is more useful in explaining the behavior of equity sensitive individuals, and organizations will need to pay particular attention to how these individuals view their relationships.

Fairness Beyond Equity: Procedural and Interactional Justice

Equity theory looks at perceived fairness as a motivator. However, the way equity theory defines fairness is limited to fairness regarding rewards. Starting in the 1970s, researchers of workplace fairness began taking a broader view of justice. Equity theory deals with outcome fairness, and therefore, it is considered to be a status inconsistency. IEEE Engineering Management Review, 1, 95–108.

distributive justice theory. Distributive justice refers to the degree to which the outputs received from the organization are fair. Two other types of fairness have been identified: procedural justice and interactional justice.

Let's assume that Marie found out she is getting a promotion that will include a pay raise, increased responsibilities, and prestige. If Marie feels she deserves to be promoted, she would perceive high distributive justice ("getting the promotion is fair"). However, Marie later found out that the department manager picked her name out of a hat! What would she feel? She might still like the outcome but feel that the decision-making process was unfair since it wasn't based on performance. This response would involve feelings of procedural injustice. Procedural justice refers to the degree to which fair decision-making procedures are used. Research shows that employees care about procedural justice for many organizational decisions, including layoffs, employee selection, surveillance of employees, performance appraisals, and pay decisions.  

They tend to care about procedural justice particularly when they do not get the outcome they feel they deserve.

If Marie


does not get the promotion and finds out that management chose the candidate by picking a name out of a hat, she may view this as adding insult to injury. When people do not get the rewards they want, they tend to hold management responsible if procedures are not fair.\textsuperscript{11}

Research has identified many ways of achieving procedural justice. For example, giving employees advance notice before laying them off, firing them, or disciplining them is perceived as fairer.\textsuperscript{12} Allowing employees voice into decision making is also important.\textsuperscript{13}


When designing a performance appraisal system or implementing a reorganization, asking employees for their input may be a good idea because it increases perceptions of fairness. Even when it is not possible to have employees participate, providing explanations is helpful in fostering procedural justice. Finally, people expect consistency in treatment. If one person is given extra time when taking a test while another is not, individuals would perceive decision making as unfair.

Now let’s imagine Marie’s boss telling her she is getting the promotion. The manager’s exact words: “Yes, Marie, we are giving you the promotion. The job is so simple that we thought even you can handle it.” Now what is Marie’s reaction? The unpleasant feelings she may now experience are explained by interactional justice. Interactional justice refers to the degree to which people are treated with respect, kindness, and dignity in interpersonal interactions. We expect to be treated with dignity by our peers, supervisors, and customers. When the opposite happens, we feel angry. Even when faced with negative outcomes such as a pay cut, being treated with dignity and respect serves as a buffer and alleviates our stress.

Employers would benefit from paying attention to all three types of justice perceptions. In addition to being the right thing to do, justice perceptions lead to outcomes companies care about. Injustice is directly harmful to employee psychological health and well-being and contributes to stress.\textsuperscript{17} High levels of justice create higher levels of employee commitment to organizations, are related to higher job performance, higher levels of organizational citizenship (behaviors that are not part of one's job description but help the organization in other ways such as speaking positively about the company and helping others), and higher levels of customer satisfaction, whereas low levels of justice lead to retaliation and supporting union certification movements.\textsuperscript{18}


Expectancy Theory

According to expectancy theory, individual motivation to put forth more or less effort is determined by a rational calculation. According to this theory, individuals ask themselves three questions.


The first question is whether the person believes that high levels of effort will lead to desired outcomes. This perception is labeled as expectancy. For example, do you believe that the effort you put forth in a class is related to learning worthwhile material and receiving a good grade? If you do, you are more likely to put forth effort.

The second question is the degree to which the person believes that performance is related to secondary outcomes such as rewards. This perception is labeled as instrumentality. For example, do you believe that passing the class is related to rewards such as getting a better job, or gaining approval from your instructor, from your friends, or parents? If you do, you are more likely to put forth effort.

Finally, individuals are also concerned about the value of the rewards awaiting them as a result of performance. The anticipated satisfaction that will result from an outcome is labeled as valence. For example, do you value getting a better job or gaining approval from your instructor, friends, or parents? If these outcomes are desirable to you, you are more likely to put forth effort.

As a manager, how can you influence these perceptions to motivate employees? In fact, managers can influence all three
perceptions. To influence their expectancy perceptions, managers may train their employees, or hire people who are qualified for the jobs in question. Low expectancy may also be due to employees feeling that something other than effort predicts performance, such as political behaviors on the part of employees. In this case, clearing the way to performance and creating an environment in which employees do not feel blocked will be helpful. The first step in influencing instrumentality is to connect pay and other rewards to performance using bonuses, award systems, and merit pay. Publicizing any contests or award programs is helpful in bringing rewards to the awareness of employees. It is also important to highlight that performance and not something else is being rewarded. For example, if a company has an employee-of-the-month award that is rotated among employees, employees are unlikely to believe that performance is being rewarded. In the name of being egalitarian, such a reward system may actually hamper the motivation of highest performing employees by eroding instrumentality. Finally, to influence valence, managers will need to find out what their employees value. This can be done by talking to employees, or surveying them about what rewards they find valuable.

**Reinforcement Theory**

Reinforcement theory is based on the work of Ivan Pavlov in behavioral conditioning and the later work B. F. Skinner did on

operant conditioning. According to this theory, behavior is a function of its consequences. Imagine that even though no one asked you to, you stayed late and drafted a report. When the manager found out, she was ecstatic and took you out to lunch and thanked you genuinely. The consequences following your good deed were favorable, and therefore you are more likely to do similar good deeds in the future. In contrast, if your manager had said nothing about it and ignored the sacrifice you made, you would be less likely to demonstrate similar behaviors in the future, or your behavior would likely become extinct.

Despite the simplicity of reinforcement theory, how many times have you seen positive behavior ignored or, worse, negative behavior rewarded? In many organizations, this is a familiar scenario. People go above and beyond the call of duty, and yet their behaviors are ignored or criticized. People with disruptive habits may receive no punishments because the manager is afraid of the reaction the person will give when confronted. They may even receive rewards such as promotions so that the person is transferred to a different location and becomes someone else’s problem! Moreover, it is common for people to be rewarded for the wrong kind of behavior. Steven Kerr labeled this phenomenon “the folly of rewarding A while hoping for B.” For example, a company may make public statements about the importance of quality. Yet, they choose to reward shipments on time regardless of the number of known defects contained in the shipments. As a result, employees are more likely to ignore quality and focus on hurrying the delivery process.

Reinforcement Interventions

Reinforcement theory describes four interventions to modify employee behavior. Two of these are methods of increasing the frequency of desired behaviors while the remaining two are methods of reducing the frequency of undesired behaviors.

Positive reinforcement is a method of increasing the desired behavior. Positive reinforcement involves making sure that behavior is met with positive consequences. Praising an employee for treating a customer respectfully is an example of positive reinforcement. If the praise immediately follows the positive behavior, it is more effective.

behavior, the employee will see a link between behavior and positive consequences and will be motivated to repeat similar behaviors.

Negative reinforcement is also used to increase the desired behavior. Negative reinforcement involves removal of unpleasant outcomes once desired behavior is demonstrated. Nagging an employee to complete a report is an example of negative reinforcement. The negative stimulus in the environment will remain present until positive behavior is demonstrated. The problem with negative reinforcement may be that the negative stimulus may lead to unexpected behaviors and may fail to stimulate the desired behavior. For example, the person may start avoiding the manager to avoid being nagged.

Extinction occurs when a behavior ceases as a result of receiving no reinforcement. For example, suppose an employee has an annoying habit of forwarding e-mail jokes to everyone in the department, cluttering up people's in-boxes and distracting them from their work. Commenting about the jokes, whether in favorable or unfavorable terms, may be encouraging the person to keep forwarding them. Completely ignoring the jokes may reduce their frequency.

Punishment is another method of reducing the frequency of undesirable behaviors. Punishment involves presenting negative consequences following unwanted behaviors. Giving an employee a warning for consistently being late to work is an example of punishment.

Reinforce for Performance

This is a systematic application of reinforcement theory to modify employee behaviors. The model consists of five stages. The process starts with identifying the behavior that will be modified. Let’s assume that we are interested in reducing absenteeism among employees. In step 2, we need to measure the baseline level of
absenteeism. In step 3, the behavior’s antecedents and consequences are determined. Why are employees absent? More importantly, what is happening when an employee is absent? If the behavior is being unintentionally rewarded, we may expect these to reinforce absenteeism behavior. For example, suppose that absences peak each month on the days when a departmental monthly report is due, meaning that coworkers and supervisors must do extra work to prepare the report. To reduce the frequency of absenteeism, it will be necessary to think of financial or social incentives to follow positive behavior and negative consequences to follow negative behavior. In step 4, an intervention is implemented. Removing the positive consequences of negative behavior may be an effective way of dealing with the situation, for example, starting the monthly report preparation a few days earlier, or letting employees know that if they are absent when the monthly report is being prepared, their contribution to the report will be submitted as incomplete until they finish it. Punishments may be used in persistent cases. Finally, in step 5 the behavior is measured periodically and maintained. Studies examining the effectiveness of OB Mod have been supportive of the model in general. A review of the literature found that OB Mod interventions resulted in an average of 17% improvement in performance.24

Properly designed sales commissions are widely used to motivate sales employees. The blend of straight salary and commissions should be carefully balanced to achieve optimum sales volume, profitability, and customer satisfaction.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Outcome: Theory X vs. Theory Y

What you’ll learn to do: compare and contrast Theory X and Theory Y managers

When we consider what motivates employees, we also need to think about the impact of the manager’s attitudes on those employees’ motivation. This idea was originally proposed by Douglas McGregor, a management professor at the Massachusetts Institute of Technology during the 1950s and 1960s. McGregor believed that managers have one of two management styles, which he called “Theory X” and “Theory Y.” In this section you’ll learn more about these styles and how they relate to worker motivation. As you read, see if the descriptions fit anyone you have worked for.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Douglas McGregor’s Theory X and Theory Y
• Self Check: Theory X vs. Theory Y

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Douglas McGregor’s Theory X and Theory Y

In his 1960 management book, The Human Side of Enterprise, Douglas McGregor made his mark on the history of organizational management and motivational psychology when he proposed the two theories by which managers perceive employee motivation. He referred to these opposing motivational methods as Theory X and Theory Y management. Each assumes that the manager's role is to organize resources, including people, to best benefit the company. However, beyond this commonality, they're quite dissimilar.

Theory X Management

According to McGregor, Theory X leadership assumes the following:

• Work is inherently distasteful to most people, and they will attempt to avoid work whenever possible.
• Most people are not ambitious, have little desire for responsibility, and prefer to be directed.
• Most people have little aptitude for creativity in solving organizational problems.
• Motivation occurs only at the physiological and security levels of Maslow’s Needs Hierarchy.
• Most people are self-centered. As a result, they must be closely
controlled and often coerced to achieve organizational objectives

- Most people resist change.
- Most people are gullible and unintelligent.

Essentially, Theory X assumes that the primary source of most employee motivation is monetary, with security as a strong second.

The Hard Approach and Soft Approach

Under Theory X, management approaches to motivation range from a hard approach to a soft approach.

The hard approach to motivation relies on coercion, implicit threats, micromanagement, and tight controls—essentially an environment of command and control. The soft approach, however, is to be permissive and seek harmony in the hopes that, in return, employees will cooperate when asked. However, neither of these extremes is optimal. The hard approach results in hostility, purposely low output, and extreme union demands. The soft approach results in increasing desire for greater reward in exchange for diminishing work output.

It would appear that the optimal approach to human resource management would lie somewhere between these extremes. However, McGregor asserts that neither approach is appropriate since the foundations of Theory X are incorrect.

The Problem with X Theory

Drawing on Maslow’s Hierarchy of Needs, McGregor argues that a need, once satisfied, no longer motivates. The company relies on monetary rewards and benefits to satisfy employees’ lower level
needs. Once those needs have been satisfied, the motivation is gone. This management style, in fact, hinders the satisfaction of higher-level needs. Consequently, the only way that employees can attempt to satisfy higher level needs at work is to seek more compensation, so it is quite predictable that they will focus on monetary rewards. While money may not be the most effective way to self-fulfillment, it may be the only way available. People will use work to satisfy their lower needs and seek to satisfy their higher needs during their leisure time. Unfortunately, employees can be most productive when their work goals align with their higher level needs.

McGregor makes the point that a command-and-control environment is not effective because it relies on lower needs for motivation, but in modern society those needs are mostly satisfied and thus no longer motivate. In this situation, one would expect employees to dislike their work, avoid responsibility, have no interest in organizational goals, resist change, etc., thus creating a self-fulfilling prophecy. To McGregor, motivation seemed more likely with the Theory Y model.

**Theory Y**

The higher-level needs of esteem and self-actualization are continuing needs in that they are never completely satisfied. As such, it is these higher-level needs through which employees can best be motivated.

In strong contrast to Theory X, Theory Y leadership makes the following general assumptions:

- Work can be as natural as play if the conditions are favorable.
- People will be self-directed and creative to meet their work and organizational objectives if they are committed to them.
- People will be committed to their quality and productivity objectives if rewards are in place that address higher needs.
such as self-fulfillment.

- The capacity for creativity spreads throughout organizations.
- Most people can handle responsibility because creativity and ingenuity are common in the population.
- Under these conditions, people will seek responsibility.

Under these assumptions, there is an opportunity to align personal goals with organizational goals by using the employee's own need for fulfillment as the motivator. McGregor stressed that Theory Y management does not imply a soft approach.

McGregor recognized that some people may not have reached the level of maturity assumed by Theory Y and therefore may need tighter controls that can be relaxed as the employee develops.

**XY Theory Management Application: Business Implications for Workforce Motivation**

If Theory Y holds true, an organization can apply these principles of scientific management to improve employee motivation:

- **Decentralization and Delegation**—If firms decentralize control and reduce the number of levels of management, managers will have more subordinates and consequently will be forced to delegate some responsibility and decision making to them.
- **Job Enlargement**—Broadening the scope of an employee's job adds variety and opportunities to satisfy ego needs.
- **Participative Management**—Consulting employees in the decision making process taps their creative capacity and provides them with some control over their work environment.
- **Performance Appraisals**—Having the employee set objectives and participate in the process of evaluating how well they were met ensures that the employee understands the goals of the company and works to support them.
If properly implemented, such an environment would result in a high level of workforce motivation as employees work to satisfy their higher level personal needs through their jobs.

Check Your Understanding

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=219
Outcome: Strategies for Motivating Employees

What you’ll learn to do: identify ways in which managers can use the various motivation theories to motivate individual employees in an increasingly diverse workplace

In this module we’ve focused on a number of well-known theories used to explain human motivation—and employee motivation, in particular. However, a theory is just a theory until it’s translated into actions, policies, procedures, and management practices. In this section you’ll study two methods used by managers to put motivational theory into practice: job models and goals. These two practices can be observed in almost every organization, profit and non-profit alike. You’ll also see some examples of the way companies are actually implementing those practices today.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Job Models and Goals
- Videos: Motivation in Today’s Workplace
- Self Check: Strategies for Motivating Employees

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Job Rotation, Enlargement, and Enrichment

One of the early alternatives to job specialization was job rotation, which involves moving employees from job to job at regular intervals, thereby relieving the monotony and boredom typical in repetitive jobs. For example, Maids International, a company that provides cleaning services to households and businesses, uses job rotation such that maids cleaning the kitchen in one house would clean the bedroom in another house. Using this technique, among others, the company was able to reduce its turnover level. In a study conducted in a supermarket, cashiers were rotated to work in different departments. As a result of the rotation, employee stress level was reduced as measured by their blood pressure. Moreover, they reported fewer pain symptoms in their neck and shoulders.

Job rotation has a number of advantages for organizations. It’s an effective way for employees to acquire new skills, as the rotation involves cross-training to new tasks; this means that organizations

increase the overall skill level of their employees.\textsuperscript{3} In addition, job rotation is a means of knowledge transfer between departments.\textsuperscript{4} For the employees, rotation is a benefit because they acquire new skills, which keeps them marketable in the long run.

Anecdotal evidence suggests that companies successfully rotate high-level employees to train their managers and increase innovativeness in the company. For example, Nokia uses rotation at all levels, such as assigning lawyers to act as country managers or moving network engineers to handset design. These approaches are thought to bring a fresh perspective to old problems.\textsuperscript{5} India’s information technology giant Wipro, which employs about 80,000 employees, uses a 3-year plan to groom future leaders of the company by rotating them through different jobs.\textsuperscript{6}

*Job enlargement* refers to expanding the tasks performed by employees to add more variety. Like job rotation, job enlargement can reduce boredom and monotony as well as use human resources more effectively. When jobs are enlarged, employees view themselves as being capable of performing a broader set of

\begin{thebibliography}{6}
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Job enlargement is positively related to employee satisfaction and higher-quality customer services, and it increases the chances of catching mistakes. At the same time, the effects of job enlargement may depend on the type of enlargement. For example, exclusively giving employees simpler tasks had negative consequences on employee satisfaction with the job of catching errors, whereas giving employees more tasks that require them to be knowledgeable in different areas seemed to have more positive effects.

Job enrichment is a job redesign technique that allows workers more control over how they perform their own tasks, giving them more responsibility. As an alternative to job specialization, companies using job enrichment may experience positive outcomes such as reduced turnover, increased productivity, and reduced absences. This may be because employees who have the authority

and responsibility over their own work can be more efficient, eliminate unnecessary tasks, take shortcuts, and overall increase their own performance. At the same time, there is some evidence that job enrichment may sometimes cause employees to be dissatisfied.\textsuperscript{11} The reason may be that employees who are given additional autonomy and responsibility may expect greater levels of pay or other types of compensation, and if this expectation is not met, they may feel frustrated. One more thing to remember is that job enrichment may not be suitable for all employees.\textsuperscript{12} Not all employees desire to have control over how they work, and if they do not have this desire, they may feel dissatisfied in an enriched job.

**Job Characteristics Model**

The *job characteristics model* is one of the most influential attempts


to design jobs to increase their motivational properties. Proposed in the 1970s by Hackman and Oldham, the model describes five core job dimensions, leading to three critical psychological states, which lead to work-related outcomes. In this model, shown in Figure 1 below, there are five core job dimensions.

![Job Characteristics Model](image)

**Figure 1. Job Characteristics Model. Adapted from Hackman, J. R., & Oldham, G. R. (1975). Development of the job diagnostic survey. Journal of Applied Psychology, 60, 159–170.**

Skill variety refers to the extent to which the job requires the person to use multiple high-level skills. A car wash employee whose job consists of directing employees into the automated carwash demonstrates low levels of skill variety, whereas a car wash employee who acts as a cashier, maintains carwash equipment, and manages the inventory of chemicals demonstrates high skill variety.

Task identity refers to the degree to which the person completes a piece of work from start to finish. A Web designer who designs parts of a Web site will have low task identity because the work blends in with other Web designers’ work, and in the end, it will be hard for the person to claim responsibility for the final output. The Webmaster who designs the entire Web site will have high task identity.

Task significance refers to whether the person’s job substantially...

affects other people’s work, health, or well-being. A janitor who cleans the floor at an office building may find the job low in significance, thinking it is not an important job. However, janitors cleaning the floors at a hospital may see their role as essential in helping patients recover in a healthy environment. When they see their tasks as significant, employees tend to feel that they are making an impact on their environment and their feelings of self worth are boosted.\textsuperscript{14}

Autonomy is the degree to which the person has the freedom to decide how to perform tasks. As an example, a teacher who is required to follow a predetermined textbook, cover a given list of topics, and use a specified list of classroom activities has low autonomy, whereas a teacher who is free to choose the textbook, design the course content, and use any materials she sees fit has higher levels of autonomy. Autonomy increases motivation at work, but it also has other benefits. Autonomous workers are less likely to adopt a “this is not my job” attitude and instead be proactive and creative.\textsuperscript{15} Giving employees autonomy is also a great way to train


them on the job. For example, Gucci’s CEO Robert Polet describes
autonomy he received while working at Unilever as the key to his
development of leadership talents.\textsuperscript{16}

Feedback refers to the degree to which the person learns how
effective he or she is at work. Feedback may come from other
people such as supervisors, peers, subordinates, customers, or from
the job. A salesperson who makes informational presentations to
potential clients but is not informed whether they sign up has low
feedback. If this salesperson receives a notification whenever
someone who has heard his presentation becomes a client, feedback
will be high.

The mere presence of feedback is not sufficient for employees to
feel motivated to perform better, however. In fact, in about one-
third of the cases, feedback was detrimental to performance.\textsuperscript{17} In
addition to whether feedback is present, the character of the
feedback (positive or negative), whether the person is ready to
receive the feedback, and the manner in which feedback was given
will all determine whether employees feel motivated or demotivated
as a result of feedback.


\textsuperscript{17} Kluger, A. N., & DeNisi, A. (1996). The effects of feedback
interventions on performance: A historical review, a
meta-analysis, and a preliminary feedback intervention
Goal Setting Theory

Goal setting theory\(^{18}\) is one of the most influential and practical theories of motivation. It has been supported in over 1,000 studies with employees, ranging from blue-collar workers to research and development employees, and there is strong evidence that setting goals is related to performance improvements.\(^{19}\) In fact, according to one estimate, goal setting improves performance between 10% and 25% or more.\(^{20}\) On the basis of evidence such as this, thousands of companies around the world are using goal setting

in some form, including companies such as Coca-Cola, PricewaterhouseCoopers, Nike, Intel, and Microsoft to name a few.

Setting SMART Goals

The mere presence of a goal does not motivate individuals. Think about New Year’s resolutions that you may have made and failed to keep. Maybe you decided that you should lose some weight but then never put a concrete plan in action. Maybe you decided that you would read more but didn’t. Why did you, like 97% of those who set New Year’s resolutions, fail to meet your goal?

Accumulating research evidence indicates that effective goals are SMART. SMART goals are specific, measurable, achievable, realistic, and timely. Here is a sample SMART goal: Wal-Mart recently set a goal to eliminate 25% of the solid waste from its U.S. stores by the year 2009. This goal meets all the conditions of being SMART if we assume that it is an achievable goal. Even though it seems like a simple concept, in reality many goals that are set within organizations may not be SMART. For example, Microsoft recently conducted an audit of its goal-setting and performance review system and found that only about 40% of the goals were specific and measurable.

There are at least four reasons why goals motivate. First, goals

give us direction; therefore, goals should be set carefully. Giving employees goals that are not aligned with company goals will be a problem because goals will direct employee’s energy to a certain end. Second, goals energize people and tell them not to stop until they reach that point. Third, having a goal provides a challenge. When people have goals and when they reach them, they feel a sense of accomplishment. Finally, SMART goals urge people to think outside the box and rethink how they are working. If a goal is substantially difficult, merely working harder will not get you the results. Instead, you will need to rethink the way you usually work and devise a creative way of working. It has been argued that this is how designers and engineers in Japan came up with the bullet train. Having a goal that went way beyond the current speed of trains prevented engineers from making minor improvements and urged them to come up with a radically different concept. \(^{24}\)

Are There Downsides to Goal Setting?

As with any management technique, there may be some downsides to goal setting. \(^ {25}\) First, setting goals for specific outcomes may

hamper employee performance if employees lack skills and abilities to reach the goals. In these situations, setting goals for behaviors and for learning may be more effective than setting goals for outcomes. Second, goal setting may motivate employees to focus on a goal and ignore the need to respond to new challenges. For example, one study found that when teams had difficult goals and when employees within the team had high levels of performance orientation, teams had difficulty adapting to unforeseen circumstances. Third, goals focus employee attention on the activities that are measured, which may lead to sacrificing other important elements of performance. When goals are set for production numbers, quality may suffer. As a result, it is important to set goals touching on all critical aspects of performance. Finally, aggressive pursuit of goals may lead to unethical behaviors. Particularly when employees are rewarded for goal accomplishment but there are no rewards whatsoever for coming very close to reaching the goal, employees may be tempted to cheat.

None of these theories are complete by themselves, but each theory provides us with a framework we can use to analyze, incentives. Academy of Management Executive, 18, 130–133; Pritchard, R. D., Roth, P. L., Jones, S. D., Galgay, P. J., & Watson, M. D. (1988). Designing a goal-setting system to enhance performance: A practical guide. Organizational Dynamics, 17, 69–78; Seijts, G. H., & Latham, G. P. (2005). Learning versus performance goals: When should each be used? Academy of Management Executive, 19, 124–131.

interpret, and manage employee behaviors in the workplace, which are important skills managers use when conducting their leading function. In fact, motivation is important throughout the entire P-O-L-C framework because most managerial functions involve accomplishing tasks and goals through others.

KEY TAKEAWAYS

By properly tying rewards to positive behaviors, eliminating rewards following negative behaviors and punishing negative behaviors, leaders can increase the frequency of desired behaviors. In job design, there are five components that increase the motivating potential of a job: Skill variety, task identity, task significance, autonomy, and feedback. These theories are particularly useful in designing reward systems within a company. Goal-setting theory is one of the most influential theories of motivation. To motivate employees, goals should be SMART (specific, measurable, achievable, realistic, and timely). Setting goals and objectives is a task managers undertake when involved in the planning portion of the P-O-L-C function.
193. Videos: Motivation in Today's Workplace

Motivation in Today’s Workplace

The following videos give examples of motivational theory being used in today’s companies. As you watch, see if you can recognize any of the theories you’ve studied. Are they need based or process based? What are the results of the different motivational strategies these companies use?

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=222
A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=222
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=222
Putting It Together: Motivating Employees

Summary

In this module you learned about motivation and how organizations can use motivation theory to achieve organizational goals and objectives. The following is a summary of the key points.

Scientific Management

Scientific management is an approach to management proposed by Frederick Taylor in 1913. Taylor believed that some of the same principles that applied to the study of other phenomena could be applied to the workplace. Some of the components of scientific management are still used by organizations today, including organizational charts, sales goals and objectives, and time and motion studies.

The Hawthorne Effect

Conducted at the Western Electric Hawthorne Works plant in Cicero, Illinois, Elton Mayo and his colleagues attempted to apply Taylor's process of scientific management by conducting experiments in the workplace. What resulted is a phenomenon known as the “Hawthorne effect,” which occurs when subjects being
studied change their behavior simply because they are being observed and treated differently.

Need-Based Theories

The first theories used to explain human motivation were need based. These theories proposed that people are mainly motivated by trying to meet certain needs and that if you can understand their needs, you can better motivate them. Among the need-based theories are Maslow’s hierarchy of needs, ERG theory, and Herzberg’s two-factor theory.

Process-Based Theories

Process-based theories of motivation view motivation as a more rational, deliberate process. The three best-known process-based theories are equity, expectancy, and reinforcement theories.

Theory X vs. Theory Y

Douglas McGregor theorized that worker motivation is closely linked to the way managers view and treat their workers and that all managers fall into one of two types—Theory X and Theory Y. In reality, most managers are neither all X or Y but usually a combination of the two.
Strategies for Motivating Employees

Two methods of applying motivation theory in the workplace are job models and goal setting. Beyond these two applications, companies have become very aware of the way motivated employees impact organizational effectiveness and efficiency.

Synthesis

Have you ever heard the expression “stubborn as a mule” and heard it used to describe someone who won’t change their mind or way of doing things? What would it take to get such a mulish person to change, to work in a different way—say, more efficiently or effectively? Well, now that you have some motivational theories under your belt, you probably have some ideas. Being able to motivate people is obviously an invaluable skill—in business and in life—and it’s not surprising that the most effective leaders and managers are those who can inspire others to work hard and get things done.

At the beginning of this module you were asked what motivates you, how you motivate others, and which strategies have worked (or not worked) for you. Now that you have completed the module, reflect on your answers to those questions. Can you identify some of these motivational theories at work in your own motivations? Do you have a better understanding of where your own motivation comes from?

One last thought as we conclude the module. When you came up
with your list of motivating factors, it was your list. What motivates you might not motivate the person working beside you. So, as you interact with people throughout your personal and professional life, keep in mind that motivation is highly variable. It doesn't mean that the theories are wrong or completely irrelevant—it's just that everyone, like you, is motivated by a different set of needs, wants, and aspirations, and you'll need to understand those differences before creatively engaging with them. If you can, you'll be well on your way to being an effective leader and achieving great things.
PART XII

MODULE II: HUMAN RESOURCE MANAGEMENT

Why recognize the role of human resource management in planning, recruiting, and managing a workforce?

It’s the early 1900s and you are twelve years old, living in an American city where industrialization has begun to boom. On Monday morning at 5 a.m., you line up with the rest of your family to begin your long workday at a textile factory. If it isn’t terribly busy you will end your day around 8:00 p.m. You visit with your parents and siblings during your fifteen-minute lunch break. The factory where you work is not heated, has no ventilation system, and the windows can’t be opened to let the exhaust fumes from the machinery escape. Since you are small, your responsibility is to climb in between the machinery and dislodge pieces of material that get caught in the gears and belts—while the machines are still running. You have to be especially careful because the only light in the factory is the sunlight that comes through the dirty
windows. If you are not killed or maimed by the equipment, chances are good that your life will be cut short by the toxic fumes you inhale while in the factory. Every member of your family works there, including your four-year-old sister. Your father, the most highly skilled worker in the family, makes about ten cents per hour, your mother makes about half that since she's a woman, and you, as a child, make even less. Fortunately you don’t have to worry about doing homework, because you don’t attend school, and you'll learn to read and write only if your parents teach you on Sunday—the one day of the week when you don't go to work.

Grim working conditions similar to these continued for decades in America until labor unions formed and activists began to lobby for worker protections. It's hard, today, to imagine what those conditions really must have been like. We have always worked in conditions regulated for health and safety. We aren't forced to work for pennies per day. Understanding how far we have come in terms of employee rights and protections is an important context for thinking about human resource management. As you work through this section, try to keep this historical perspective in mind.

Learning Outcomes

- Define human resource management and explain how managers develop and implement a human resource plan
- Identify the areas where legislation and law affect the employer-employee relationship: labor laws/unions, workplace safety, equal opportunity, and civil rights
- Describe the methods businesses use to recruit employees
- Identify the steps in appraising employee performance
- Discuss the challenges faced by human resource managers in today's business environment, such as outsourcing, aging workforce, technological advances
What do all businesses have in common regardless of the product, good, or service? EMPLOYEES! Unless you are a business of one, you will have to navigate through the process of planning for, recruiting, hiring, training, managing, and possibly firing employees. This is a broad but not exhaustive list of the functions that the HR department performs in order to keep a business running and well staffed. Again you’ll notice that the word plan appears in your learning outcome! This is because every detail such the number, qualification, salary, and location of every cashier, accountant, lawyer, or carpenter who works in an organization is the result of thoughtful planning on the part of human resource managers. Let’s get started by taking a closer look at some of the many components that make up a human resource plan.
LEARNING ACTIVITIES

The learning activities for this section include:

• Video: Hiring the Right Employees
• Reading: Human Resource Management
• Self Check: Human Resource Management

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
197. Video: Hiring the Right Employees

Hiring the Right Employees

How do hiring decisions affect a company's success? Zappos is well known for consistently providing excellent customer service. In the video below, CEO Tony Hsieh explains how company values drive their hiring decisions.

https://www.youtube.com/watch?v=VQ6rVsqfMiQ
Employees at Starbucks are vital to the company’s success—they are its public face, and every dollar of sales passes through their hands. According to Howard Schultz, they can make or break the company. If a customer has a positive interaction with an employee, the customer will come back. If an encounter is negative, the customer is probably gone for good. That’s why it’s crucial for Starbucks to recruit and hire the right people, train them properly, motivate them to do their best, and encourage them to stay with the company. Thus, the company works to provide satisfying jobs, a positive work environment, appropriate work schedules, and fair compensation and benefits. These activities are part of Starbucks’s strategy to deploy human resources in order to gain competitive advantage. The process is called human resource management (HRM), which consists of all actions that an organization takes to attract, develop, and retain quality employees. Each of these activities is complex. Attracting talented employees involves the recruitment of qualified candidates and the selection of those who best fit the organization’s needs. Development encompasses both new-employee orientation and the training and development of current workers. Retaining good employees means motivating them to excel, appraising their performance, compensating them fairly, and doing what’s possible to retain them.
Human Resource Planning

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

A strategic HR plan lays out the steps that an organization will take to ensure that it has the right number of employees with the right skills in the right places at the right times. HR managers begin by analyzing the company’s mission, objectives, and strategies. Starbucks’s objectives, for example, include the desire to “develop enthusiastically satisfied customers” as well as to foster an environment in which employees treat both customers and each other with respect. Thus, the firm’s HR managers look for people who are “adaptable, self-motivated, passionate, creative team members.” Likewise, Disney’s overall objectives include not only making all visitors feel as if they’re special in a special place but also ensuring that employees’ appearance reflects a special image (there’s even a forty-seven-page book on the subject). Disney looks for people who best fulfill these job requirements. The main goal of Norwegian Cruise Lines—to lavish passengers with personal attention—determines not only the type of employee desired (one with exceptionally good customer-relation skills and a strong work ethic) but also the number needed (one for every two passengers on the *Norwegian Dawn*).
Job Analysis

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

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

HR Supply and Demand Forecasting

Once they’ve analyzed the jobs within the organization, HR managers must forecast future hiring (or firing) needs. This is the three-step process summarized below in Figure 1, “How to Forecast Hiring (and Firing) Needs”:
Starbucks, for instance, might find that it needs three hundred new employees to work at stores scheduled to open in the next few months. Disney might determine that it needs two thousand new cast members to handle an anticipated surge in visitors. The *Norwegian Dawn* might be short two dozen restaurant workers because of an unexpected increase in reservations.

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

*Figure 1. How to Forecast Hiring (and Firing) Needs*
Recruiting Qualified Employees

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

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

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

The first step in recruiting is to find qualified candidates. Where do you look for them, and how do you decide whether they're qualified? Let's start with the second part of the question first. A qualified person must be able to perform the duties listed in the job description and must possess the skills, knowledge, and abilities detailed in the job specification. In addition, he or she must be a good “fit” for the company. A Disney recruiter, for example, wants a candidate who fits a certain image—someone who's clean-cut and “wholesome” looking. The same recruiter might also favor candidates with certain qualities—someone who has a “good attitude,” who's a “go-getter” and a “team player,” and who's smart, responsible, and stable.

Internal vs. External Recruiting

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

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

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

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

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

Recruiting gets people to apply for positions, but once you’ve received applications, you still have to select the best candidate—another complicated process. The selection process entails gathering information on candidates, evaluating their qualifications, and choosing the right one. At the very least, the process can be time-consuming—particularly when you’re filling a high-level position—and often involves several members of an organization.

Let’s examine the selection process more closely by describing the steps that you’d take to become a special agent for the Federal Bureau of Investigation (FBI). Most business students don’t generally aspire to become FBI agents, but the FBI is quite interested in business graduates—especially if you have a major in accounting or finance. With one of these backgrounds, you’ll be given priority in hiring. Why? Unfortunately, there’s a lot of white-collar crime that needs to be investigated, and people who know how to follow the money are well suited for the task.

Application

The first step in becoming a gun-toting accountant is, obviously, applying for the job. Don’t bother unless you meet the minimum qualifications: you must be a U.S. citizen, be age twenty-three to thirty-seven, be physically fit, and have a bachelor’s degree. To provide factual information on your education and work background, you’ll submit an application, which the FBI will use as an initial screening tool.
Employment Tests

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

Interview

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

Physical Exam and Reference Checks

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

Final Decision

The last stage in the process is out of your control. Will you be hired or rejected? This decision is made by one or more people who work for the prospective employer. For a business, the decision maker is generally the line manager who oversees the position being filled. At the FBI, the decision is made by a team at FBI headquarters. If you’re hired as a special agent, you’ll spend twenty-one weeks of intensive training at the FBI Academy in Quantico, Virginia.

Contingent Workers

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

The Positives and Negatives of Temp Work

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

What about you? Does temporary work appeal to you? On the plus side, you can move around to various companies and gain a variety of skills. You can see a company from the inside and decide up front whether it’s the kind of place you’d like to work at permanently. If it is, your temporary position lets you showcase your skills and talents and grab the attention of management, which could increase the likelihood you’ll be offered a permanent position. There are also some attractive lifestyle benefits. You might, for example, work at a job or series of jobs for, say, ten months and head for the beach for the other two. On the other hand, you’ll probably get paid less, receive no benefits, and have no job security. For most people, the idea of spending two months a year on the beach isn’t that appealing.

KEY TAKEAWAYS

- The process of **human resource management** consists of all the actions that an organization takes to attract, develop, and retain quality employees.
- To ensure that the organization is properly staffed, managers
engage in **strategic human resource planning**—the process of developing a plan for satisfying the organization’s human resource needs.

- Managers organize information about a given job by performing a **job analysis**, which they use to prepare two documents: a **job description** listing the duties and responsibilities of a position and a **job specification**, which lists the qualifications—skills, knowledge, and abilities—needed to perform the job.

- After analyzing the jobs that must be performed, the HR manager forecasts future hiring needs and begins the **recruiting** process to identify suitable candidates and encourage them to apply.

- In recruiting and hiring, managers must comply with antidiscrimination laws enforced by the **Equal Employment Opportunity Commission (EEOC)**.

- **Discrimination** occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability, such as race, color, religion, sex, national origin, age, or disability.

- Once a pool of suitable candidates has been identified, managers begin the **selection** process, reviewing information provided by candidates on employment **applications** and administering tests to assess candidates’ skills and knowledge.

- Candidates who pass this stage may be granted an **interview** and, perhaps, offered a job.

### Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether
to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=228
199. Outcome: Legislation and Employer-Employee Relationships

What you’ll learn to do: identify the areas where legislation and law affect the employer-employee relationship: labor laws/union, workplace safety, equal opportunity, and civil rights)

Employers can find themselves in deep trouble when they violate the legislation and laws that govern the employer/employee relationship. Violations can ruin a company financially, and the outcome in the court of public opinion can tarnish a once golden reputation. How important is it for HR managers to know and follow employment laws? Consider what it cost these companies as you study this next section.

- $250 million—Arnett v. California Public Employees’ Retirement System, Case No.: 95- 3022 (N.D. Cal. Jan. 29, 2003) (approval given to consent decree in a lawsuit involving charges that the
California Public Employees’ Retirement System discriminated against public safety officers who took disability retirements on the basis of age).


- **$172 million**—*Roberts v. Texaco*, Case No.: 94-2015 (S.D.N.Y. July 29, 1997) (approval given to settlement in a lawsuit involving fees for services rendered prior to the entry of judgment in the race discrimination lawsuit).

- **$132.5 million**—*Haynes v. Shoney’s, Inc.*, Case No.: 89-30093-RV (N.D. Fla. 1993) (approval given to consent decree in a race discrimination lawsuit brought in 1989 by a class of African-American Shoney’s employees).  

### LEARNING ACTIVITIES

The learning activities for this section include:

- Video: The Top Five Manager Mistakes That Cause Lawsuits
- Reading: Working with Labor Unions

1. Workplace Class Action Blog by Seyfarth Shaw LLP. Chicago, IL http://www.workplaceclassaction.com/
• Reading: Collective Bargaining
• Reading: Employee Rights: Job Protection and Privacy
• Reading: Multiculturalism and the Law
• Self Check: Legislation and Employer-Employee Relationships

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
The Top Five Manager Mistakes That Cause Lawsuits

There's been an explosion in the number of employee lawsuits in the U.S. during the past few years, and manager mistakes are at the center of many of them. That's why it's important to know at least the basics of employment law. In the following video, Business Management Daily's editorial director Pat DiDomenico describes the top five manager mistakes that cause lawsuits.
Unhappy Employees Could Equal Unionization

As the HR manager for a two-hundred-person company, you generally have a pretty good sense of employee morale. Recently you grew concerned because morale has dropped. Employees are unhappy because of pay and the increasing cost of health benefits. You discuss these concerns with upper-level management, but owing to financial pressures, the company cannot address the issue this year.

One afternoon, the manager of the marketing department comes to you with this concern, but also with some news. She tells you that she has heard talk of employees unionizing if they do not receive pay raises within the next few months. She says that the employees are very unhappy, and productivity is suffering as a result. She explains that employees have already started the unionization process by contacting the National Labor Relations Board and are in the process of proving 30 percent worker interest in unionization. As you mull over this news, you are concerned because the organization has always had a family atmosphere, and a union might change this. You are also concerned about the financial pressures to the organization should the employees unionize and negotiate higher pay. You know you must take action to prevent this development. However, you know that you and all managers are legally bound by rules relating to unionization, and you need a refresher on what these rules are. You decide to call a meeting first with the CEO and then with managers to discuss strategy and inform them of the legal implications of this process. You feel
confident that a resolution can be reached before the unionization happens.

The Nature of Unions

A labor union, or union, is defined as workers banding together to meet common goals, such as better pay, benefits, or promotion rules. In the United States, 11.9 percent of American workers belong to a union, down from 20.1 percent in 1983 (“Union Members: 2010,” Bureau of Labor Statistics, US Department of Labor, news release, January 21, 2011, accessed April 4, 2011). In this section, we will discuss the history of unions, reasons for decline in union membership, union labor laws, and the process employees go through to form a union. First, however, we should discuss some of the reasons why people join unions.

People may feel their economic needs are not being met with their current wages and benefits and believe that a union can help them receive better economic prospects. Fairness in the workplace is another reason why people join unions. They may feel that scheduling, vacation time, transfers, and promotions are not given fairly and feel that a union can help eliminate some of the inequity associated with these processes. Let's discuss some basic information about unions before we discuss the unionization process.

History and Organization of Unions

Trade unions were developed in Europe during the Industrial Revolution, when employees had little skill and thus the employer had most of the power. Many employees were treated unfairly and were underpaid. In the United States, unionization increased with
the building of railroads in the late 1860s. Wages in the railroad industry were low and the threat of injury or death was high, as was the case in many manufacturing facilities with few or no safety laws or regulations in place. As a result, the Brotherhood of Locomotive Engineers and several other brotherhoods (focused on specific tasks only, such as conductors and brakemen) were formed to protect workers' rights, although many workers were fired because of their membership.

*Labor Union AFL-CIO Perspective*

The following video shows a history of labor unions from the perspective of the AFL-CIO:

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=231
The first local unions in the United States were formed in the nineteenth century, in the form of the National Labor Union (NLU). The National Labor Union, formed in 1866, paved the way for other labor organizations. The goal of the NLU was to form a national labor federation that could lobby government for labor reforms on behalf of the labor organizations. Its main focus was to limit the workday to eight hours. While the NLU garnered many supporters, it excluded Chinese workers and only made some attempts to defend the rights of African Americans and female workers. The NLU can be credited with the eight-hour workday, which was passed in 1862. Because of a focus on government reform rather than collective bargaining, many workers joined the Knights of Labor in the 1880s.

The Knights of Labor started as a fraternal organization, and when the NLU dissolved, the Knights grew in popularity as the labor union of choice. The Knights promoted the social and cultural spirit of the worker better than the NLU had. It originally grew as a labor union for coal miners but also covered several other types of industries. The Knights of Labor initiated strikes that were successful in increasing pay and benefits. When this occurred, membership increased. After only a few years, though, membership declined because of unsuccessful strikes, which were a result of a too autocratic structure, lack of organization, and poor management. Disagreements between members within the organization also caused its demise.

The American Federation of Labor (AFL) was formed in 1886, mostly by people who wanted to see a change from the Knights of Labor. The focus was on higher wages and job security. Infighting among union members was minimized, creating a strong organization that still exists today. In the 1930s, the Congress of Industrial Organizations (CIO) was formed as a result of political differences in the AFL. In 1955, the two unions joined together to form the AFL-CIO.

Currently, the AFL-CIO is the largest federation of unions in the United States and is composed of fifty-six national and international
unions. The goal of the AFL-CIO isn’t to negotiate specific contracts for employees but rather to support the efforts of local unions throughout the country.

Currently in the United States, there are two main national labor unions that oversee several industry-specific local unions. There are also numerous independent national and international unions, such as the following, that are not affiliated with either national union:

1. AFL-CIO: local unions include Airline Pilots Association, American Federation of Government Employees, Associated Actors of America, and Federation of Professional Athletes
2. CTW (Change to Win Federation): includes the Teamsters, Service Employees International Union, United Farm Workers of America, and United Food and Commercial Workers

The national union plays an important role in legislative changes, while the local unions focus on collective bargaining agreements and other labor concerns specific to the area. Every local union has a union steward who represents the interests of union members. Normally, union stewards are elected by their peers.

A national union, besides focusing on legislative changes, also does the following:

1. Lobbies in government for worker rights laws
2. Resolves disputes between unions
3. Helps organize national protests
4. Works with allied organizations and sponsors various programs for the support of unions

For example, in 2011, the national Teamsters union organized demonstrations in eleven states to protest the closing of an Ontario,

Figure 1. The Complicated Structure of AFL-CIO. Source: AFL-CIO

Current Union Challenges

The labor movement is currently experiencing several challenges, including a decrease in union membership, globalization, and
employers’ focus on maintaining nonunion status. As mentioned in the opening of this section, the United States has seen a steady decline of union membership since the 1950s. In the 1950s, 36 percent of all workers were unionized, as opposed to just over 11 percent today (Gerald Friedman, “Labor Unions in the United States,” Economic History Association, February 2, 2010, accessed April 4, 2011).

Claude Fischer, a researcher from University of California Berkeley, believes the shift is cultural. His research says the decline is a result of American workers preferring individualism as opposed to collectivism (Claude Fischer, “Why Has Union Membership Declined?” Economist’s View, September 11, 2010, accessed April 11, 2011). Other research says the decline of unions is a result of globalization and the fact that many formerly unionized jobs in the manufacturing arena have now moved overseas. Other reasoning points to management and that its unwillingness to work with unions has caused the decline in membership. Others suggest that unions are on the decline because of themselves. Past corruption, negative publicity, and hard-line tactics have made joining a union less desirable.

To fully understand unions, it is important to recognize their global aspect. Statistics from worldwide data unions in all countries declining but still healthy in some countries. For example, in eight of the twenty-seven European Union member states, more than half the working population is part of a union. In fact, in the most populated countries, unionization rates are still at three times the unionization rate of the United States (Federation of European Employers, “Trade Unions across Europe,” accessed April 4, 2011). Italy has a unionization rate of 30 percent of all workers, while the UK has 29 percent, and Germany has a unionization rate of 27 percent.

In March 2011, Wisconsin governor Scott Walker proposed limiting the collective bargaining rights of state workers to save a foundering budget. Some called this move “union busting” and said this type of act is illegal, as it takes away the basic rights of workers.
The governor defended his position, saying that there was no other choice, since the state was in a budget crisis. Other states such as Ohio have considered similar measures. Whatever happens, there is a clear shift for unions today.

Globalization is also a challenge in labor organizations today. As more and more goods and services are produced overseas, unions lose not only membership but union values in the stronghold of worker culture. As globalization has increased, unions have continued to demand more governmental control but have been only somewhat successful in these attempts. For example, free trade agreements such as the North American Free Trade Agreement (NAFTA) have made it easier and more lucrative for companies to manufacture goods overseas. For example, La-Z-Boy and Whirlpool closed production facilities in Dayton and Cleveland, Ohio, and built new factories in Mexico to take advantage of cheaper labor and less stringent environmental standards. Globalization creates options for companies to produce goods wherever they think is best to produce them. As a result, unions are fighting the globalization trend to keep jobs in the United States.

There are a number of reasons why companies do not want unions in their organizations, which we will discuss in greater detail later. One of the main reasons, though, is increased cost and less management control. As a result, companies are on a quest to maintain a union-free work environment. In doing so, they try to provide higher wages and benefits so workers do not feel compelled to join a union. Companies that want to stay union-free constantly monitor their retention strategies and policies.

Labor Union Laws

The Railway Labor Act (RLA) of 1926 originally applied to railroads and in 1936 was amended to cover airlines. The act received support from both management and unions. The goal of the act is to ensure
no disruption of interstate commerce. The main provisions of the act include alternate dispute resolution, arbitration, and mediation to resolve labor disputes. Any dispute must be resolved in this manner before a strike can happen. The RLA is administered by the National Mediation Board (NMB), a federal agency, and outlines very specific and detailed processes for dispute resolution in these industries.

The Norris-LaGuardia Act of 1932 (also known as the anti-injunction bill), barred federal courts from issuing injunctions (a court order that requires a party to do something or refrain from doing something) against nonviolent labor disputes and barred employers from interfering with workers joining a union. The act was a result of common yellow-dog contracts, in which a worker agreed not to join a union before accepting a job. The Norris-LaGuardia Act made yellow-dog contracts unenforceable in courts and established that employees were free to join unions without employer interference.

In 1935, the Wagner Act (sometimes called the National Labor Relations Act) was passed, changing the way employers can react to several aspects of unions. The Wagner Act had the following features:

1. Employers must allow freedom of association and organization and cannot interfere with, restrain, or coerce employees who form a union.
2. Employers may not discriminate against employees who form or are part of a union, or those who file charges.
3. An employer must bargain collectively with representation of a union.

The National Labor Relations Board (NLRB) oversees this act, handling any complaints that may arise from the act. For example, in April 2011, the NLRB worked with employees at Ozburn-Hessey Logistics in Tennessee after they had been fired because of their involvement in forming a union. The company was also accused of
interrogating employees about their union activities and threatened employees with loss of benefits should they form a union. The NLRB utilized their attorney to fight on behalf of the employees, and a federal judge ordered the company to rehire the fired employees and also to desist in other antiunion activities.\(^1\)

The Taft–Hartley Act also had major implications for unions. Passed in 1947, Taft–Hartley amended the Wagner Act. The act was introduced because of the upsurge of strikes during this time period. While the Wagner Act addressed unfair labor practices on the part of the company, the Taft–Hartley Act focused on unfair acts by the unions. For example, it outlawed strikes that were not authorized by the union, called wildcat strikes. It also prohibited secondary actions (or secondary boycotts) in which one union goes on strike in sympathy for another union. The act allowed the executive branch of the federal government to disallow a strike should the strike affect national health or security. One of the most famous injunctions was made by President Ronald Reagan in 1981. Air traffic controllers had been off the job for two days despite their no-strike oath, and Reagan ordered all of them (over eleven thousand) discharged because they violated this federal law.

The Landrum Griffin Act, also known as the Labor Management Reporting and Disclosure (LMRDA) Act, was passed in 1959. This act required unions to hold secret elections, required unions to submit their annual financial reports to the U.S. Department of Labor, and created standards governing expulsion of a member from a union. This act was created because of racketeering charges and corruptions charges by unions. In fact, investigations of the

Teamsters Union found they were linked to organized crime, and the Teamsters were banned from the AFL-CIO. The goal of this act was to regulate the internal functioning of unions and to combat abuse of union members by union leaders.

<table>
<thead>
<tr>
<th>Act</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>Railway Labor Act</td>
<td>Covers railroad and airlines, alternate dispute resolution methods instead of striking for these two industries</td>
</tr>
<tr>
<td>Norris-LaGuardia Act</td>
<td>As a result of yellow-dog contracts, barred federal courts from issuing injunctions against nonviolent labor disputes</td>
</tr>
<tr>
<td>Wagner Act</td>
<td>Allowed for freedom to join a union without interference, may not discriminate against union employees, set collective bargaining rules</td>
</tr>
<tr>
<td>Taft-Hartley Act</td>
<td>Amended Wagner Act, focus was on unfair practices by the union</td>
</tr>
<tr>
<td>Landrum-Friffing Act</td>
<td>Required unions to hold secret elections, financial reporting of unions required</td>
</tr>
</tbody>
</table>

Figure 2. Major Acts Regarding Unions, at a Glance

The Unionization Process

There are one of two ways in which a unionization process can begin. First, the union may contact several employees and discuss the possibility of a union, or employees may contact a union on their own. The union will then help employees gather signatures to show that the employees want to be part of a union. To hold an election, the union must show signatures from over 30 percent of the employees of the organization.
Once the signatures are gathered, the National Labor Relations Board is petitioned to move forward with a secret-ballot election. An alternative to the secret-ballot election is the card check method, in which the union organizer provides the company with authorization cards signed by a simple majority (half plus one). The employer can accept the cards as proof that the employees desire a union in their organization. The NLRB then certifies the union as the employees’ collective bargaining representative.

If the organization does not accept the card check method as authorization for a union, the second option is via a secret ballot. Before this method is used, a petition must be filed by the NLRB, and an election is usually held two months after the petition is filed. In essence, the employees vote whether to unionize or not, and there must be a simple majority (half plus one). The NLRB is responsible for election logistics and counting of ballots. Observers from all
parties can be present during the counting of votes. Once votes are counted, a decision on unionization occurs, and at that time, the collective bargaining process begins.

Once the NLRB is involved, there are many limits as to what the employer can say or do during the process to prevent unionization of the organization. It is advisable for HR and management to be educated on what can legally and illegally be said during this process. It is illegal to threaten or intimidate employees if they are discussing a union. You cannot threaten job, pay, or benefits loss as a result of forming a union. Figure 4, “Things That Shouldn't Be Said to Employees during a Unionization Process,” below includes information on what should legally be avoided if employees are considering unionization.

![Figure 4. Things That Shouldn't Be Said to Employees during a Unionization Process](image)

Obviously, it’s in the best interest of the union to have as many members as possible. Because of this, unions may use many tactics during the organizing process. For example, many unions are also politically involved and support candidates who they feel best represent labor. They provide training to organizers and sometimes even encourage union supporters to apply for jobs in nonunion environments to actively work to unionize other employees when they are hired. This practice is called union salting. Unions,
especially on the national level, can be involved in corporate campaigns that boycott certain products or companies because of their labor practices. The United Food and Commercial Workers (UFCW), for example, has a “Wake Up Walmart Campaign” that targets the labor practices of this organization.

Strategies Companies Use to Avoid Unionization

Most organizations feel the constraints of having a union organization are too great. It affects the cost to the organization and operation efficiency. Collective bargaining at times can put management at odds with its employees and cost more to produce products and services. Ideally, companies will provide safe working conditions, fair pay, and benefits so the employees do not feel they need to form a union. There are three main phases of unionization, as follows:

1. **Phase 1:** Your organization is union-free and there is little or no interest in unionizing.
2. **Phase 2:** You learn that some employees are discussing unionization or you learn about specific attempts by the union to recruit employees.
3. **Phase 3:** You receive a petition from the National Labor Relations Board filed by a union requesting a unionization vote.

Because of increased costs and operational efficiency, it is normally in a company's best interest to avoid unionization. While in phase 1, it is important to review employee relations programs including pay, benefits, and other compensation. Ensure the compensation plans are fair so employees feel fairly treated and have no reason to seek the representation of a union.

Despite your best efforts, you could hear of unionization in your organization. The goal here is to prevent the union from gaining
support to ask for a National Labor Relations Board election. Since only 30 percent of employees need to sign union cards for a vote to take place, this phase to avoid unionization is very important. During this time, HR professionals and managers should respond to the issues the employees have and also develop a specific strategy on how to handle the union vote, should it get that far.

In phase 3, familiarization with all the National Labor Relations Board rules around elections and communications is important. With this information, you can organize meetings to inform managers on these rules. At this time, you will likely want to draw up an antiunion campaign and communicate that to managers, but also make sure it does not violate laws. To this end, develop specific strategies to encourage employees to vote “no” for the union. Some of the arguments that might be used include talking with the employee and mentioning the following:

1. Union dues are costly.
2. Employees could be forced to go on strike.
3. Employees and management may no longer be able to discuss matters informally and individually.
4. Unionization can create more bureaucracy within the company.
5. Individual issues may not be discussed.
6. Many decisions within a union, such as vacation time, are based on seniority only.

With unionization in decline, it is likely you may never need to handle a new union in your organization. However, organizations such as Change to Win are in the process of trying to increase union membership. This organization has four affiliated unions, with a goal to strengthen the labor movement. Teamsters, United Food and Commercial Workers, United Farm Workers, and Service Employees International Union are all unions affiliated with this organization (Change to Win website, accessed April 7, 2011). The next few years will be telling as to the fate of unions in today’s organizations.
Perhaps no organization is better known for its antiunion stance than Walmart. Walmart has more than 3,800 stores in the United States and more than 4,800 internationally with $419 billion in sales (“Investors,” Walmart Corporate, 2011, accessed August 15, 2011). Walmart employs more than 2 million associates worldwide (“Investors,” Walmart Corporate, 2011, accessed August 15, 2011). The billions of dollars Walmart earns do not immunize the company against trouble. In 2005, the company's vice president, Tom Coughlin, was forced to resign after admitting that between $100,000 and $500,000 was spent for undeclared purposes, but it was eventually found that the money was spent to keep the United Food and Commercial Workers union (UFCW) out of Walmart (Los Angeles Times Wire Services, “Wal-Mart Accused of Unfair Labor Practices,” accessed September 15, 2011). (He was found guilty and sentenced to two years of house arrest).

Other claims surrounding union busting are the closing of stores, such as the Walmart Tire and Lube Express in Gatineau, Quebec, UFCW Canada, when discussions of unionization occurred. Other reports of union busting include the accusation that company policy requires store managers to report rumors of unionizing to corporate headquarters. Once the report is made, all labor decisions for that store are handled by the corporate offices instead of the store manager. According to labor unions in the United States, Walmart is willing to work with international labor unions but continues to fiercely oppose unionization in the United States. In one example, after butchers at a Jacksonville, Texas, Walmart voted to unionize, Walmart eliminated all U.S. meat-cutting departments.

A group called OUR Walmart (Organization United for Respect), financed by the United Food and Commercial Workers* (UFCW) union, has stemmed from the accusations of union busting. Walmart spokesperson David Tovar says he sees the group as a Trojan horse assembled by labor organizations to lay the groundwork for full-fledged unionization and seek media attention to fulfill their
agenda. While the organization's activities may walk a fine line between legal and illegal union practices under the Taft-Hartley Act, this new group will certainly affect the future of unionization at Walmart in its US stores.

*Note: UFCW was part of the AFL-CIO until 2005 and now is an independent national union.

The Impact of Unions on Organizations

You may wonder why organizations are opposed to unions. As we have mentioned, since union workers do receive higher wages, this can be a negative impact on the organization. Unionization also impacts the ability of managers to make certain decisions and limits their freedom when working with employees. For example, if an employee is constantly late to work, the union contract will specify how to discipline in this situation, resulting in little management freedom to handle problems themselves. In 2010, for example, the Art Institute of Seattle faculty filed signatures and voted on unionization ("Union Push in For-Profit Higher Ed," Inside Higher Ed, May 24, 2010, accessed August 15, 2011). Some of the major issues were scheduling difficulties and office space, not necessarily pay and benefits. While the particular National Labor Relations Board vote was no to unionization, a yes vote could have given less freedom to management in scheduling, since scheduling would be based on collective bargaining contracts. Another concern about unionization for management is the ability to promote workers. A union contract may stipulate certain terms (such as seniority) for promotion, which means the manager has less control over the employees he or she can promote.
KEY TAKEAWAYS

• Union membership in the United States has been slowly declining. Today, union membership consists of about 11.9 percent of the workforce, while in 1983 it consisted of 20 percent of the workforce.
• The reasons for decline are varied, depending on whom you ask. Some say the moving of jobs overseas is the reason for the decline, while others say unions' hard-line tactics put them out of favor.
• Besides declining membership, union challenges today include globalization and companies' wanting a union-free workplace.
• The United States began its first labor movement in the 1800s. This was a result of low wages, no vacation time, safety issues, and other issues.
• Many labor organizations have disappeared, but the American Federation of Labor (AFL) still exists today, although it merged with the Congress of Industrial Organizations (CIO) and is now known as the AFL-CIO. It is the largest labor union and represents local labor unions in a variety of industries.
• The United States has a low number of union members compared with other countries. Much of Europe, for example, has over 30 percent of their workforce in labor unions, while in some countries as much as 50 percent of the workforce are members of a labor union.
• Legislation has been created over time to support both labor unions and the companies who have labor unions. The Railway Labor Act applies to airlines and railroads and stipulates that employees may not strike until they have gone through an extensive dispute resolution process. The Norris-LaGuardia Act made yellow-dog contracts illegal and barred courts from issuing injunctions.
• The Wagner Act was created to protect employees from retaliation should they join a union. The Taft-Hartley Act was
developed to protect companies from unfair labor practices by unions.

- The National Labor Relations Board is the overseeing body for labor unions, and it handles disputes between companies as well as facilitates the process of new labor unions in the developing stages. Its job is to enforce both the Wagner Act and the Taft-Hartley Act.

- The Landrum Griffin Act was created in 1959 to combat corruption in labor unions during this time period.

- To form a union, the organizer must have signatures from 30 percent of the employees. If this occurs, the National Labor Relations Board will facilitate a card check to determine more than 50 percent of the workforce at that company is in agreement with union representation. If the company does not accept this, then the NLRB holds secret elections to determine if the employees will be unionized. A collective bargaining agreement is put into place if the vote is yes.

- Companies prefer to not have unions in their organizations because it affects costs and operational productivity. Companies will usually try to prevent a union from organizing in their workplace.

- Managers are impacted when a company does unionize. For example, management rights are affected, and everything must be guided by the contract instead of management prerogative.
The Process of Collective Bargaining

When employees of an organization vote to unionize, the process for collective bargaining begins. Collective bargaining is the process of negotiations between the company and representatives of the union. The goal is for management and the union to reach a contract agreement, which is put into place for a specified period of time. Once this time is up, a new contract is negotiated. In this section, we will discuss the components of the collective bargaining agreement.

In any bargaining agreement, certain management rights are not negotiable, including the right to manage and operate the business, hire, promote, or discharge employees. However, in the negotiated agreement there may be a process outlined by the union for how these processes should work. Management rights also include the ability of the organization to direct the work of the employees and to establish operational policies. As an HR professional sits at the bargaining table, it is important to be strategic in the process and tie the strategic plan with the concessions the organization is willing to make and the concessions the organization will not make.

Another important point in the collective bargaining process is the aspect of union security. Obviously, it is in the union’s best interest to collect dues from members and recruit as many new members as possible. In the contract, a checkoff provision may be negotiated. This provision occurs when the employer, on behalf of the union, automatically deducts dues from union members' paychecks. This ensures that a steady stream of dues is paid to the union.
To recruit new members, the union may require something called a union shop. A union shop requires a person to join the union within a certain time period of joining the organization. In right-to-work states a union shop may be illegal. Twenty-two states have passed right-to-work laws, as you can see below in Figure 5, “Map of Right-to-Work States.” These laws prohibit a requirement to join a union or pay dues and fees to a union. To get around these laws, agency shops were created. An agency shop is similar to a union shop in that workers do not have to join the union but still must pay union dues. Agency shop union fees are known as agency fees and may be illegal in right-to-work states. A closed shop used to be a mechanism for a steady flow of membership. In this arrangement, a person must be a union member to be hired. This, however, was made illegal under the Taft-Hartley Act. According to a study by CNBC, all twenty-two right-to-work states are in the top twenty-five states for having the best workforces (1) However, according to the AFL-CIO, the average worker in a right-to-work state makes $5,333 less per year than other workers (2)

In a collective bargaining process, both parties are legally bound to bargain in good faith. This means they have a mutual obligation to participate actively in the deliberations and indicate a desire to find a basis for agreement. There are three main classification of bargaining topics: mandatory, permissive, and illegal. Wages, health and safety, management rights, work conditions, and benefits fall into the mandatory category. Permissive topics are those that are not required but may be brought up during the process. An example might include the requirement of drug testing for candidates or the required tools that must be provided to the employee to perform the job, such as a cellular phone or computer. It is important to note that while management is not required by labor laws to bargain on these issues, refusing to do so could affect employee morale. We can also classify bargaining issues as illegal topics, which obviously cannot be discussed. These types of illegal issues may be of a
discriminatory nature or anything that would be considered illegal outside the agreement.

Examples of Bargaining Topics

- Pay rate and structure
- Health benefits
- Incentive programs
- Job classification
- Performance assessment procedure
- Vacation time and sick leave
- Health plans
- Layoff procedures
- Seniority
- Training process
- Severance pay
- Tools provided to employees
- Process for new applicants

The collective bargaining process has five main steps; we will discuss each of these steps next. The first step is the preparation of both parties. The negotiation team should consist of individuals with knowledge of the organization and the skills to be an effective negotiator. An understanding of the working conditions and dissatisfaction with working conditions is an important part of this preparation step. Establishing objectives for the negotiation and reviewing the old contract are key components to this step. The management team should also prepare and anticipate union demands, to better prepare for compromises.
The second step of the process involves both parties agreeing on how the time lines will be set for the negotiations. In addition, setting ground rules for how the negotiation will occur is an important step, as it lays the foundation for the work to come.

In the third step, each party comes to the table with proposals. It will likely involve initial opening statements and options that exist to resolve any situations that exist. The key to a successful proposal is to come to the table with a “let’s make this work” attitude. An initial discussion is had and then each party generally goes back to determine which requests it can honor and which it can’t. At this point, another meeting is generally set up to continue further discussion.

Once the group comes to an agreement or settlement (which may take many months and proposals), a new contract is written and the union members vote on whether to accept the agreement. If the union doesn’t agree, then the process begins all over again.

Ramifications of a Bargaining Impasse

When the two parties are unable to reach consensus on the
collective bargaining agreement, this is called a bargaining impasse. Various kinds of strikes are used to show the displeasure of workers regarding a bargaining impasse. An economic strike is a strike stemming from unhappiness about the economic conditions during contract negotiations. For example, 45,000 Verizon workers rallied in the summer of 2011 when contract negotiations failed (3) The two unions, Communications Workers of America and the International Brotherhood of Electric Workers, claim that the new contract is unfair, as it asks Verizon workers to contribute more to health plans, and the company is also looking to freeze pensions at the end of the year and reduce sick time (Dan Goldberg, “Verizon Strike Could Last Months,” New Jersey News, August 7, 2011). Verizon says the telecommunications business is changing, and it cannot afford these expenses.

An unfair labor practices strike can happen during negotiations. The goal of an unfair labor practices strike is to get the organization to cease committing what the union believes to be an unfair labor practice. A bargaining impasse could mean the union goes on strike or a lockout occurs. The goal of a lockout, which prevents workers from working, is to put pressure on the union to accept the contract. A lockout can only be legally conducted when the existing collective bargaining agreement has expired and there is truly an impasse in contract negotiations. In summer 2011, the National Basketball Association locked out players when the collective bargaining agreement expired, jeopardizing the 2011–12 season while putting pressure on the players to accept the agreement (4). Similarly, the goal of a strike is to put pressure on the organization to accept the proposed contract. Some organizations will impose a

lockout if workers engage in slowdowns, an intentional reduction in productivity. Some unions will engage in a slowdown instead of a strike, because the workers still earn pay, while in a strike they do not.

A sick-out is when members of a union call in sick, which may be illegal since they are using allotted time, while a walk-out is an unannounced refusal to perform work. However, this type of tactic may be illegal if the conduct is irresponsible or indefensible, according to a judge. Jurisdictional strikes are used to put pressure on an employer to assign work to members of one union versus another (if there are two unions within the same organization) or to put pressure on management to recognize one union representation when it currently recognizes another. The goal of a sick-out strike is to show the organization how unproductive the company would be if the workers did go on strike. As mentioned under the Taft-Hartley Act, wildcat strikes are illegal, as they are not authorized by the union and usually violate a collective bargaining agreement. Sympathy strikes are work stoppages by other unions designed to show support for the union on strike. While they are not illegal, they may violate the terms of the collective bargaining agreement.

KEY TAKEAWAYS

- A union has two goals: to add new members and to collect dues. A check-off provision of a contract compels the organization to take union dues out of the paycheck of union members.
- In a union shop, people must join the union within a specified time period after joining the organization. This is illegal in right-to-work states. An agency shop is one where union membership is not required but union dues are still required to be paid. This may also be illegal in right-to-work states.
• Made illegal by the Taft-Hartley Act, a closed shop allows only union members to apply and be hired for a job.

• Collective bargaining is the process of negotiating the contract with union representatives. Collective bargaining, to be legal, must always be done in good faith.

• There are three categories of collective bargaining issues. Mandatory issues might include pay and benefits. Permissive bargaining items may include things such as drug testing or the required equipment the organization must supply to employees. Illegal issues are those things that cannot be discussed, which can include issues that could be considered discriminatory.

• The collective bargaining process can take time. Both parties prepare for the process by gathering information and reviewing the old contract. They then set time lines for the bargaining and reveal their wants and negotiate those wants. A bargaining impasse occurs when members cannot come to an agreement.

• When a bargaining impasse occurs, a strike or lockout of workers can occur. An economic strike occurs during negotiations, while an unfair labor practices strike can occur anytime, and during negotiations. A sick-out can also be used, when workers call in sick for the day. These strategies can be used to encourage the other side to agree to collective bargaining terms.

• Some tips for working with unions include knowing and following the contract, involving unions in company decisions, and communicating with transparency.
Job Protection Rights

Employee rights is defined as the ability to receive fair treatment from employers. This section will discuss employee rights surrounding job protection and privacy.

If HR doesn't understand or properly manage employee rights, lawsuits are sure to follow. It's the HR professional's job to understand and protect the rights of employees. In the United States, the employment-at-will principle (EAW) is the right of an employer to fire an employee or an employee to leave an organization at any time, without any specific cause. The EAW principle gives both the employee and employer freedom to terminate the relationship at any time. There are three main exceptions to this principle, and whether they are accepted is up to the various states:

1. **Public policy exception.** With a public policy exception, an employer may not fire an employee if it would violate the individual state's doctrine or statute. For example, in Borse v. Piece Goods Shop in Pennsylvania, a federal circuit court of appeals ruled that Pennsylvania law may protect at-will employees from being fired for refusing to take part in drug test programs if the employee's privacy is invaded. Borse contended that the free speech provisions of the state and of the First Amendment protected the refusal to participate.
Some public policy exceptions occur when an employee is fired for refusing to violate state or federal law.

2. **Implied contract exception.** In a breach of an implied contract, the discharged employee can prove that the employer indicated that the employee has job security. The indication does not need to be formally written, only implied. In *Wright v. Honda*, an Ohio employee was terminated but argued that the implied contract exception was relevant to the employment-at-will doctrine. She was able to prove that in orientation, Honda stressed to employees the importance of attendance and quality work. She was also able to prove that the language in the associate handbook implied job security: “the job security of each employee depends upon doing your best on your job with the spirit of cooperation.” Progress reports showing professional development further solidified her case, as she had an implied contract that Honda had altered the employment-at-will doctrine through its policies and actions.

3. **Good faith and fair dealing exception.** In the good faith and fair dealing exception, the discharged employee contends that he was not treated fairly. This exception to the employment-at-will doctrine is less common than the first two. Examples might include firing or transferring of employees to prevent them from collecting commissions, misleading employees about promotions and pay increases, and taking extreme actions that would force the employee to quit.

Table 1. State’s Acceptance of Employment-at-Will Exceptions
<table>
<thead>
<tr>
<th>State</th>
<th>Public-Policy Exception</th>
<th>Implied-Contract Exception</th>
<th>Good Faith and Fair Dealing Exception</th>
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</table>

**Bold text indicates a state with all three exceptions.**

**Italic text indicates a state with none of the three exceptions.**
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When one of the exceptions can be proven, wrongful discharge accusations may occur. The United States is one of the few major industrial powers that utilize an employment-at-will philosophy. Most countries, including France and the UK, require employers to show just cause for termination of a person's employment (USLegal, “Employment at Will,” accessed March 15, 2011). The advantage of employment at will allows for freedom of employment; the possibility of wrongful discharge tells us that we must be prepared to defend the termination of an employee, as to not be charged with a wrongful discharge case.

Employees also have job protection if they engage in whistleblowing. Whistleblowing refers to an employee’s telling the public about ethical or legal violations of his or her organization. This protection was granted in 1989 and extended through the Sarbanes-Oxley Act of 2002. Many organizations create whistleblowing policies and a mechanism to report illegal or unethical practices within the organization (Lilanathi Ravishankar, “Encouraging Internal Whistle Blowing,” Santa Clara University, accessed March 15, 2011).

Another consideration for employee job protection is that of an implied contract. It is in the best interest of HR professionals and managers alike to avoid implying an employee has a contract with the organization. In fact, many organizations develop employment-at-will policies and ask their employees to sign these policies as a disclaimer for the organization.

A constructive discharge means the employee resigned, but only because the work conditions were so intolerable that he or she had no choice. For example, if James is being sexually harassed at work, and it is so bad he quits, he would need to prove not only the sexual harassment but that it was so bad it required him to quit. This type of situation is important to note; should James’s case go to court and sexual harassment and constructive discharge are found, James may be entitled to back pay and other compensation.

The Worker Adjustment and Retraining Notification Act (WARN) requires organizations with more than one hundred
employees to give employees and their communities at least sixty days' notice of closure or layoff affecting fifty or more full-time employees. This law does not apply in the case of unforeseeable business circumstances. If an employer violates this law, it can be subject to back pay for employees (US Department of Labor, “WARN Fact Sheet,” accessed March 15, 2011). This does not include workers who have been with the organization for less than six months, however.

Retaliatory discharge means punishment of an employee for engaging in a protected activity, such as filing a discrimination charge or opposing illegal employer practices. For example, it might include poor treatment of an employee because he or she filed a workers’ compensation claim. Employees should not be harassed or mistreated should they file a claim against the organization.

Privacy Rights

Technology makes it possible to more easily monitor aspects of employees’ jobs, although a policy on this subject should be considered before implementing it. In regard to privacy, there is a question about whether an employer should be allowed to monitor an employee’s online activities. This may include work e-mail, websites visited using company property, and also personal activity online.

Digital Footprints, Inc. is a company that specializes in tracking the digital movements of employees and can provide reports to the organization by tracking these footprints. This type of technology might look for patterns, word usage, and other communication patterns between individuals. This monitoring can be useful in determining violations of workplace policies, such as sexual harassment. This type of software and management can be expensive, so before launching it, it’s imperative to address its value in the workplace.
Another privacy concern can include monitoring of employee postings on external websites. Companies such as Social Sentry, under contract, monitor employee postings on sites such as Facebook, Twitter, LinkedIn, and YouTube (Teneros Corporation, “Social Sentry Lets Employers Track Their Workers across the Internet,” accessed March 17, 2011). Lawyers warn, however, that this type of monitoring should only be done if the employee has consented (People Management, “Employers Should Have Monitoring Policy for Social Networks,” accessed March 17, 2011). A monitoring company isn't always needed to monitor employees' movements on social networking. And sometimes employees don't even have to tweet something negative about their own company to lose their job. A case in point is when Chadd Scott, who does Atlanta sports updates for 680/The Fan, was fired for tweeting about Delta Airlines. In his tweet, he complained about a Delta delay and said they did not have enough de-icing fluid. Within a few hours, he was fired from his job, because Delta was a sponsor of 680/The Fan (Rodney Ho, “Chadd Scott Said He Was Fired for Tweets about Delta,” Access Atlanta (blog), accessed March 16, 2011).

The US Patriot Act also includes caveats to privacy when investigating possible terrorist activity. The Patriot Act requires organizations to provide private employee information when requested. Overall, it is a good idea to have a clear company policy and perhaps even a signed waiver from employees stating they understand their activities may be monitored and information shared with the US government under the Patriot Act.

Depending on the state in which you live, employees may be given to see their personnel files and the right to see and correct any incorrect information within their files. Medical or disability information should be kept separate from the employee’s work file, per the Americans with Disabilities Act. In addition, the Health Insurance Portability and Accountability Act (HIPAA) mandates that health information should be private, and therefore it is good practice to keep health information in a separate file as well.

Finally, drug testing and the right to privacy is a delicate balancing
act. Organizations that implement drug testing often do so for insurance or safety reasons. Because of the Drug-Free Workplace Act of 1988, requires that some federal contractors and all federal grantees agree they will provide a drug-free workplace as a condition of obtaining a contract. Some federal contractors and all federal grantees must agree they will provide a drug-free workplace, as a condition of obtaining the contract. The ADA does not view testing for illegal drug use as a medical examination (making them legal), and people using illegal drugs are not protected under the ADA (US Equal Employment Opportunity Commission, “The ADA, Your Responsibilities as an Employer,” accessed August 1, 2011). However, people covered under ADA laws are allowed to take medications directly related to their disability. In a recent case, Bates v. Dura Automotive Systems, an auto parts manufacturer had a high accident rate and decided to implement drug testing to increase safety. Several prescription drugs were banned because they were known to cause impairment. The plaintiffs in the case had been dismissed from their jobs because of prescription drug use, and they sued, claiming the drug-testing program violated ADA laws (Jackson Lewis, “Employees’ ADA Claims on Prescription-Drug-Use Dismissals Rejected by Federal Court,” December 1, 2010, accessed August 1, 2011). However, the Sixth Circuit Court reversed the case because the plaintiffs were not protected under ADA laws (they did not have a documented disability).

In organizations where heavy machinery is operated, a monthly drug test may be a job requirement. In fact, under the Omnibus Transportation Employee Testing Act of 1991, employers are legally required to test for drugs in transportation-related businesses such as airlines, railroads, trucking, and public transportation, such as bus systems. Medical marijuana is a relatively new issue that is still being addressed in states that allow its use. For example, if the company requires a drug test and the employee shows positive for marijuana use, does asking the employee to prove it is being used for medical purposes violate HIPAA privacy laws? This issue is certainly one to watch over the coming years.
Employee Privacy at XYZ Company

Email Monitoring
Emails can be monitored without prior notification if the company deems this necessary. If there is evidence that you are not adhering to the guidelines set out in the technology or email policy, the company reserves the right to take disciplinary action, including termination.

Website Monitoring
Websites visited during work hours may be monitored without prior notification. If there is evidence that inappropriate websites that violate company policy are visited, disciplinary action may be taken, including termination.

Social Media Monitoring
As a representative of this organization, all posts on social network sites such as Facebook or Twitter should not mention the organization, its customer or suppliers. Your social media websites may be monitored, and if inappropriate posts are made, disciplinary action may be taken including termination.

Signed

Dated

Department

Figure 1. Sample Policies on Privacy Relating to Technology

KEY TAKEAWAYS

- The employment-at-will principle means that an employer can separate from an employee without cause, and vice versa.
- Even though we have employment at will, a wrongful discharge can occur when there are violations of public policy, an employee has a contract with an employer, or an employer
does something outside the boundaries of good faith.

- **Whistleblowing** is when an employee notifies organizations of illegal or unethical activity. Whistleblowers are protected from discharge due to their activity.

- A *constructive discharge* means the conditions are so poor that the employee had no choice but to leave the organization.

- The *Worker Adjustment and Retraining Notification Act (WARN)* is a law that requires companies of one hundred or more employees to notify employees and the community if fifty or more employees are to be laid off.

- A *retaliatory discharge* is one that occurs if an employer fires or lays off an employee owing to a charge the employee filed. For example, if an employee files a workers’ compensation claim and then is let go, this could be a retaliatory discharge.

- The privacy of employees is an issue that HR must address. It is prudent to develop policies surrounding what type of monitoring may occur within an organization. For example, some organizations monitor e-mail, computer usage, and even postings on social network sites.

- Drug testing is also a privacy issue, although in many industries requiring safe working conditions, drug testing can be necessary to ensure the safety of all employees.
204. Reading: Multiculturalism and the Law

Multiculturalism and the Law

As we already know, it is in an organization's best interest to hire and promote a multicultural and diverse workforce. Sometimes though, people are still discriminated against at work. As a result, a federal agency has been established to ensure employees have a place to file complaints should they feel discriminated against.

Equal Employment Opportunity Commission (EEOC)

The Equal Employment Opportunity Commission (EEOC) is a federal agency charged with the task of enforcing federal employment discrimination laws. The laws include those that protect people from discrimination in all areas of employment, such as discrimination based on race, color, religion, sex, national origin, age, and disability. People who have filed a discrimination charge are also protected against discrimination under the EEOC. Employers with at least fifteen employees (twenty for age discrimination) are covered under the EEOC. This agency covers not only discrimination in hiring but also discrimination in all types of work situations such as firing, promotions, harassment, training, wages, and benefits. The EEOC has the authority to investigate charges of discrimination against employers. The agency investigates the claims, makes a finding, and then tries to settle the charge. If they are unsuccessful in settling the charge, the EEOC has
the right to file a lawsuit on behalf of the complainants. The EEOC has headquarters in Washington, DC, with fifty-three field offices throughout the United States.

If a company has more than one hundred employees, a form called the EEO-1 must be filled out yearly. This form confirms the demographics of an organization based on different job categories (Equal Opportunity Employment Commission, 2011 EEO-1 Survey, accessed December 20, 2010). An organization that employs more than fifty people and works for the federal government must also file an EEO-1 yearly, with the deadline normally in September. In addition, organizations must post the EEOC notice, which you have probably seen before, perhaps in the company break room. Finally, organizations should keep on file records such as hiring statistics in the event of an EEOC investigation.

It is necessary to mention here that while there is a legal compliance concern, as discussed before, it is in the company's best interest to hire a diverse workforce. So while we can discuss the legal aspects, remember that the purpose of having a diverse workforce is not just to meet EEOC requirements but to create a better, more profitable workplace that better serves customers.

Table 1. How the EEOC Process Works and Requirements for Employers
**Requirements by EEOC**

- Post Federal and State EEOC notices
- File yearly report called EEO-1
- Keep copies of documents on file

**Process for Investigation**

1. The EEOC complaint is filed.
2. The EEOC notifies the organization of the charges.
3. The EEOC acts as a mediator between the employee and the employer to find a solution.
4. If step 3 is unsuccessful, the EEOC will initiate an investigation.
5. The EEOC makes a determination, and then the employer has the option of remedying the situation or face a potential lawsuit.

**EEOC Federal Legislation**

While the EEOC is the larger governing body, many pieces of legislation relating to multicultural practices are part of the EEOC family of laws. Many of these laws began with Title VII of the Civil Rights Act in 1964. This act, enforced by the EEOC, covers several areas in which discrimination was rampant. However, a bona fide occupational qualification (BFOQ) is a quality or attribute employers are allowed to consider when making decisions during the selection process. Examples of BFOQs are a maximum age limit for airline pilots for safety reasons and a Christian college’s requirement that the president of the college be Christian.

EEOC laws relate specifically to the following:

1. Age
2. Disability
3. Equal pay
4. Genetic information
5. National origin
Age

Age discrimination involves treating someone less favorably because of his or her age. Created in 1967, the Age Discrimination in Employment Act (ADEA) is enforced by the EEOC. This law covers people who are age forty or older. It does not cover favoring an older worker over a younger worker, if the older worker is forty years or older. The law covers any aspect of employment such as hiring, firing, pay, job assignments, promotions, layoffs, training, fringe benefits, and any other condition or term of employment.

The law also goes deeper by forbidding harassment of someone based on age. While simple teasing or offhand comments are not covered, more serious offensive remarks about age are covered by this EEOC law.

Disability

The Americans with Disabilities Act (ADA) prohibits discrimination against those with disabilities and is enforced by the EEOC. Discrimination based on disability means treating a qualified person unfavorably because of a disability. For example, if someone has AIDS that is controlled, the employee cannot be treated unfavorably. The law requires an employer to provide reasonable accommodation to an employee or applicant with a disability, unless this accommodation would cause significant difficulty or expense.
for the employer. A reasonable accommodation is defined by the EEOC as any change in the work environment or in the way things are customarily done that enables an individual with a disability to enjoy equal employment opportunities. A reasonable accommodation might include making the workplace accessible for wheelchair use or providing equipment for someone who is hearing or vision impaired.

This law does not mean that organizations are required to hire unqualified people. The law specifically states the person must be qualified for the job and have a disability defined by the law. A disability defined by the law can include the following:

1. Physical or mental condition that limits a major life activity (walking, talking, seeing, hearing, or learning)
2. History of a disability (e.g., cancer that is in remission)
3. Physical or mental impairment that is not transitory (lasting or expected to last less than six months)

The law places limits on employers when it comes to asking job applicants questions about medical history or asking a person to take a medical exam.

**Equal Pay/Compensation**

The basis of this law is that people are paid the same for the same type of work, and the law specifically addresses gender pay differences. Rather than job title, job content is used to determine if the job is the same work. In addition to covering salary, it deals with overtime pay, bonus, stock options, profit sharing, and other types of bonus plans such as vacation and holiday pay. If inequality in pay is found, the employer cannot reduce the wages of either sex to equalize the pay.

An employee who files an equal pay charge has the option to go directly to court rather than the EEOC.
Genetic Information

This law is one of the newer EEOC laws, which took effect in November 2009. The EEOC's definition of genetic information includes family medical information or information about the manifestation of a disease or disorder in an individual's family. For example, an employer cannot discriminate against an employee whose family has a history of diabetes or cancer. This information could be used to discriminate against an employee who has an increased risk of getting a disease and may make health-care costs more expensive for the organization.

In addition, the employer is not allowed to seek out genetic information by requesting, requiring, or purchasing this information. However, there are some situations in which receiving this information would not be illegal:

1. A manager or supervisor overhears an employee talking about a family member's illness.
2. Information is received based on wellness programs offered on a voluntary basis.
3. If the information is required as documentation to receive benefits for the Family and Medical Leave Act (FMLA). FMLA is discussed in Section 3 “Pregnancy”.
4. If the information is commercial, such as the appearance of information in a newspaper, as long as the employer is not specifically searching those sources for the purpose of finding genetic information.
5. If genetic information is required through a monitoring program that looks at the biological effects of toxic substances in the workplace.
6. For those professions that require DNA testing, such as law enforcement agencies. In this case, the genetic information may only be used for analysis in relation to the specific case at hand.
This law also covers how information about genetics should be kept. For example, genetic information must be kept separate from an employee’s regular file.

**National Origin**

It is illegal to treat people unfavorably because they are from a particular country or part of the world, because of their accent, or because they appear to be of a particular descent (even if they are not). The law protecting employees based on national origin refers to all aspects of employment: hiring, firing, pay, job assignments, promotions, layoffs, training, and fringe benefits. An employer can require an employee to speak English only if it is necessary to perform the job effectively. An English-only policy is allowed only if it is needed to ensure the safe or efficient operations of the employer's business. An employer may not base an employment decision on a foreign accent, unless the accent seriously interferes with job performance.

**Pregnancy**

This section of the EEOC refers to the unfavorable treatment of a woman because of pregnancy, childbirth, or a medical condition related to pregnancy or childbirth. The Pregnancy Discrimination Act of 1978, added to the Civil Rights Act of 1964, is enforced by the EEOC. The woman who is unable to perform her job owing to pregnancy must be treated the same as other temporarily disabled employees. For example, modified tasks or alternative assignments should be offered. This law refers not only to hiring but also to firing, pay, job assignments, promotions, layoffs, training, and fringe benefits. In addition to this law against discrimination of pregnant women, the Family and Medical Leave Act (FMLA) is enforced by the
US Department of Labor (US Department of Labor, Leave Benefits: Family and Medical Leave, US Department of Labor, accessed December 20, 2010). The FMLA requires companies with fifty or more employees to provide twelve weeks of unpaid leave for the following:

1. Birth and care of a newborn child
2. Care of an adopted child
3. Care for immediate family members (spouse, child, or parent) with a serious health condition
4. Medical leave for the employee who is unable to work because of a serious health condition

In addition to the company size requirement, the employee must have worked at least 1,250 hours over the past 12 months.

Race/Color

This type of discrimination refers to treating someone unfavorably because he or she is of a certain race or because of certain characteristics associated with race. These characteristics might include hair texture, skin color, or facial features. Discrimination can occur when the person discriminating is the same race or color of the person who is being discriminated against. EEOC law also protects people who are married to or associated with someone of a certain race or color. As with the other types of antidiscrimination laws we have discussed, this law refers not only to the initial hiring but also to firing, pay, job assignments, promotions, layoffs, training, and fringe benefits.

Religion

This part of the EEOC refers to treating a person unfavorably
because of their religious beliefs. This law requires a company to reasonably accommodate an employee's religious beliefs or practices, unless doing so would burden the organization's operations. For example, allowing flexible scheduling during certain religious periods of time might be considered a reasonable accommodation. This law also covers accommodations in dress and grooming, such as a headscarf, religious dress, or uncut hair and a beard in the case of a Sikh. Ideally, the employee or applicant would notify the employer that he or she needs such an accommodation for religious reasons, and then a discussion of the request would occur. If it wouldn't pose hardship, the employer should honor the request. If the request might cause a safety issue, decrease efficiency, or infringe on the rights of other employees, it may not be honored.

Retaliation

In all the laws mentioned, the EEOC set of laws makes it illegal to fire, demote, harass, or retaliate against people because they filed a charge of discrimination, complained about discrimination, or participated in employment discrimination proceedings. Perhaps one of the most high-profile sexual harassment and retaliation cases was that of Sanders v. Thomas. Isiah Thomas, then coach of the New York Knicks, fired Anucha Browne Sanders because she hired an attorney to file sexual harassment claims charges. The jury awarded Browne Sanders $11.6 million in punitive charges because of the hostile work environment Thomas created and another $5.6 million because Browne Sanders was fired for complaining (Michael Schmidt, “Jury Awards $11.6 Million to Former Knicks Executive,” New York Times, October 2, 2007, accessed July 12, 2011). A portion of the lawsuit was to be paid by Madison Square Garden and James Dolan, chairman of Cablevision, the parent company of Madison Square Garden and the Knicks. Browne Sanders's lawyers successfully argued that the inner workings of Madison Square
Garden were hostile and lewd, and that the former marketing executive of the organization subjected her to hostility and sexual advances. Thomas left the organization as coach and president in 2008. As in this case, there are large financial and public relations penalties not only for sexual harassment but for retaliation after a harassment suit has been filed.

**Sex and Sexual Harassment**

Sex discrimination involves treating someone unfavorably because of their sex. As with all EEOC laws, this relates to hiring, firing, pay, job assignments, promotions, layoffs, training, and fringe benefits. This law directly ties into sexual harassment laws, which include unwelcome sexual advances, requests for sexual favors, and other verbal or physical harassment of a sexual nature. The victim can be male or female, and sexual harassment can occur female to female, female to male, male to female, and male to male.

**Harassment at Yale?** The following 2011 video outlines a sexual harassment lawsuit at Yale University. It shows that the lawsuit blamed Yale not for the harassment but for not taking a harder stand on this type of harassment.
Military Service

The Uniformed Services Employment and Reemployment Rights Act (USERR) protects people who serve or have served in the armed forces, Reserves, National Guard, or other uniformed services. The act ensures these individuals are not disadvantaged in their civilian careers because of their service. It also requires they be reemployed in their civilian jobs upon return to service and prohibits discrimination based on past, present, or future military service.
KEY TAKEAWAYS

• The Equal Employment Opportunity Commission (EEOC) is a federal agency charged with the development and enforcement of laws relating to multiculturalism and diversity in the workplace.
• The EEOC covers discrimination based on several areas. Companies cannot discriminate based on age; EEOC law covers people who are forty years or older.
• Employers cannot discriminate against people with disabilities and must provide reasonable accommodations, such as the addition of a wheelchair ramp to accommodate those with disabilities.
• Equal pay refers to the fact people should legally be paid the same amount for performing the same type of work, even if the job title is different.
• The newest addition to EEOC law prohibits discrimination based on genetic information, such as a history of cancer in a family.
• Unfavorable treatment of people because they are from a particular country or part of the world or have an accent is covered by the EEOC. An organization cannot require people to speak English, unless it is a requirement for the job or needed for safety and efficient operation of the organization.
• Women can’t be discriminated against because they are pregnant. The inability to perform certain tasks due to pregnancy should be treated as a temporary disability; accommodation can be in the form of modified tasks or alternative assignments.
• The EEOC protects people from discrimination based on their race or color.
• Religion is also an aspect of the EEOC family of laws. The protection of religion doesn’t allow for discrimination; accommodations include modifications of work schedules or
dress to be made for religious reasons.

- Discrimination on the basis of sex is illegal and covered by the EEOC. Sexual harassment is also covered by the EEOC and states that all people, regardless of sex, should work in a harassment-free environment.
- Retaliation is also illegal. An organization cannot retaliate against anyone who has filed a complaint with the EEOC or a discrimination lawsuit.
- The US Department of Labor oversees some aspects of EEOC laws, such as the Family and Medical Leave Act (FMLA). This act requires organizations to give twelve weeks of unpaid leave in the event of an adoption, a birth, or a need to provide care to sick family members.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:

https://library.achievingthedream.org/baycollegeintrobusiness/?p=234
205. Outcome: Recruiting Employees

What you’ll learn to do: describe the methods that businesses use to recruit employees

Recruiting employees might call to mind placing advertisements in newspapers, listing positions with local job placement agencies, or using social media. However, there is much more involved in the recruitment and final selection of employees. Often a person’s first job is in some kind of retail environment, and it might seem like there is little thought or effort behind the recruitment process. Before you begin your study of the recruitment function of HR, take a few minutes to watch the video below and listen to three retail CEOs talk about the process of placing the right person in the right position.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Recruitment Process
- Self Check: Recruiting Employees

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
The Recruitment Process

The recruitment process is an important part of human resource management (HRM). It doesn’t happen without proper strategic planning. Recruitment is defined as a process that provides the organization with a pool of qualified job candidates from which to choose. Before companies recruit, they must implement proper staffing plans and forecasting to determine how many people they will need. The basis of the forecast will be the annual budget of the organization and the short- to long-term plans of the organization—for example, the possibility of expansion. Forecasting is based on both internal and external factors. Internal factors include the following:

1. Budget constraints
2. Expected or trend of employee separations
3. Production levels
4. Sales increases or decreases
5. Global expansion plans

External factors might include the following:

1. Changes in technology
2. Changes in laws
3. Unemployment rates
4. Shifts in population
5. Shifts in urban, suburban, and rural areas
6. Competition
Once the forecasting data are gathered and analyzed, the HR professional can see where gaps exist and then begin to recruit individuals with the right skills, education, and backgrounds. This section will discuss this step in HR planning.

Recruitment Strategy

Although it might seem easy, recruitment of the right talent, at the right place and at the right time, takes skill and practice, but more important, it takes strategic planning. An understanding of the labor market and the factors determining the relevant aspects of the labor market is key to being strategic about your recruiting processes.

Based on this information, when a job opening occurs, the HRM professional should be ready to fill that position. Here are the aspects of developing a recruitment strategy:

1. Refer to a staffing plan.
2. Confirm the job analysis is correct through questionnaires.
3. Write the job description and job specifications.
4. Have a bidding system to recruit and review internal candidate qualifications for possible promotions.
5. Determine the best recruitment strategies for the position.
6. Implement a recruiting strategy.

The first step in the recruitment process is acknowledgment of a job opening. At this time, the manager and/or the HRM look at the job description for the job opening (assuming it isn't a new job).

Assuming the job analysis and job description are ready, an organization may decide to look at internal candidates' qualifications first. Internal candidates are people who are already working for the company. If an internal candidate meets the qualifications, this person might be encouraged to apply for the
job, and the job opening may not be published. Many organizations have formal job posting procedures and bidding systems in place for internal candidates. For example, job postings may be sent to a listserv or other avenue so all employees have access to them. However, the advantage of publishing open positions to everyone in and outside the company is to ensure the organization is diverse.

Then the best recruiting strategies for the type of position are determined. For example, for a high-level executive position, it may be decided to hire an outside head-hunting firm. For an entry-level position, advertising on social networking websites might be the best strategy. Most organizations will use a variety of methods to obtain the best results.

Another consideration is how the recruiting process will be managed under constraining circumstances such as a short deadline or a low number of applications. In addition, establishing a protocol for how applications and résumés will be processed will save time later. For example, some HRM professionals may use software such as Microsoft Excel to communicate the time line of the hiring process to key managers.

Once these tasks are accomplished, the hope is that you will have a diverse group of people to interview (called the selection process). Before this is done, though, it is important to have information to ensure the right people are recruited. This is where the job analysis and job description come in.

**Job Analysis and Job Descriptions**

The job analysis is a formal system developed to determine what tasks people actually perform in their jobs. The purpose of a job analysis is to ensure creation of the right fit between the job and the employee and to determine how employee performance will be assessed. A major part of the job analysis includes research, which may mean reviewing job responsibilities of current employees,
researching job descriptions for similar jobs with competitors, and analyzing any new responsibilities that need to be accomplished by the person with the position. According to research by Hackman and Oldham, a job diagnostic survey should be used to diagnose job characteristics prior to any redesign of a job (J. Richard Hackman and Greg R. Oldham, “Motivation through the Design of Work: Test of a Theory,” Organizational Behavior and Human Performance 16, no. 2, August 1976, pp 250–79).

To start writing a job analysis, data need to be gathered and analyzed, keeping in mind Hackman and Oldham's model. Figure 1, “Process for Writing the Job Analysis,” below shows the process of writing a job analysis. Please note, though, that a job analysis is different from a job design. Job design refers to how a job can be modified or changed to be more effective—for example, changing tasks as new technology becomes available.

![Figure 1. Process for Writing the Job Analysis](image)

The information gathered from the job analysis is used to develop both the job description and the job specifications. A job description is a list of tasks, duties, and responsibilities of a job. Job specifications, on the other hand, discuss the skills and abilities the person must have to perform the job. The two are tied together, as job descriptions are usually written to include job specifications. A job analysis must be performed first, and then based on that data,
we can successfully write the job description and job specifications. Think of the analysis as “everything an employee is required and expected to do.” HR professionals might use paper or online questionnaires to gather data for a job analysis.

Two types of job analyses can be performed: a task-based analysis and a competency- or skills-based analysis. A task-based analysis focuses on the duties of the job, as opposed to a competency-based analysis, which focuses on the specific knowledge and abilities an employee must have to perform the job. An example of a task-based analysis might include information on the following:

1. Write performance evaluations for employees.
2. Prepare reports.
3. Answer incoming phone calls.
4. Assist customers with product questions.
5. Cold-call three customers a day.

With task job analysis, the specific tasks are listed and it is clear. With competency based, it is less clear and more objective. However, competency-based analysis might be more appropriate for specific, high-level positions. For example, a competency-based analysis might include the following:

1. Able to utilize data analysis tools
2. Able to work within teams
3. Adaptable
4. Innovative

You can clearly see the difference between the two. The focus of task-based analyses is the job duties required, while the focus of competency-based analyses is on how a person can apply their skills to perform the job. One is not better than the other but is simply used for different purposes and different types of jobs. For example, a task-based analysis might be used for a receptionist, while a competency-based analysis might be used for a vice
president of sales position. Consider the legal implications, however, of which job analysis is used. Because a competency-based job analysis is more subjective, it might be more difficult to tell whether someone has met the criteria.

Once you have decided if a competency-based or task-based analysis is more appropriate for the job, you can prepare to write the job analysis. Of course, this isn’t something that should be done alone. Feedback from managers should be taken into consideration to make this task useful in all levels of the organization.

Organization is a key component to preparing for your job analysis. For example, will you perform an analysis on all jobs in the organization or just focus on one department? Once you have determined how you will conduct the analysis, a tool to conduct the analysis should be chosen. Most organizations use questionnaires (online or hard copy) to determine the duties of each job title. Some organizations will use face-to-face interviews to perform this task, depending on time constraints and the size of the organization. A job analysis questionnaire usually includes the following types of questions, obviously depending on the type of industry:

1. Employee information such as job title, how long in position, education level, how many years of experience in the industry
2. Key tasks and responsibilities
3. Decision making and problem solving: this section asks employees to list situations in which problems needed to be solved and the types of decisions made or solutions provided.
4. Level of contact with colleagues, managers, outside vendors, and customers
5. Physical demands of the job, such as the amount of heavy lifting or ability to see, hear, or walk
6. Personal abilities required to do the job—that is, personal characteristics needed to perform well in this position
7. Specific skills required to do the job—for example, the ability to run a particular computer program
8. Certifications to perform the job
Once all employees (or the ones you have identified) have completed the questionnaire, you can organize the data, which is helpful in creating job descriptions. If there is more than one person completing a questionnaire for one job title, the data should be combined to create one job analysis for one job title. There are a number of software packages available to help human resources perform this task, such as AutoGOJA.

Once the job analysis has been completed, it is time to write the job description and specifications, using the data you collected. Job descriptions should always include the following components:

1. Job functions (the tasks the employee performs)
2. Knowledge, skills, and abilities (what an employee is expected to know and be able to do, as well as personal attributes)
3. Education and experience required
4. Physical requirements of the job (ability to lift, see, or hear, for example)
Job Description:

The Department of Commerce, Community and Economic Development (CCED) is seeking a technically skilled individual to fill a key Systems Programmer position. This position supports all aspects of the department’s imaging and document repository infrastructure. The position is responsible for administering the imaging environment, including software and hardware installation, configuration, security and providing programming support to Analyst/Programmers coding applications that access and manipulate images.

Commerce’s imaging environment utilizes Oracle Content Management and .Net applications. The successful candidate should be technically skilled and motivated to learn new technologies and processes.

Key responsibilities include:

- Administer all aspects of the department’s Oracle UCM (Universal Content Management) servers and Kofax environment.
- Code custom image access and manipulation services using WSDL (web service definition language) and .Net.
- Configure, modify and update Adobe Capture and UCM inbound refinery. Develop batch classes and custom validation and release scripts.
- Install, configure and maintain high speed and flatbed scanner equipment.
- Work with users and programming staff to develop efficient physical paper workflows and practical scanning processes.
- Develop relevant scan workflows and required hardware for a variety of media such as envelopes, plain paper, and odd sizes.
- Monitor production system CPU, disk space, network utilization and error logs and make appropriate configuration changes and updates.

Figure 2. Sample Job Description

Notice how the job description includes the job function; knowledge, skills, and abilities required to do the job; education and
experience required; and the physical requirements of the job. Once the job description has been written, obtaining approval from the hiring manager is the next step. Then the HR professional can begin to recruit for the position.

KEY TAKEAWAYS

- The recruitment process provides the organization with a pool of qualified applicants.
- Some companies choose to hire internal candidates—that is, candidates who are already working for the organization. However, diversity is a consideration here as well.
- A job analysis is a systematic approach to determine what a person actually does in his or her job. This process might involve a questionnaire to all employees. Based on this analysis, an accurate job description and job specifications can be written. A job description lists the components of the job, while job specifications list the requirements to perform the job.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times. Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
207. Outcome: Employee Performance

What you’ll learn to do: identify the steps in appraising employee performance

Many employees will not have interaction with Human Resources after they are hired until it is time for a review of their performance. Few things cause more apprehension among employees than performance evaluations. Often this is the result of uncertainty about the criteria by which they are being evaluated or the possible outcome of their review. Having a well-designed and communicated process for appraising employee performance is a critical part of the HR manager’s job. Not only does it support the development and growth of the workforce, but it can also prevent many of the legal issues you read about earlier in this module.

LEARNING ACTIVITIES

The learning activities for this section include:
• Reading: Performance Appraisal
• Self Check: Employee Performance

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Performance Appraisal

Employees generally want their managers to tell them three things: what they should be doing, how well they’re doing it, and how they can improve their performance. Good managers address these issues on an ongoing basis. On a semiannual or annual basis, they also conduct formal performance appraisals to discuss and evaluate employees’ work performance.

The Basic Three-Step Process

Appraisal systems vary both by organization and by the level of the employee being evaluated, but as you can see in Figure 1, “How to Do a Performance Appraisal,” below, it’s generally a three-step process:

1. Before managers can measure performance, they must set goals and performance expectations and specify the criteria (such as quality of work, quantity of work, dependability, initiative) that they’ll use to measure performance.
2. At the end of a specified time period, managers complete written evaluations that rate employee performance according to the predetermined criteria.
3. Managers then meet with each employee to discuss the evaluation. Jointly, they suggest ways in which the employee can improve performance, which might include further training and development.
It sounds fairly simple, but why do so many managers report that, except for firing people, giving performance appraisals is their least favorite task? To get some perspective on this question, we'll look at performance appraisals from both sides, explaining the benefits and identifying potential problems with some of the most common practices.

Among other benefits, formal appraisals provide the following:

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

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

360-Degree and Upward Feedback

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

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

Retaining Valuable Employees

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

Creating a Positive Work Environment

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

What sort of things improve employee attitudes? The twelve thousand employees of software maker SAS Institute fall into the category of “happy workers.” They choose the furniture and equipment in their own (private) offices; eat subsidized meals at one of three on-site restaurants; enjoy free soft drinks, fresh fruit on Mondays, M&M's on Wednesdays, and a healthy breakfast snack on Fridays in convenient break rooms; and swim and work out at a seventy-seven-thousand-square-foot fitness center. They set their own work hours, and they’re encouraged to stay home with sick children. They also have job security: no one’s ever been laid off because of an economic downturn. The employee-friendly work environment helps SAS employees focus on their jobs and contribute to the attainment of company goals. Not surprisingly, it also results in very low 3 percent turnover.

Recognizing Employee Contributions

Thanking people for work done well is a powerful motivator. People who feel appreciated are more likely to stay with a company than those who don't. Robert McGarvey, “A Tidal Wave of Turnover,” American Way, December 15, 2004, 32–36. While personal thank-yous are always helpful, many companies also have formal programs for identifying and rewarding good performers. The Container Store, a national storage and container retailer, rewards employee accomplishments in a variety of ways. Recently, for example, twelve employees chosen by coworkers were rewarded with a Colorado vacation with the company's owners, and the seven winners of a sales contest got a trip to visit an important supplier—in Sweden. The company is known for its supportive environment and
has frequently been selected as one of the top U.S. companies to work for.

Involving Employees in Decision Making

Companies have found that involving employees in decisions saves money, makes workers feel better about their jobs, and reduces turnover. Some have found that it pays to take their advice. When General Motors asked workers for ideas on improving manufacturing operations, management was deluged with more than forty-four thousand suggestions during one quarter. Implementing a few of them cut production time on certain vehicles by 15 percent and resulted in sizable savings (Freda Turner, “An Effective Employee Suggestion Program Has a Multiplier Effect,” WebPro News, March 4, 2003, accessed October 11, 2011).

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

Why People Quit

As important as such initiatives can be, one bad boss can spoil everything. The way a person is treated by his or her boss may be the primary factor in determining whether an employee stays or goes. People who have quit their jobs cite the following behavior by superiors:
• Making unreasonable work demands
• Refusing to value their opinions
• Failing to be clear about what’s expected of subordinates
• Rejecting work unnecessarily
• Showing favoritism in compensation, rewards, or promotions

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

Involuntary Termination

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

Employment at Will

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

Fortunately for you, over the past several decades, the courts have undercut employers’ rights under the employment-at-will doctrine. By and large, management can no longer fire employees at will: usually, employers must show just cause for termination, and in some cases, they must furnish written documentation to substantiate the reasons for terminating an employee. If it’s a case of poor performance, the employee is generally warned in advance that his or her current level of performance could result in termination. As a rule, managers give employees who have been warned a reasonable opportunity to improve performance. When termination is unavoidable, it should be handled in a private conversation, with the manager explaining precisely why the action is being taken.

KEY TAKEAWAYS

• Managers conduct performance appraisals to evaluate work performance, usually following a three-step process:
  ◦ Setting goals and performance expectations and specifying the criteria for measuring performance
  ◦ Completing written evaluations to rate performance according to predetermined criteria
  ◦ Meeting with employees to discuss evaluations and ways to improve performance

• Turnover—the permanent separation of an employee from a company—has a negative effect on an organization.
In addition to offering competitive compensation, companies may take a variety of steps to retain qualified employees:

- Providing appropriate training and development
- Helping employees achieve a satisfying work/nonwork balance in their lives
- Creating a positive work environment
- Recognizing employee efforts
- Involving employees in decision making

On the other hand, employers may have to terminate the employment of (that is, fire) some workers.

- They may lay off workers because revenues are down and they have to **downsize**—to cut costs by eliminating jobs.
- Sometimes a job is phased out, and sometimes an employee simply fails to meet performance requirements.

If there's no written employment contract, the employment relationship falls under the principle of **employment-at-will**, by which an employer can end it at any time. Usually, however, the employer must show just cause.

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**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
209. Outcome: Challenges in Human Resource Management

What you’ll learn to do: discuss the challenges faced by human resource managers in today’s business environment, such as outsourcing, aging workforce, and technological advances.

The environment within which human resource managers operate can resemble a tangled web of issues, interests, technologies, and laws. As the business environment becomes increasingly complex, so does the job of the HR professional. This means that staying informed about these changes is critical to both the human resource manager’s personal success and the organization’s success. In this section of the module you will learn about some of the challenges faced by these professionals.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Today’s HRM Challenges
- Self Check: Challenges in Human Resource Management

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Containing Costs

All departments within an organization must prove their value and contributions to the overall business strategy, and the same is true with HRM. As companies are becoming more concerned with cutting costs, HRM departments must show the value they add to the organization through alignment with business objectives. Being able to add value starts with understanding some of the challenges of businesses and finding ways to reduce a negative impact on the business. If you were to ask most business owners what their biggest challenges are, they will likely tell you that cost management is a major factor in the success or failure of their business. In most businesses today, the people part of the business is the most likely place for cuts when the economy isn’t doing well. Expenses that involve the people part of any business include benefits, hiring process costs, and many more . . .

Benefits

These costs cut into the bottom line of any business. The trick is to figure out how much, how many, or how often benefits should be offered, without sacrificing employee motivation. A company can cut costs by not offering benefits or 401(k) plans, but if its goal is to hire the best people, a hiring package without these items will most certainly not get the best people. Containment of costs, therefore, is a balancing act. An HR manager must offer as much as he or she
can to attract and retain employees, but not offer too much, as this can put pressure on the company’s bottom line.

**Hiring and Turnover**

Another consideration is the cost of hiring and turnover. The hiring process and the cost of turnover in an organization can be very expensive. Turnover refers to the number of employees who leave a company in a particular period of time. By creating a recruiting and selection process with cost containment in mind, HR can contribute directly to cost-containment strategies company wide. In fact, the cost of hiring an employee or replacing an old one (turnover) can be as high as $9,777 for a position that pays $60,000 (James Del Monte, “Cost of Hiring and Turnover,” JDA Professional Services, Inc., 2010, accessed October 1, 2010). By hiring smart the first time, HR managers can contain costs for their organization.

**Offshoring**

One cost-containment strategy for U.S. businesses has been offshoring. Offshoring is the process of moving jobs overseas to contain costs. It is estimated that 3.3 million U.S. jobs will be moved overseas by 2015 (Vivek Agrawal and Diana Farrell, “Who Wins in Offshoring?” in “Global Directions,” special issue, McKinsey Quarterly, 2003, pp 36–41). According to the U.S. Census Bureau, most of these jobs are Information Technology (IT) jobs as well as manufacturing jobs. This issue is unique to HR, as the responsibility for developing training for new workers and laying off domestic workers will often fall under the realm of HRM. Of course, cost containment isn’t only up to HRM and managers, but as
organizations look at various ways to contain costs, human resources can certainly provide solutions.

Technology

Technology has greatly affected human resources and will continue to do so as new technology is developed. Through use of technology, many companies have virtual workforces that perform tasks from nearly all corners of the world. When employees are not located just down the hall, management of these human resources creates some unique challenges. For example, technology creates an even greater need to have multicultural or diversity understanding. Since many people will work with individuals from across the globe, cultural sensitivity and understanding is the only way to ensure the use of technology results in increased productivity rather than decreased productivity due to miscommunications.

Technology also creates a workforce that expects to be mobile. Because of the ability to work from home or anywhere else, many employees may request and even demand a flexible schedule to meet their own family and personal needs. Productivity can be a concern for all managers in the area of flextime, and another challenge is the fairness to other workers when one person is offered a flexible schedule. Many companies, however, are going a step further and creating virtual organizations, which don't have a physical location (cost containment) and allow all employees to work from home or the location of their choice. As you can imagine, this creates concerns over productivity and communication within the organization.
The use of smartphones and social networking has impacted human resources, as many companies now disseminate information to employees via these methods. Of course, technology changes constantly, so the methods used today will likely be different one year or even six months from now. Of course, the major challenge with technology is its constantly changing nature, which can impact all practices in HRM.

The Economy

Tough economic times in a country usually results in tough times for business, too. High unemployment and layoffs are clearly HRM
and managerial issues. If a human resource manager works for a unionized company, union contracts are the guiding source when having to downsize owing to a tough economy. Besides union restrictions, legal restrictions on who is let go and the process followed to let someone go should be on the forefront of any manager’s mind when he or she is required to lay off people because of a poor economy. Dealing with performance issues and measuring performance can be considerations when it is necessary to lay off employees.

Likewise, in a growth economy, the HR manager may experience a different kind of stress. Massive hiring to meet demand might occur if the economy is doing well. For example, McDonald’s restaurants had to fill six hundred positions throughout Las Vegas and held

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1050 | Reading: Today’s HRM Challenges
hiring day events in 2010 (“McDonald's Readies for Massive Hiring Spree,” Fox 5 News, Las Vegas, May 2010, accessed October 5, 2010). Imagine the process of hiring this many people in a short period of time. The same recruiting and selection processes used under normal circumstances will be helpful in mass hiring situations.

The Changing and Diverse Workforce

Human resources should be aware that the workforce is constantly changing. It is expected that over the next ten years, more than 40 percent of the workforce will retire, and there will not be enough younger workers to take the jobs once held by the retiring workers (Alvaro Fernandez, “Training the Aging Workforce,” SharpBrains, August 10, 2007, accessed October 6, 2010). In fact, the American Society of Training and Development says that in the next twenty years, seventy-six million Americans will retire, and only forty-six million will replace them. First, the retirement of baby boomers results in a loss of a major part of the working population, and there are not enough people to fill those jobs that are left vacant. Second, the baby boomers' knowledge is lost upon their retirement. Much of this knowledge isn't formalized or written down, but it contributes to the success of business. Third, elderly people are living longer, and this results in higher health-care costs for all currently in the workforce.
KEY TAKEAWAYS

Whether it is changes in health care laws, an aging workforce, changes in technology or an increasingly diverse workforce the fact remains that human resource managers must always be attuned to the changes in the external environment in order to plan for and maintain the workforce necessary for the company to achieve its goals.

- One of the major challenges of HRM is containment of costs. This can be done in several ways, for example, in the way health care and benefits are offered.
• Hiring is a very expensive part of human resources, and therefore HRM should take steps to ensure they are hiring the right people for the job the first time. Turnover is a term used to describe the departure of an employee.
• Technology is also a challenge to be met by human resources. For example, employees may request alternative work schedules because they can use technology at home to get their work done.
• The economy is a major factor in human resource management. HR managers, no matter what the state of the economy, must plan effectively to make sure they have the right number of workers at the right time. When we deal with a down economy, the legal and union implications of layoffs must be considered, and in an up economy, hiring of workers to meet the internal demand is necessary.
• The retirement of baby boomers is creating a gap in the workplace, related to not only the number of people available but also the skills people have. Multigenerational companies, or companies with workers of a variety of ages, must find ways to motivate employees, even though those employees may have different needs. HR must be aware of this and continually plan for the challenge of a changing workforce.

Check Your Understanding

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211. Putting It Together: Human Resource Management

Summary

Human Resource Management

Human resource managers are responsible for the activities needed to recruit, hire, train, develop, and retain a workforce that meets the requirements of the companies strategic human resource plan. At all levels within the organization, the process of hiring workers results from a process of job analysis, operational planning, and the careful crafting of job descriptions that set out clear requirements for job performance.

Legislation and Employer-Employee Relationships

Federal and state legislation have been enacted to prevent discrimination, set minimum wages, establish maximum work hours, and set standards for health and safety. Laws such as the ADA, EEOC, and the Civil Rights Act combine to create a work environment that affords workers protection from discrimination and exploitation.
Recruiting Employees

HR professionals manage the recruitment process in order to identify the pool of qualified applicants. Both internal and external candidates are selected based on job specifications, which are the result of an analysis of the job/position.

Employee Performance

Once employees are hired, the HR managers must manage the process by which employees' performance is evaluated. The process includes setting goals, completing a formal written evaluation, communicating the results to the employee, and then taking corrective action where needed.

Challenges in Human Resource Management

The future holds many challenges for HR Managers. An aging workforce, increased diversity, working from home, and advances in technology all create an environment that brings new challenges to human resources.

Synthesis

Since the 1900s, American society has evolved and the working conditions of employees have improved dramatically. Workplace discrimination and inequities still exist, however, and human resource professionals play an important role in reducing and eliminating them. How can such efforts impact your work life?
If your position in a company gives you human resource management responsibilities, then it is essential that you understand the employer-employee relationship from both a legal and ethical perspective. Failure to properly apply laws, regulations, and policies in your management of the workforce can result in high turnover rates, grievances, strikes, and even worse—lawsuits. A discrimination lawsuit can potentially be a death blow to a company, displacing hundreds or thousands of workers and negatively impacting the economy.

If you are an employee, then it is crucial for you to understand your rights under employment law. Knowing and exercising your rights is important not only for your own protection but for the general progress of improving conditions, pay, and benefits for other workers. Human resource managers are skilled in these areas and are a resource for employees should they experience discrimination, unfair treatment, or unsafe working conditions.

Recall the nineteenth-century workers you read about at the start of this module—they didn’t have a human resource manager to act as their advocate in the face of dismal and dangerous conditions. Today, the work environment for most employees is certainly better—not perfect, but better. Just how much has it improved? Take a few minutes to watch the following video to see just how far we’ve come.
Why It Matters: Marketing

Why understand key components of the marketing function and its role in contributing to the success of a business?

What words come to mind when you hear the words *pharmaceutical company*?

Large pharmaceutical or drug companies are often blamed for the rising cost of medical care, delaying the introduction of new drugs to increase corporate profitability and blocking the acceptance of alternative medicines. Setting aside the question of whether that view is justifiable, most people would agree that the major drug companies don't generally hold a place near and dear to our hearts.

You might be thinking, So what?—Isn't this module about marketing, not drug companies? Well, yes. You're correct, but read on.

By the time you finish this module you will have a broader understanding of marketing beyond televisions commercials and popup ads on your computer. Marketing is a tool used by companies, organizations, and even people to shape our perceptions of them, and they do it by means of a well-designed marketing strategy. Before we delve into the mechanics of such a strategy, though, think about that large drug company once more and watch the following short video.
Learning Outcomes

- Define the term “marketing”
- Define and give examples of the four Ps of the marketing mix (price, product, promotion, and place)
- Identify forces in the external marketing environment
- Describe the process for and purpose of market research
- Understand and outline the elements of a marketing plan as a planning process
- Define “brand” and explain the role of branding strategies in the creation of a successful product or business
- Explain pricing strategies for new and existing products
• Explain product distribution strategies and how they contribute to business success
• Explain the promotion mix, promotion strategies, and the process of developing a successful promotion for both traditional and digital channels
• Describe social media marketing, including its advantages and disadvantages
Marketing is more than just banner ads, television commercials, and people standing on the side of the road dressed up like the Statue of Liberty during tax time. It's a complex set of activities and strategies that influence where we live, what we wear, how we conduct business, and how we spend our time and money. Marketing activities are conducted in an environment that changes quickly both in terms of customer demand and the methods by which consumers obtain information and make purchases. However, before you learn about these complex variables, you will need a good working definition of marketing. The following video has one (actually two).
Now that you have that under your belt, let’s move ahead so that you’ll have more than just a definition—you’ll have an understanding of marketing!

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Defining Marketing
- Self Check: What is Marketing?
Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Defining Marketing

Marketing is defined by the American Marketing Association in the following way:

The activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

If you read the definition closely, you see that there are four activities, or components, of marketing:

1. **Creating.** The process of collaborating with suppliers and customers to create offerings that have value.
2. **Communicating.** Broadly, describing those offerings, as well as learning from customers.
3. **Delivering.** Getting those offerings to the consumer in a way that optimizes value.
4. **Exchanging.** Trading value for those offerings.

Let’s look more closely at some of the components that make up this definition.
Value

Value is at the center of everything that marketing does (Figure 1). What does value mean?

Marketing is composed of four activities centered on customer value: creating, communicating, delivering, and exchanging value.

When we use the term value, we mean the benefits buyers receive that meet their needs. In other words, value is what the customer gets by purchasing and consuming a company's offering. So, although the offering is created by the company, the value is determined by the customer.

Furthermore, our goal as marketers is to create a profitable exchange for consumers. By profitable, we mean that the
consumer’s personal value equation is positive. The personal value equation is value = benefits received – [price + hassle]

_Hassle_ is the time and effort the consumer puts into the shopping process. The equation is a personal one because how each consumer judges the benefits of a product will vary, as will the time and effort he or she puts into shopping. Value, then, varies for each consumer.

One way to think of value is to think of a meal in a restaurant. If you and three friends go to a restaurant and order the same dish, each of you will like it more or less depending on your own personal tastes. Yet the dish was exactly the same, priced the same, and served exactly the same way. Because your tastes varied, the benefits you received varied. Therefore the value varied for each of you. That’s why we call it a personal value equation.

Value varies from customer to customer based on each customer's needs. The marketing concept, a philosophy underlying all that marketers do, requires that marketers seek to satisfy customer wants and needs. Firms operating with that philosophy are said to be market oriented. At the same time, market-oriented firms recognize that exchange must be profitable for the company to be successful. A marketing orientation is not an excuse to fail to make profit.

Firms don’t always embrace the marketing concept and a market orientation. Beginning with the Industrial Revolution in the late 1800s, companies were production orientation. They believed that the best way to compete was by reducing production costs. In other words, companies thought that good products would sell themselves. Perhaps the best example of such a product was Henry Ford’s Model A automobile, the first product of his production line innovation. Ford’s production line made the automobile cheap and affordable for just about everyone. The production era lasted until the 1920s, when production-capacity growth began to outpace demand growth and new strategies were called for. There are, however, companies that still focus on production as the way to compete.
From the 1920s until after World War II, companies tended to be selling orientation, meaning they believed it was necessary to push their products by heavily emphasizing advertising and selling. Consumers during the Great Depression and World War II did not have as much money, so the competition for their available dollars was stiff. The result was this push approach during the selling era. Companies like the Fuller Brush Company and Hoover Vacuum began selling door-to-door and the vacuum-cleaner salesman (they were always men) was created. Just as with production, some companies still operate with a push focus.

In the post–World War II environment, demand for goods increased as the economy soared. Some products, limited in supply during World War II, were now plentiful to the point of surplus. Companies believed that a way to compete was to create products different from the competition, so many focused on product innovation. This focus on product innovation is called the product orientation. Companies like Procter & Gamble created many products that served the same basic function but with a slight twist or difference in order to appeal to a different consumer, and as a result products proliferated. But as consumers had many choices available to them, companies had to find new ways to compete. Which products were best to create? Why create them? The answer was to create what customers wanted, leading to the development of the marketing concept. During this time, the marketing concept was developed, and from about 1950 to 1990, businesses operated in the marketing era.

So what era would you say we're in now? Some call it the value era: a time when companies emphasize creating value for customers. Is that really different from the marketing era, in which the emphasis was on fulfilling the marketing concept? Maybe not. Others call today's business environment the one-to-one era, meaning that the way to compete is to build relationships with customers one at a time and seek to serve each customer's needs individually. For example, the longer you are customer of Amazon, the more detail they gain in your purchasing habits and the better they can
target you with offers of new products. With the advent of social media and the empowerment of consumers through ubiquitous information that includes consumer reviews, there is clearly greater emphasis on meeting customer needs. Yet is that substantially different from the marketing concept?

Still others argue that this is the time of service-dominant logic and that we are in the service-dominant logic era. Service-dominant logic is an approach to business that recognizes that consumers want value no matter how it is delivered, whether it’s via a product, a service, or a combination of the two. Although there is merit in this belief, there is also merit to the value approach and the one-to-one approach. As you will see throughout this book, all three are intertwined. Perhaps, then, the name for this era has yet to be devised.

Whatever era we’re in now, most historians would agree that defining and labeling it is difficult. Value and one-to-one are both natural extensions of the marketing concept, so we may still be in the marketing era. To make matters more confusing, not all companies adopt the philosophy of the era. For example, in the 1800s Singer and National Cash Register adopted strategies rooted in sales, so they operated in the selling era forty years before it existed. Some companies are still in the selling era. Recently, many considered automobile manufacturers to be in the trouble they were in because they work too hard to sell or push product and not hard enough on delivering value.

Creating Offerings That Have Value

Marketing creates those goods and services that the company offers at a price to its customers or clients. That entire bundle consisting of the tangible good, the intangible service, and the price is the company’s offering. When you compare one car to another, for example, you can evaluate each of these dimensions—the tangible,
the intangible, and the price—separately. However, you can't buy one manufacturer's car, another manufacturer's service, and a third manufacturer's price when you actually make a choice. Together, the three make up a single firm's offer.

Marketing people do not create the offering alone. For example, when the iPad was created, Apple's engineers were also involved in its design. Apple’s financial personnel had to review the costs of producing the offering and provide input on how it should be priced. Apple's operations group needed to evaluate the manufacturing requirements the iPad would need. The company's logistics managers had to evaluate the cost and timing of getting the offering to retailers and consumers. Apple's dealers also likely provided input regarding the iPad's service policies and warranty structure. Marketing, however, has the biggest responsibility because it is marketing's responsibility to ensure that the new product delivers value.

**Communicating Offerings**

Communicating is a broad term in marketing that means describing the offering and its value to your potential and current customers, as well as learning from customers what it is they want and like. Sometimes communicating means educating potential customers about the value of an offering, and sometimes it means simply making customers aware of where they can find a product. Communicating also means that customers get a chance to tell the company what they think. Today companies are finding that to be successful, they need a more interactive dialogue with their customers. For example, Comcast customer service representatives monitor Twitter. When they observe consumers tweeting problems with Comcast, the customer service reps will post resolutions to their problems. Similarly, JCPenney has created consumer groups that talk among themselves on JCPenney-monitored Web sites. The
company might post questions, send samples, or engage in other activities designed to solicit feedback from customers.

Mobile devices, like iPads and Droid smartphones, make mobile marketing possible too. For example, if consumers check-in at a shopping mall on Foursquare or Facebook, stores in the mall can send coupons and other offers directly to their phones and pad computers.

Companies use many forms of communication, including advertising on the Web or television, on billboards or in magazines, through product placements in movies, and through salespeople. Other forms of communication include attempting to have news media cover the company’s actions (part of public relations [PR]), participating in special events such as the annual International Consumer Electronics Show in which Apple and other companies introduce their newest gadgets, and sponsoring special events like the Susan G. Komen Race for the Cure.

**Delivering Offerings**

Marketing can't just promise value, it also has to deliver value. Delivering an offering that has value is much more than simply getting the product into the hands of the user; it is also making sure that the user understands how to get the most out of the
product and is taken care of if he or she requires service later. Value is delivered in part through a company's supply chain. The supply chain includes a number of organizations and functions that mine, make, assemble, or deliver materials and products from a manufacturer to consumers. The actual group of organizations can vary greatly from industry to industry, and include wholesalers, transportation companies, and retailers. Logistics, or the actual transportation and storage of materials and products, is the primary component of supply chain management, but there are other aspects of supply chain management that we will discuss later.

**Exchanging Offerings**

In addition to creating an offering, communicating its benefits to consumers, and delivering the offering, there is the actual transaction, or exchange, that has to occur. In most instances, we consider the exchange to be cash for products and services. However, if you were to fly to Louisville, Kentucky, for the Kentucky Derby, you could “pay” for your airline tickets using frequent-flier miles. You could also use Hilton Honors points to “pay” for your hotel, and cash back points on your Discover card to pay for meals. None of these transactions would actually require cash. Other exchanges, such as information about your preferences gathered through surveys, might not involve cash.

When consumers acquire, consume (use), and dispose of products and services, exchange occurs, including during the consumption phase. For example, via Apple's “One-to-One” program, you can pay a yearly fee in exchange for additional periodic product training sessions with an Apple professional. So each time a training session occurs, another transaction takes place. A transaction also occurs when you are finished with a product. For example, you might sell your old iPhone to a friend, trade in a car, or ask the Salvation Army to pick up your old refrigerator.
Disposing of products has become an important ecological issue. Batteries and other components of cell phones, computers, and high-tech appliances can be very harmful to the environment, and many consumers don’t know how to dispose of these products properly. Some companies, such as Office Depot, have created recycling centers to which customers can take their old electronics. Apple has a Web page where consumers can fill out a form, print it, and ship it along with their old cell phones and MP3 players to Apple. Apple then pulls out the materials that are recyclable and properly disposes of those that aren’t. By lessening the hassle associated with disposing of products, Office Depot and Apple add value to their product offerings.

KEY TAKEAWAYS

The focus of marketing has changed from emphasizing the product, price, place, and promotion mix to one that emphasizes creating, communicating, delivering, and exchanging value. Value consists of the benefits an individual receives minus the price the consumer paid and the time and effort they expended making the purchase.

Check Your Understanding

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Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
215. Outcome: The Four Ps of Marketing

What you’ll learn to do: define and give examples of the four Ps of the marketing mix

These peas are delicious. Thank you, Mama, for making them for me

Not everyone is as excited about peas as Baby Lulu shown in the photo above! As a student of business and marketing, you’ll learn in this section that at least four Ps are vital to the exchange relationship we call marketing. Without the four Ps there would be no marketing mix. As a result, businesses would not be as efficient at developing products that consumers want, pricing them so that consumers will purchase them, promoting them so consumers know they are available, and getting them from their “place” to ours. Even if you didn’t eat or enjoy peas when you were Lulu’s age, after this section you might have gained a solid appreciation for the mighty P.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Four Ps of Marketing
- Self Check: The Four Ps of Marketing

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
The Four Ps of Marketing

The traditional way of viewing the components of marketing is in terms of the four Ps:

1. **Product.** Goods and services (creating offerings).
2. **Promotion.** Communication.
3. **Place.** Getting the product to a point at which the customer can purchase it (delivering).
4. **Price.** The monetary amount charged for the product (exchanging).

Introduced in the early 1950s, the four Ps were called the marketing mix, and a typical marketing plan would include a mix of these four components. Getting the four Ps right for any given marketing effort depends first on identifying your target customer – who are you trying to sell to, and how will you provide value to them? Once you know who you’re targeting, you can refine decisions around product, promotion, place and price to ensure you are delivering something of value.

Recall the American Marketing Association's current definition of marketing, which emphasizes the four activities of **creating, communicating, delivering, and exchanging**. You might be wondering why this definition shifts away from the four Ps. The answer is that they are not exactly the same. Product, price, place, and promotion are nouns. As such, these words fail to capture all the activities of marketing. For example, exchanging requires mechanisms for a transaction, which consist of more than simply
a price or place. Exchanging requires, among other things, the transfer of ownership. For example, when you buy a car, you sign documents that transfer the car’s title from the seller to you. That’s part of the exchange process.

Even the term *product*, which seems pretty obvious, is limited. Does the product include services that come with your new car purchase (such as free maintenance for a certain period of time on some models)? Or does the product mean only the car itself? The following video expands upon the concept of the four Ps and explains its more dynamic use today.

![4Ps: Product! Place! Promotion! Price!](image)

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=247
Check Your Understanding

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https://library.achievingthedream.org/
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217. Outcome: External Marketing Environment

What you’ll learn to do: identify forces in the external marketing environment that can impact a business

When Steve Jobs started Apple in his garage, he was perhaps already thinking about how he would market his product to potential consumers. But, do you think he ever planned or anticipated the topic of the following video?

A YouTube element has been excluded from this version of the text. You can view it online here:
How companies anticipate and react to the complex environment is a challenge, and the inability to react or adapt the marketing mix to address these external forces can mean the difference between success and failure. In this next section you will learn about some of these factors and the role they play in shaping marketing decisions.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Marketing Environment
- Reading: Generation Effects and Consumer Behavior
- Self Check: External Marketing Environment

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
By and large, managers can control the four Ps of the marketing mix: they can decide which products to offer, what prices to charge for them, how to distribute them, and how to reach target audiences. Unfortunately, there are other forces at work in the marketing world—forces over which marketers have much less control. These forces make up a company’s external marketing environment, which, as you can see in Figure 1, “The Marketing Environment,” can be divided into five sets of factors:

1. Political and regulatory
2. Economic
3. Competitive
4. Technological
5. Social and cultural
These factors—and changes in them—present both threats and opportunities that require shifts in marketing plans. To spot trends and other signals that conditions may be in flux, marketers must continually monitor the environment in which their companies operate. To get a better idea of how they affect a firm’s marketing activities, let’s look at each of the five areas of the external environment.

Figure 1. The Marketing Environment
The Political and Regulatory Environment

Federal, state, and local bodies can set rules or restrictions on the conduct of businesses. The purpose of regulation is to protect both consumers and businesses. Businesses favor some regulations (such as patent laws) while chafing under others (such as restrictions on advertising). The tobacco industry, for example, has had to learn to live with a federal ban on TV and radio advertising. More recently, many companies in the food industry have expressed unhappiness over regulations requiring the labeling of trans-fat content. The broadcasting industry is increasingly concerned about fines being imposed by the Federal Communications Commission for offenses against “standards of decency.” The loudest outcry probably came from telemarketers in response to the establishment of “do-not-call” registries. All these actions occasioned changes in the marketing strategies of affected companies. Tobacco companies rerouted advertising dollars from TV to print media. Food companies reduced trans-fat levels and began targeting health-conscious consumers. Talent coordinators posted red flags next to the names of Janet Jackson (of the now-famous malfunctioning costume) and other performers. The telemarketing industry fired workers and scrambled to reinvent its entire business model.

The Economic Environment

Every day, marketing managers face a barrage of economic news. They must digest it, assess its impact, and alter marketing plans accordingly. Sometimes (but not recently), the news is cause for optimism—the economy’s improving, unemployment’s declining, consumer confidence is up. At other times (like today), the news makes them nervous—our economy is weak, industrial production is down, jobless claims are rising, consumer confidence has...
plummeted, credit is hard to get. Naturally, business thrives when the economy is growing, employment is full, and prices are stable. Marketing products is easier because consumers are willing to buy. On the other hand, when the economy is slowing (or stalled) and unemployment is rising, people have less money to spend, and the marketer's job is harder. Then there's inflation, which pushes interest rates upward. If you're trying to sell cars, you know that people facing higher interest rates aren't so anxious to take out car loans. Sales will slip, and to counteract the anticipated slowdown, you might have to add generous rebates to your promotional plans. Moreover, if you operate in foreign markets, you can't focus on solely domestic economic conditions: you have to monitor the economy in every region where you do business. For example, if you're the marketing director for a U.S. company whose goods are manufactured in China and sold in Brazil, you'll need to know as much as you can about the economies in three countries: the United States, China, and Brazil. For one thing, you'll have to pay particular attention to fluctuations in exchange rates, because changes will affect both your sales and your profits.

The Competitive Environment

Imagine playing tennis without watching what your opponent was doing. Marketers who don't pay attention to their competitors are playing a losing game. In particular, they need to monitor the activities of two groups of competitors: the makers of competing brands and the makers of substitute products. Coke and Pepsi, for instance, are brand competitors who have engaged in the so-called cola wars for decades. Each tries to capture market share by convincing people that its soft drinks are better. Because neither wants to lose share to the other, they tend to resort to similar tactics. In summer 2004, both companies came out with nearly identical new colas boasting half the sugar, half the calories, and half
the carbohydrates of regular colas. Coke called its product Coke C2, while Pepsi named its competing brand PepsiEdge. Both companies targeted cola drinkers who want the flavor of a regular soda but fewer calories. (By the way, both products failed and were taken off the market.) Meanwhile, Coke and Pepsi have to watch Nantucket Nectars, whose fruit drinks are substitute products. What if Nantucket Nectars managed to get its drinks into the soda machines at more fast-food restaurants? How would Coke and Pepsi respond? What if Nantucket Nectars, which markets an ice tea with caffeine, introduced an ice tea drink with mega amounts of caffeine? Would marketers at Coke and Pepsi take action? What if Nantucket Nectars launched a marketing campaign promoting the health benefits of fruit drinks over soda? Would Coke and Pepsi reply with campaigns of their own? Would they respond by introducing new non-cola products?

The Technological Environment

When’s the last time you rented a DVD of a new movie? And do you even remember ever renting a videotape? Technology evolves rapidly and these days, videotapes are long since past. While DVDs are still common, Blu-ray, digital downloads and on-demand services are the more forward-looking formats for people who want to watch movies at home. Hopefully one-time videotape makers monitored technological trends in the industry and took steps to keep up or otherwise protect themselves from losses (maybe even getting out of the market). In addition to making old products obsolete, technological advances create new products. Where would we be without the cell phone, digital cameras, text messaging, LASIK surgery, and global positioning systems? New technologies also transform the marketing mix in another important way: they alter the way companies market their products. Consider the revolutionary changes brought about by the Internet,
which offers marketers a new medium for promoting and selling a vast range of goods and services. Marketers must keep abreast of technological advances and adapt their strategies, both to take advantage of the opportunities and to ward off threats.

The Social and Cultural Environment

Marketers also have to stay tuned to social and cultural factors that can affect sales. The values and attitudes of American consumers are in a state of almost constant flux; what’s cool one year is out of style the next. Think about the clothes you wore five years ago: would you wear them today? A lot of people wouldn’t—they’re the wrong style, the wrong fit, the wrong material, the wrong color, or just plain wrong. Now put yourself in the place of a marketer for a clothing company that targets teenagers and young adults. You wouldn't survive if you tried to sell the same styles every year. As we said at the outset of this chapter, the key to successful marketing is meeting the needs of customers. This means knowing what they want right now, not last year. Here’s another illustration. The last few decades have witnessed monumental shifts in the makeup of the American workforce. The number of women at all levels has increased significantly, the workforce has become more diverse, and telecommuting is more common. More people place more importance on balancing their work lives with the rest of their lives, and fewer people are willing to sacrifice their health to the demands of hectic work schedules. With these changes have come new marketing opportunities. As women spend more time at work, the traditional duties of the “homemaker” have shifted to day-care centers, nannies, house-cleaning services, and (for those who can afford them) child chauffeurs, birthday-party coordinators, and
even family-photo assemblers.¹ The number of gyms has mushroomed, the selection of home office furniture has expanded, and McDonald’s has bowed to the wishes of the health-conscious by eliminating its “super-size” option.

Generation Gaps

Clothiers who target teens and young adults (such as Gap and Abercrombie & Fitch) must estimate the size of both current and future audiences. So must companies that specialize in products aimed at customers in other age brackets—say, young children or retirees. Marketers pay particular attention to population shifts because they can have dramatic effects on a consumer base, either increasing or decreasing the number of potential customers. Marketers tend to assign most Americans born in the last sixty years to one of three groups: the baby-boom generation (those born between 1946 and 1964), Generation X (1965 to 1975), and Generation Y—also known as “echo baby boomers” or “millennials” (1976 to 2001). In addition to age, members of each group tend to share common experiences, values, and attitudes that stay with them as they mature. These values and attitudes have a profound effect on both the products they want and the marketing efforts designed to sell products to them. Let’s look a little more closely at some of the defining characteristics of each group.

Baby Boomers

The huge wave of baby boomers began arriving in 1946, following World War II, and marketers have been catering to them ever since.
What are they like? Sociologists have attributed to them such characteristics as “individuality, tolerance, and self-absorption.” There are seventy million of them, and as they marched through life over the course of five decades, marketers crowded the roadside to supply them with toys, clothes, cars, homes, and appliances—whatever they needed at the time. They’re still a major marketing force, but their needs have changed: they’re now the target market for Botox, pharmaceutical products, knee surgery, financial investments, cruises, vacation homes, and retirement communities.

Generation X

Because birth rates had declined by the time the “Gen X” babies first arrived in 1965, this group had just one decade to grow its numbers. Thus, it’s considerably smaller (seventeen million) than the baby-boomer group, and it has also borne the brunt of rising divorce rates and the arrival of AIDS. Experts say, however, that they’re diverse, savvy, and pragmatic and point out that even though they were once thought of as “slackers,” they actually tend to be self-reliant and successful. At this point in their lives, most are at their peak earning power and affluent enough to make marketers stand up and take notice.

Generation Y

When they became parents, baby boomers delivered a group to rival their own. Born between 1976 and 2001, their sixty million children are sometimes called “echo boomers” (because their population boom is a reverberation of the baby boom). They’re still evolving, but they’ve already been assigned some attributes: they’re committed to
integrity and honesty, they're family oriented and close to parents, ethnically diverse and accepting of differences, upbeat and optimistic about the future (although the troubled economy is lessening their optimism), education focused, independent, and goal oriented. They also seem to be coping fairly well: among today's teens, arrests, drug use, drunk driving, and school dropout rates are all down. Generation Ys are being courted by carmakers. Global car manufacturers have launched a number of 2012 cars designed to cater to the members of Generation Y. Advertisers are also busy trying to find innovative ways to reach this group, but they're finding that it's not easy. Generation Ys grew up with computers and other modes of high technology, and they're used to doing several things at once—simultaneously watching TV, texting, and playing games on the computer. As a result, they're quite adept at tuning out ads. Try to reach them through TV ads and they'll channel-surf right past them or hit their TiVo remotes. You can't get to them over the Internet because they know all about pop-up blockers. In one desperate attempt to get their attention, an advertiser paid college students fifty cents to view thirty-second ads on their computers. Advertisers keep trying, because Generation Y is big enough to wreck a brand by giving it a cold shoulder.

Consumer Behavior

Why did you buy an Apple computer when your friend bought a Dell PC? What information did you collect before making the decision? What factors did you consider when evaluating alternatives? How did you make your final choice? Were you happy with your decision? To design effective strategies, marketers need to find the answers that consumers give to questions such as these. In other words, they try to improve their understanding of consumer behavior—the decision process that individuals go through when purchasing or using products. Later we'll look at the process that buyers go
through in choosing one product over another. Then, we'll explore some factors that influence consumers' behavior.

The Buying Process

Generally speaking, buyers run through a series of steps in deciding whether to purchase a particular product. Some purchases are made without much thought. You probably don't think much, for example, about the brand of gasoline you put in your car; you just stop at the most convenient place. Other purchases, however, require considerable thought. For example, you probably spent a lot of time deciding which college to attend. Let's revisit that decision as a means of examining the five steps that are involved in the consumer buying process and that are summarized in Figure 2, “The Buying Process”: need recognition, information search, evaluation, purchase, and postpurchase evaluation.
1. **Need recognition.** The process began when you recognized a need to go to college. Perhaps you wanted to prepare for a particular career, to become better educated, or to postpone going to work full time. Maybe your parents insisted.

2. **Information search.** Once you recognized the need to go to college, you probably started gathering information about colleges. You may have gone online and studied the Web sites posted by a few schools. Perhaps you attended college fairs or spoke with your high school guidance counselor. You probably talked with friends about your options. Once you let colleges know that you were interested, admissions departments likely sent you tons of information.

3. **Evaluation.** At this point, you studied the information you’d
gathered. First, you probably decided what you wanted from a college. Perhaps price was your number-one criterion, or maybe distance from home. Maybe size was important, or reputation or available majors. Maybe it was the quality of the football team or the male-to-female ratio.

4. **Purchase.** Ultimately you made a “purchase” decision. In so doing, you focused on what was most important to you. Naturally, you could choose only among schools that had accepted you.

5. **Postpurchase evaluation.** The buying process didn’t end when you selected a school. It continues today, while you’re using the “product” you purchased. How many times have you rethought your decision? Are you happy with it? Would you make the same choice again?

Understanding the buying process of potential students is crucial to college administrators in developing marketing strategies to attract qualified “buyers.” They’d certainly like to know what information you found useful, which factors most influenced your decision, and how you made your final choice. They’ll also want to know whether you're happy with your choice. This is the kind of information that colleges are seeking when they solicit feedback, both from students who chose their schools and from those who didn’t.

**Influences on Buying Behavior**

Did you ever buy something you knew you shouldn’t buy but just couldn't help yourself—something you simply wanted? Maybe it was a spring-break trip to the Bahamas that you really couldn't afford. Objectively, you may have made a bad decision, but not all decisions are made on a purely objective basis. *Psychological* and *social influences* come into play. Let’s take a closer look at each of these factors.

1096 | Reading: Generation Effects and Consumer Behavior
Psychological Influences

Under this category, we can identify at least the following five variables:

1. **Motivation.** The internal process that causes you to seek certain goals.
2. **Perception.** The way you select, organize, and interpret information.
3. **Learning.** Knowledge gained through experience and study.
4. **Attitudes.** Your predisposition to respond in particular ways because of learned values and beliefs.
5. **Personality.** The collection of attributes that characterize an individual.

Social Influences

Here, we find the following four factors:

1. **Family.**
2. **Reference groups.** Friends or other people with whom you identify.
3. **Economic or social status.**
4. **Culture.** Your set of accepted values.

It shouldn't be surprising that marketers are keenly interested in the effect of all these influences on your buying decisions. For instance, suppose the travel agency that sold you your spring-break getaway found that you bought the package because you viewed it as a reward for studying hard and doing well academically. In that case, it might promote student summer-travel programs as rewards for a hard year's work at school.
KEY TAKEAWAYS

- A number of forces over which it has little or no control affect a company’s marketing activities.
- Taken together, they make up its external marketing environment, which includes regulatory and political activity, economic conditions, competitive forces, changes in technology, and social and cultural influences.
- Successful marketing often hinges on understanding consumer behavior—the decision process that individuals go through when purchasing or using products.
- Several psychological and social variables influence buyers’ decisions. They go through a series of steps in reaching the decision to buy a product: need recognition, information search, evaluation, purchase, and postpurchase evaluation.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
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220. Outcome: Market Research

What you’ll learn to do: describe the process for and purpose of market research

Where do companies come up with the ideas for their new products, goods, and services? How do they determine whether they need to change the packaging of their product, reduce the price, or add new features? They could use their knowledge or experience of the industry, but no matter how insightful they are, it's still very possible to miss something or get it wrong. These errors can be expensive and do irreparable damage to the company’s market position and financial well-being. Rather than operating with a “best guess” approach, companies use market research to determine what consumers want. In this next section you will learn about the process for market research, how companies use the information gained, and how technology is influencing this process.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Using Market Research to Understand Consumers
- Reading: The Market Research Process
- Video: Market Research in “Real Time”
- Self Check: Market Research
Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
What Is a Consumer?

A consumer is a person (or group) who pays to consume the goods and/or services produced by a seller (i.e., company, organization).

Using Market Research to Understand Consumers

The ultimate goal of consumer research is to serve as the voice of the consumer. This type of research focuses on understanding the
consumer as a person by learning more about his or her attitudes, needs, motivations, and behavior as they relate to a product or service. More broadly, consumer research helps provide a company with relevant, reliable, valid, and current information about their target buyer.

In the field of marketing, consumer market research can generally be defined as the systematic collection and evaluation of data regarding customers’ preferences for actual and potential products and services. It is also important to note that consumer market research is not the exactly the same as marketing research. Marketing research is actually comprised of both consumer and business-to-business research and examines all aspects of a business environment.

Consumer market research can serve a variety of purposes, including the following:

• Help companies make better business decisions and gain advantages over the competition
• Help marketing managers or executives make numerous strategic and tactical decisions in the process of identifying and satisfying customer needs
• Remove some of the uncertainty by providing relevant information about the marketing variables, environment, and consumers. In the absence of relevant information, the consumer response to marketing programs cannot be predicted reliably or accurately
• Provide insights that help guide the creation of a business plan, launch a new product or service, optimize existing products and services, and guide expansion into new markets
• Determine which portion of the population will be most likely to purchase a product or service, based on variables such as age, gender, location, and income level
• Reveal characteristics of a target market
• Understand how consumers talk about the products in the
market
• Identify which consumer needs are important and whether the needs are being met by current products

For instance, a consumer goods company that wants to develop a new cheese product for the growing Hispanic demographic can use market research. If the consumer market research demonstrates that consumers do in fact have an unsatisfied need for a cheese that could replace the product they are currently consuming in Latin America, the company could go ahead and develop the cheese product.

Quantitative and Qualitative Models to Explain Patterns of Behavior

Both quantitative and qualitative models provide important information about consumers, but it is important to understand the benefits and shortcomings of each.

What Is Quantitative Research?

Quantitative research is defined as the systematic empirical investigation of social phenomena via statistical, mathematical, or computational techniques. It requires collection of enough data points to conduct valid statistical or mathematical analyses.

Its objective is to develop and employ mathematical models, theories, and/or hypotheses about phenomena. At its core, quantitative research is used to identify patterns and predict behavior. This type of research is used in business, marketing, and in social sciences such as psychology, economics, sociology, and political science, and, less frequently, in anthropology and history.
What Is Qualitative Research?

Qualitative research uses examination, analysis, and interpretation to discover underlying meanings and patterns of relationships in a manner that does not involve mathematical models.

Qualitative researchers aim to gather an in-depth understanding of human behavior and the reasons that govern it. The qualitative method investigates the why and how of consumer behavior, not just what, where, when. Two of the main tools used to conduct qualitative research are the focus group and the in-depth interview. In a focus group, participants are asked about their perceptions, opinions, beliefs, and attitudes toward a specific product, service, concept, advertisement, etc. Usually this takes place in an interactive group setting where participants are free to talk with one another. In an in-depth interview, researchers conduct a one-on-one discussion with the participant to explore their perceptions in detail.

Regardless of what type of research marketing managers conduct, their ultimate goal is to understand and predict consumer behavior.
The Market Research Process

Marketing research identifies opportunities, generates informed marketing actions, monitors marketing performance, and improves understanding of the marketing process.

There are three types of objectives that can be deployed in marketing research: exploratory research, descriptive research, and causal research.

Exploratory Research

- Used to better define a problem or scout opportunities.
- In-depth interviews and discussions groups are commonly used.

Descriptive Research

- Used to assess a situation in the marketplace (i.e., potential for a specific product or consumer attitudes).
- Methods include personal interviews and surveys.
Causal Research

- Used for testing cause-and-effect relationships, typically through estimation.

The Marketing Research Process

The marketing research process involves the following six steps:

1. Problem definition
2. Development of an approach to the problem
3. Research design formulation
4. Data collection
5. Data preparation and analysis
6. Report preparation and presentation

Step 1: Problem Definition

The first step in any marketing research study is to define the problem, while taking into account the purpose of the study, the relevant background information, what information is needed, and how it will be used in decision making. This stage involves discussion with the decision makers, interviews with industry experts, analysis of secondary data, and, perhaps, some qualitative research, such as focus groups.
Step 2: Development of an Approach to the Problem

Step two includes formulating an objective or theoretical framework, analytical models, research questions, hypotheses, and identifying characteristics or factors that can influence the research design. This process is guided by discussions with management and industry experts, case studies and simulations, analysis of secondary data, qualitative research, and pragmatic considerations. Four workers standing around schedules on the wall. They appear to be planning and discussing with one another.

Step 3: Research Design Formulation

A research design is a framework or blueprint for conducting the marketing research project. It details the procedures necessary for obtaining the required information, and its purpose is to design a study that will test the hypotheses of interest, determine possible answers to the research questions, and provide the information needed for decision making. Decisions are also made regarding what data should be obtained from the respondents (e.g., by conducting a survey or an experiment). A questionnaire and sampling plan also are designed in order to select the most appropriate respondents for the study. The following steps are involved in formulating a research design:

- Secondary data analysis (based on secondary research)
- Qualitative research
- Methods of collecting quantitative data (survey, observation, and experimentation)
- Definition of the information needed
- Measurement and scaling procedures
Two students in a library looking at a book together.

The research plan outlines sources of existing data and spells out the specific research approaches, contact methods, sampling plans, and instruments that researchers will use to gather data. This plan includes a written proposal that outlines the management problem, research objectives, information required, how the results will help management decisions, and the budget allocated for the research.

Step 4: Data Collection

Data collection is a crucial step in the research process because it provides the basis for decisions that will influence the marketing strategy.

Fieldwork, or data collection, involves a field force or staff that operates either in the field, as in the case of personal interviewing (focus group, in-home, mall intercept, or computer-assisted personal interviewing), from an office by telephone (telephone or computer-assisted telephone interviewing/CATI), or through mail (traditional mail and mail panel surveys with pre-recruited households). Proper selection, training, supervision, and evaluation of the field force helps minimize data-collection errors.

An example of data collection is when a consumer goods company hires a market research company to conduct in-home ethnographies and in-store shop-alongs.

Systematic planning is required at all stages of the marketing research process, especially in the data collection step. The procedures followed at each stage are methodologically sound, well documented, and, as much as possible, planned in advance.

Marketing research aims to provide accurate information that
reflects a true state of affairs; therefore it’s important for research to be conducted as impartially as possible. While it is impossible to eliminate bias entirely, the researcher should make every effort to keep personal and political views out of the data collection process.

*Primary vs. Secondary Research*

There are many sources of information a marketer can use when collecting data. The Nielson Ratings is an audience measurement system that provides data on audience size and the composition of television markets in the United States. The Gallup Polls conduct public opinion polls with its results published daily in the form of data driven news. The U.S. Census Bureau, directed by the U.S. Government, is the principal agency responsible for producing data about American people and the economy. Population, housing, and demographic characteristics are gathered to help plan and define transportation systems, police and fire precincts, election districts, and schools.

**Step 5: Data Preparation and Analysis**

Data Analysis is an important step in the Marketing Research process where data is organized, reviewed, verified, and interpreted.

During this phase of the research process, data is carefully edited, coded, transcribed, and verified in order for it to be properly analyzed. Statistical market research tools are used. The validity of the results is also assessed to confirm how well the data measures what it is supposed to measure. Oftentimes, the research team will arrange a debriefing session with the client to review highlights from the data and brainstorm potential ideas on how the findings
can be implemented. This typically happens when a client hires a market research company and they want to remain thoroughly involved in the research process.

Analysis of data is a process of inspecting, cleaning, transforming, and modeling data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making. Data analysis has multiple facets and approaches, encompassing diverse techniques under a variety of names in different business, science, and social science domains. Data mining is a particular data analysis technique that focuses on modeling and knowledge discovery for predictive rather than purely descriptive purposes. Marketers use databases to extract applicable information that identifies customer patterns, characteristics and behaviors.

Business intelligence covers data analysis that relies heavily on aggregation and focusing on business information. In statistical applications, some people divide data analysis into descriptive statistics, exploratory data analysis (EDA), and confirmatory data analysis (CDA). EDA focuses on discovering new features in the data and CDA focuses on confirming or falsifying existing hypotheses. Predictive analytics focuses on application of statistical or structural models for predictive forecasting or classification. Text analytics applies statistical, linguistic, and structural techniques to extract and classify information from textual sources, a species of unstructured data. All are varieties of data analysis.

Step 6: Report Preparation and Presentation

During the Report Preparation & Presentation step, the entire project should be documented in a written report that addresses the specific research questions identified; describes the approach, the research design, data collection, and data analysis procedures adopted; and presents the results and the major findings. This
permanent document is also helpful because it can be easily referenced by others who may not have been part of the research.

The findings should be presented in a comprehensible format so that they can be readily used in the decision making process. In addition, an oral presentation should be made to management using tables, figures, and graphs to enhance clarity and impact.

A successful presentation may include the following elements:

- Charts, graphs, and visual elements that help showcase important facts and make the presentation easily digestible and memorable
- Recommendations about how to apply the research
- Final conclusions (based on the insights gathered from data collected) that effectively meet the initial objectives of the research

A formal research report presentation typically includes the following:

- Table of Contents
- Executive Summary
- Background
- Research Objectives
- Research Methodology
- Highlights of Data Collected
- Findings/Insights
- Recommendations/Implications and Action Plan
- Appendix (including Respondent Screening Instrument and Questionnaire)

As you can tell, a great deal of thought and effort goes into determining opportunities and managing the marketing process both before and after the product, good or service ever reaches the consumer.
Technological advances in mobile computing, smart phones, social networking, and data collection have changed the way companies capture information about consumer interest and behavior. One of the results of this new type of “research” is predictive advertising. This video gives you a glimpse of the impact this has had on consumer data collection.

A YouTube element has been excluded from this version of the text. You can view it online here:
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=254
224. Outcome: Marketing Strategies and Plan

What you’ll learn to do: understand and outline the elements of a marketing plan as a planning process

Have you ever wondered how an organization decides which products and services to develop, promote, and sell? Just as your personal plans—such as what you plan to major in or where you want to find a job—are likely to change, a company’s marketing plan will change as new opportunities and challenges present themselves.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Developing Organizational Objectives and Formulating Strategies
• Reading: Overview of the Marketing Plan
• Self Check: Marketing Strategies and Plan

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Developing Objectives

Objectives are what organizations want to accomplish—the end results they want to achieve—in a given time frame. In addition to being accomplished within a certain time frame, objectives should be realistic (achievable) and be measurable, if possible. “To increase sales by 2 percent by the end of the year” is an example of an objective an organization might develop. You have probably set objectives for yourself that you want to achieve in a given time frame. For example, your objectives might be to maintain a certain grade point average and get work experience or an internship before you graduate.

Objectives help guide and motivate a company’s employees and give its managers reference points for evaluating the firm’s marketing actions. Although many organizations publish their mission statements, most for-profit companies do not publish their objectives. Accomplishments at each level of the organization have helped PepsiCo meet its corporate objectives over the course of the past few years. PepsiCo’s business units (divisions) have increased the number of their facilities to grow their brands and enter new markets. PepsiCo’s beverage and snack units have gained market share by developing healthier products and products that are more convenient to use.

A firm’s marketing objectives should be consistent with the company’s objectives at other levels, such as the corporate level and business level. An example of a marketing objective for PepsiCo
might be “to increase by 4 percent the market share of Gatorade by the end of the year.” The way firms analyze their different divisions or businesses will be discussed later in the chapter.

Formulating Strategies

Firms formulate strategies to help them achieve their objectives. Strategies are the means to the ends, the game plan, or what a firm is going to do to achieve its objectives. Successful strategies help organizations establish and maintain a competitive advantage that competitors cannot imitate easily.

Firms then use a variety of tactics to execute their strategies. Tactics include specific actions, such as coupons, television commercials, banner ads, and so on, taken to execute the strategy. PepsiCo attempts to sustain its competitive advantage by constantly developing new products and innovations, including “mega brands,” which include nineteen individual brands that generate over $1 billion in sales each. The tactics may consist of specific actions (digital media campaigns, Super Bowl commercials; coupons; buy one get one free offers; etc.) to promote products and brands.

Firms often use multiple strategies to accomplish their objectives and capitalize on marketing opportunities. For example, in addition to pursuing a low cost strategy (selling products inexpensively), Walmart has simultaneously pursued a strategy of opening new stores rapidly around the world. Many companies develop marketing strategies as part of their general, overall business plans. Other companies prepare separate marketing plans.

A marketing plan is a strategic plan at the functional level that provides a firm’s marketing group with direction. It is a road map that improves the firm’s understanding of its competitive situation. The marketing plan also helps the firm allocate resources and divvy up the tasks that employees need to do for the company to meet...
its objectives. Let's take a look at the different types of basic market strategies firms pursue before they develop their marketing plans.

The different types of product and market entry strategies a firm can pursue in order to meet their objectives.

**Market penetration strategies** focus on increasing a firm's sales of its existing products to its existing customers. Companies often offer consumers special promotions or low prices to increase their usage and encourage them to buy products. When Frito-Lay distributes money-saving coupons to customers or offers discounts to buy multiple packages of snacks, the company is utilizing a penetration strategy. The Campbell Soup Company gets consumers to buy more soup by providing easy recipes using their soup as an ingredient for cooking quick meals.

**Product development strategies** involve creating new products for existing customers. A new product can be a totally new innovation, an improved product, or a product with enhanced value, such as one with a new feature. Cars that parallel park themselves, offer rear-view cameras or wifi are examples of a product with enhanced value. A new product can also be one that comes in different variations, such as new flavors, colors, and sizes. Mountain
Dew Voltage, introduced by PepsiCo Americas Beverages in 2009, is an example. Keep in mind, however, that what works for one company might not work for another. For example, just after Starbucks announced it was cutting back on the number of its lunch offerings, Dunkin’ Donuts announced it was adding items to its lunch menu.

**Diversification strategies** aim to enter a new industry or market by developing a new product to give the firm a foothold in that new market. By broadening – or “diversifying” – its offerings, a firm can reduce its risk of exposure to the ups and downs of operating only in one industry. Diversification is generally considered a riskier strategy, but when it succeeds, it can result in strong, multi-industry, powerhouse companies. A great example is Disney, which has diversified over time from animated films into markets for toys, apparel, theme parks, resorts and cruise vacations, among other product categories.

**Market development strategies** focus on entering new markets with existing products. For example, during the recent economic downturn, manufacturers of high-end coffee makers began targeting customers who go to coffee shops. The manufacturers are hoping to develop the market for their products by making sure consumers know they can brew a great cup of coffee at home for a fraction of what they spend at Starbucks.

New markets can include any new groups of customers such as different age groups, new geographic areas, or international markets. Many companies, including PepsiCo and Hyundai, have entered—and been successful in—rapidly emerging markets such as Russia, China, and India. Decisions to enter foreign markets are based on a company’s resources as well as the complexity of factors such as the political environmental, economic conditions, competition, customer knowledge, and probability of success in the desired market. As the figure below, “Market Entry Methods,” shows, there are different ways, or strategies, by which firms can enter international markets. The strategies vary in the amount of risk,
control, and investment that firms face. Firms can simply export, or sell their products to buyers abroad, which is the least risky and least expensive method but also offers the least amount of control. Many small firms export their products to foreign markets.

Firms can also license, or sell the right to use some aspect of their production processes, trademarks, or patents to individuals or firms in foreign markets. Licensing is a popular strategy, but firms must figure out how to protect their interests if the licensee decides to open its own business and void the license agreement. The French luggage and handbag maker Louis Vuitton faced this problem when it entered China. Competitors started illegally putting the Louis Vuitton logo on different products, which cut into Louis Vuitton’s profits.

Franchising is a longer-term (and thus riskier) form of licensing that is extremely popular with service firms, such as restaurants like McDonald’s and Subway, hotels like Holiday Inn Express, and cleaning companies like Stanley Steamer. Franchisees pay a fee for the franchise and must adhere to certain standards; however, they
benefit from the advertising and brand recognition the franchising company provides.

**Contract manufacturing** allows companies to hire manufacturers to produce their products in another country. The manufacturers are provided specifications for the products, which are then manufactured and sold on behalf of the company that contracted the manufacturing. Contract manufacturing may provide tax incentives and may be more profitable than manufacturing the products in the home country. Examples of products in which contract manufacturing is often used include cell phones, computers, and printers.

**Joint ventures** combine the expertise and investments of two companies and help companies enter foreign markets. The firms in each country share the risks as well as the investments. Some countries such as China often require companies to form a joint venture with a domestic firm in order to enter the market. After entering the market in a partnership with a domestic firm and becoming established in the market, some firms may decide to separate from their partner and become their own business. Fuji Xerox Co., Ltd. is an example of a joint venture between the Japanese Fuji Photo Film Co. and the American document management company Xerox. Another example of a joint venture is Sony Ericsson. The venture combined the Japanese company Sony's electronic expertise with the Swedish company Ericsson's telecommunication expertise. With investment by both companies, joint ventures are riskier than exporting, licensing, franchising, and contract manufacturing but also provide more control to each partner.

**Direct investment** (owning a company or facility overseas) is another way to enter a foreign market, providing the most control but also having the most risk. For example, In Bev, the Dutch maker of Beck's beer, was able to capture market share in the United States by purchasing St. Louis-based Anheuser-Busch. A direct investment strategy involves the most risk and investment but offers the most
control. Other companies such as advertising agencies may want to invest and develop their own businesses directly in international markets rather than trying to do so via other companies.

Market Entry Methods

Diversification strategies involve entering new markets with new products or doing something outside a firm’s current businesses. Firms that have little experience with different markets or different products often diversify their product lines by acquiring other companies. Diversification can be profitable, but it can also be risky if a company does not have the expertise or resources it needs to successfully implement the strategy. Warner Music Group’s purchase of the concert promoter Bulldog Entertainment is an example of a diversification attempt that failed.

KEY TAKEAWAYS

The strategic planning process includes a company’s objectives (end results desired) and strategies (means). A firm’s objectives should be realistic (achievable) and measurable. The different product market strategies firms pursue include market penetration, product development, market development, and diversification.
The Role of Marketing in the Organization

We previously discussed marketing as a set of activities that anyone can do. Marketing is also a functional area in companies, just like operations and accounting are. Within a company, marketing might be the title of a department, but some marketing functions, such as sales, might be handled by another department. Marketing activities do not occur separately from the rest of the company, however.

As we have explained, pricing an offering, for example, will involve a company’s finance and accounting departments in addition to the marketing department. Similarly, a marketing strategy is not created solely by a firm’s marketing personnel. Instead, it flows from the company’s overall strategy.

Everything Starts with Customers

Most organizations start with an idea of how to serve customers better. Apple’s engineers began working on the iPod by looking at the available technology and thinking about how customers would like to have their music more available, as well as more affordable, through downloading.

Many companies think about potential markets and customers when they start. John Deere, for example, founded his company on the principle of serving customers. When admonished for making constant improvements to his products even though farmers would take whatever they could get, Deere reportedly replied, “They
haven’t got to take what we make and somebody else will beat us, and we will lose our trade.” He recognized that if his company failed to meet customers' needs, someone else would. As a result, their company mission statement changed to the following:

We aspire to distinctively serve customers—those linked to the land—through a great business, a business as great as our products. To achieve this aspiration, our strategy is:

- Exceptional operating performance
- Disciplined SVA growth
- Aligned high-performance teamwork.

Here are a few mission statements from other companies. Note that they all refer to their customers, either directly or by making references to relationships with them. Note also how these are written to inspire employees and others who interact with the company and may read the mission statement.

**IBM**

IBM will be driven by these values:

- Dedication to every client’s success.
- Innovation that matters, for our company and for the world.
- Trust and personal responsibility in all relationships.

**Coca-Cola**

Everything we do is inspired by our enduring mission:

- To refresh the world...in body, mind, and spirit.
• To inspire moments of optimism...through our brands and our actions.
• To create value and make a difference...everywhere we engage.

McDonald’s

• To be our customers’ favorite place and way to eat.

Merck

• To provide innovative and distinctive products and services that save and improve lives and satisfy customer needs, to be recognized as a great place to work, and to provide investors with a superior rate of return.

Not all companies create mission statements that reflect a marketing orientation. Note Apple’s mission statement: “Apple ignited the personal computer revolution in the 1970s with the Apple II and reinvented the personal computer in the 1980s with the Macintosh. Today, Apple continues to lead the industry in innovation with its award-winning computers, OS X operating system and iLife and professional applications. Apple is also spearheading the digital media revolution with its iPod portable music and video players and iTunes online store, and has entered the mobile phone market with its revolutionary iPhone.”

This mission statement reflects a product orientation, or an operating philosophy based on the premise that Apple's success is due to great products and that simply supplying them will lead to demand for them. The challenge, of course, is how to create a “great” product without thinking too much about the customer’s wants and needs. Apple, and for that matter, many other companies,
have fallen prey to thinking that they knew what a great product was without asking their customers. In fact, Apple's first attempt at a graphic user interface (GUI) was the LISA, a dismal failure.

The Marketing Plan

The marketing plan is the strategy for implementing the components of marketing: creating, communicating, delivering, and exchanging value. Once a company has decided what business it is in and expressed that in a mission statement, the firm then develops a corporate strategy. Marketing strategists subsequently use the corporate strategy and mission and combine that with an understanding of the market to develop the company's marketing plan.

**Step 1: Customer Focus.** Customer focus is also an essential part of the marketing plan. Understanding who you are targeting, what are the customer’s wants and needs; how the customer wants to acquire, consume, and dispose of the offering; and what makes up their personal value equation are three important goals. Marketers need to know their customers—who they are and what they like to do—so as to uncover this information. Generally, this requires marketing researchers to collect sales and other related customer data and analyze it.
**Step 2: Product Development.** Once the firm understands who they are targeting and how to satisfy customer needs, the planners can then work to create the right offering. Products and services are developed, bundled together at a price, and then tested in the market. Decisions have to be made as to when to alter the offerings, add new ones, or drop old ones.

**Step 3: Value Chain.** Building on decisions about product offerings, planners must address questions and opportunities associated with building the value chain. Once an offering is designed, the company has to be able to make it and get it to the market. The marketing plan may address stakeholder relationships across the value chain including distribution, in order to deliver value to customers.

**Step 4: Communicating Value.** A key function of the marketing plan is to effectively communicate with the stakeholders who are essential to the success of the plan. How will various teams within the company align to support the company’s success? What compelling offer will the firm make to consumers? How does the firm make them aware of the value it has to offer? What steps should consumers take to realize this value? How does the firm help
them recognize that value and decide that they should purchase products?

**Step 5: The Exchange.** Once a consumer has decided that her personal value equation is likely to be positive, she will decide to purchase the product. That decision still has to be acted on, however, which is the exchange. Customers should have a positive experience with the exchange, and marketing plans may address improvements to this experience.

**Step 6: Evaluating Performance.** As exchanges occur, marketing planners refine their plans based on data captured throughout the consumer decision process, the feedback they receive from their customers, what their competitors are doing, and how market conditions are changing.

**The Changing Marketing Environment**

At the beginning of this chapter, we mentioned that the view of marketing has changed from a static set of four Ps to a dynamic set of processes that involve marketing professionals as well as many other employees in an organization. The way business is being conducted today is changing, too, and marketing is changing along with it. Worth noting are several themes, or important trends, that may shape company strategies and in turn marketing strategies and planning.

- **Ethics and social responsibility.** Businesses exist only because society allows them to. When businesses begin to fail society, society will punish them or revoke their license. The crackdown on companies in the subprime mortgage-lending industry is one example. These companies created and sold loans (products) that could only be paid back under ideal circumstances, and when consumers couldn't pay these loans back, the entire economy suffered greatly. Scandals such as
these illustrate how society responds to unethical business practices. However, whereas ethics require that you only do no harm, the concept of social responsibility requires that you must actively seek to improve the lot of others. Today, people are demanding businesses take a proactive stance in terms of social responsibility, and they are being held to ever-higher standards of conduct.

• **Sustainability.** Sustainability is an example of social responsibility and involves engaging in practices that do not diminish the earth's resources. Coca-Cola, for example, is working with governments in Africa to ensure clean water availability, not just for manufacturing Coke products but for all consumers in that region. Further, the company seeks to engage American consumers in participating by offering opportunities to contribute to clean water programs. Right now, companies do not *have* to engage in these practices, but because firms really represent the people behind them (their owners and employees), forward-thinking executives are seeking ways to reduce the impact their companies are having on the planet.

• **Service-dominant logic.** You might have noticed that we use the word *offering* a lot instead of the term *product*. That’s because of service-dominant logic, the approach to business that recognizes that consumers want value no matter how it is delivered—whether through a tangible product or through intangible services. That emphasis on value is what drives the functional approach to value that we’ve taken—that is, creating, communicating, delivering, and exchanging value.

• **Metrics.** Technology has increased the amount of information available to decision makers. As such, the amount and quality of data for evaluating a firm’s performance is increasing. Earlier in our discussion of the marketing plan, we explained that customers communicate via transactions. Although this sounds both simple and obvious, better information technology has given us a much more complete picture of each
exchange. Cabela’s, for example, combines data from Web browsing activity with purchase history in order to determine what the next best offer is likely to be. Using data from many sources, we can build more effective metrics that can then be used to create better offerings, better communication plans, and so forth.

- **A global environment.** Every business is influenced by global issues. The price of oil, for example, is a global concern that affects everyone’s prices and even the availability of some offerings. We already mentioned Coke’s concern for clean water. But Coke also has to be concerned with distribution systems in areas with poor or nonexistent roads, myriads of government policies and regulations, workforce availability, and so many different issues in trying to sell and deliver Coke around the world. Even companies with smaller markets source some or all their offerings from companies in other countries or else face some sort of direct competition from companies based in other countries. Every business professional, whether marketing or otherwise, has to have some understanding of the global environment in which companies operate.

**KEY TAKEAWAYS**

A company’s marketing plan flows from its strategic plan. Both begin with a focus on customers. The essential components of the plan are understanding customers, creating an offering that delivers value, communicating the value to the customer, exchanging with the customer, and evaluating the firm’s performance. A marketing plan is influenced by environmental trends such as social responsibility, sustainability, service-dominant logic, the increased availability of data and effective metrics, and the global nature of the business environment.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=257
What you’ll learn to do: define brand and the role of branding strategies in creating a successful product or business

This is NOT the kind of branding you will learn about in this part of the module! However, in the same way that cowboys brand livestock to identify them as belonging to their herd, companies brand their products so consumers can identify who “owns” them. If you walk through a parking lot at school, work, or the local mall, chances are good that you could identify all the car brands just by looking at hood emblems. When you spot someone with a “swoosh” on her T-shirt, you probably already know she’s wearing Nike-brand apparel without even asking. How is it possible to know so much just by looking at an image or a shape? The answer is branding!

LEARNING ACTIVITIES

The learning activities for this section include:
• Reading: Branding
• Self Check: Branding

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Defining a Brand

Before you begin reading about branding and the strategies companies can adopt when placing their mark on a product, take a few minutes to watch the following video about Starbucks, a truly global brand:

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=259

A brand is a promise: the promise of what a company or product will provide to the people who interact with it. A brand consists
of all the features that distinguish the goods and services of one seller from another: name, term, design, style, symbols, customer touch-points, etc. Together, all elements of the brand work as a psychological trigger or stimulus that causes an association to all other thoughts we have about this brand. Brand encompasses visual design elements (i.e., logo, color, typography, images, tagline, etc.), distinctive product features (i.e. quality, design sensibility, etc.), and intangible aspects of customers' experience with a product or company (i.e. reputation, customer experience, etc.). Branding may take place at multiple levels: the company as a whole, individual products or product lines. Other entities that work to build consumer loyalty can also be considered brands, such as celebrities (e.g. Lady Gaga), events (e.g. Susan G. Komen Race for the Cure) and places (e.g. Las Vegas).

**History**

The word “brand” is derived from the Old Norse “brand” meaning “to burn,” which refers to the practice of producers burning their mark (or brand) onto their products. Italians are considered among the first to use brands in the form of watermarks on paper in the 1200s. However, in mass-marketing, this concept originated in the nineteenth century with the introduction of packaged goods.

During the Industrial Revolution, the production of many household items, such as soap, was moved from local communities to centralized factories to be mass-produced and sold to the wider markets. When shipping their items, factories branded their logo or insignia on the barrels used. Eventually these “brands” became trademarks, or recognized symbols of a company or product that are established by use. These new brand marks enabled packaged-goods manufacturers to communicate that their products are distinctive and should be trusted as much as (or more than) local competitors. Campbell Soup, Coca-Cola, Juicy Fruit gum, Aunt
Jemima, and Quaker Oats were among the first products to be “branded.”

The Coca-Cola logo is an example of a widely recognized trademark and global brand.

**Connotations**

A successful brand is much more than just a name or logo. Brand is the sum of perceptions about a company or product in the minds of consumers. Effective brand-building can create and sustain a strong, positive, and lasting impression that is difficult to displace. Brands provide external cues to taste, design, performance, quality, value or other desired attributes if they are developed and managed properly. Brands convey positive or negative messages about a company, product or service. Brand perceptions are a direct result of past advertising, promotion, product reputation and customer experience.

A brand can convey multiple levels of meaning, as follows:
1. **Attributes**: specific product features. The Mercedes-Benz brand, for example, suggests expensive, well-built, well-engineered, durable vehicles.

2. **Benefits**: attributes translate into functional and emotional benefits. Mercedes automobiles suggest prestige, luxury, wealth, reliability.

3. **Values**: company values and operational principles. The Mercedes brand evokes company values around excellence and high performance.

4. **Culture**: cultural elements of the company and brand. Mercedes represents German precision, discipline, efficiency, quality.

5. **Personality**: strong brands often project a distinctive personality. The Mercedes brand personality combines luxury and efficiency, precision and prestige.

6. **User**: brands may suggest the types of consumers who buy and use the product. Mercedes drivers might be perceived and classified differently than, for example, the drivers of Cadillacs, Corvettes or BMWs.

As an automobile brand, the Mercedes-Benz logo suggests high prestige.
What Is the Purpose of Branding and Why Is It So Important?

Effective branding encompasses everything that shapes the perception of a company or product in the minds of customers. Names, logos, brand marks, trade characters and trademarks are commonly associated with brand, but these are just part of the picture. Branding also addresses virtually every aspect of a customer's experience with a company or product: visual design, quality, distinctiveness, purchasing experience, customer service, and so forth. Branding requires a deep knowledge of customers and how they experience the company or product. Brand-building requires long-term attention and investment in communicating about and delivering the unique value embodied in a company's “brand,” but this effort reaps long-term profitability.

In consumer and business-to-business markets, branding can influence whether consumers will buy the product and how much they are willing to pay. Branding can also help in new product introduction as a new brand extension or product line builds on consumers' positive perceptions of the established brand.

Benefits of Branding for the Consumer

Brands help simplify consumer choices. Effective branding enables the consumer to easily identify a desirable company or product because the features and benefits have been communicated effectively. Positive, well-established brand associations increase the likelihood consumers will select, purchase and consume the product. Dunkin' Donuts, for example, has an established logo and imagery familiar to many U.S. consumers. The vivid colors and image of a DD cup are easily recognized and distinguished from
competitors, and many associate this brand with tasty donuts, good coffee and great prices.

The Dunkin’ Donuts logo, which includes an image of a DD cup of coffee, makes it easy to spot anywhere. The coffee is known for being a good value at a great price.

Benefits of Branding for the Manufacturer

Branding helps create loyalty. It decreases the risk of losing market share to the competition by establishing a differential advantage. Strong brands often command premium pricing from consumers who are willing to pay more for a product they know, trust, and perceive as offering good value. Branding can be a great vehicle for effectively reaching target audiences and positioning a company relative to the competition. Brand is the ultimate touchstone to guide choices around messaging, visual design, packaging, marketing, communications and product strategy.

For example, Starbucks’ loyal fan base values and pays premium prices for its coffee. Starbucks’ choices about beverage products, neighborhood shops, the buying experience and corporate social responsibility all help build the Starbucks brand and communicate its value to a global customer base.
Benefits of Branding for the Retailer

Branding enables the retailer to benefit from brand marketing support by helping to attract more customers (ideally ones who normally don't frequent the establishment). For example, a customer who truly values organic brands might decide to visit a Babies R Us to shop for organic household cleaners that are safe to use around babies. This customer might have learned that a company called BabyGanics, which brands itself as making “safe, effective, natural household solutions,” was only available at this particular retailer.

Brand Loyalty

In marketing, brand loyalty refers to a consumer's commitment to repurchase or otherwise continue using a particular brand by repeatedly buying a product or service.
The American Marketing Association defines brand loyalty in the following ways:

1. The situation in which a consumer generally buys the same manufacturer-originated product or service repeatedly over time rather than buying from multiple suppliers within the category (sales promotion definition)
2. The degree to which a consumer consistently purchases the same brand within a product class (consumer behavior definition)

Aside from a consumer's ability to repurchase a brand, true brand loyalty exists when the customer is committed to the brand, and the customers have a high relative attitude toward the brand, which is then exhibited through repurchase behavior. For example, if Joe has brand loyalty to Company A, he will purchase Company A’s products even if Company B’s products are cheaper and/or of a higher quality.

Brand loyalty is viewed as a multidimensional construct, determined by several distinct psychological processes, such as the customers' perception of value, brand trust, satisfaction, repeat-purchase behavior, and commitment. Commitment and repeated-purchase behavior are considered necessary conditions for brand loyalty, followed by perceived value, satisfaction, and brand trust.

Philip Kotler identifies the following four customer types that exhibit similar patterns of behavior:

1. Hardcore Loyals, who buy the brand all the time
2. Split Loyals, loyal to two or three brands
3. Shifting Loyals, moving from one brand to another
4. Switchers, with no loyalty (possibly “deal-prone,” constantly looking for bargains, or “vanity prone,” looking for something different)
Benefits of Brand Loyalty

The benefits of brand loyalty are longer tenure (or staying a customer for longer), and lower sensitivity to price. Recent research found evidence that longer-term customers were indeed less sensitive to price increases.

According to Andrew Ehrenberg, consumers buy “portfolios of brands." They switch regularly between brands, often because they simply want a change. Thus, “brand penetration” or “brand share” reflects only a statistical chance that the majority of customers will buy that brand next time as part of a portfolio of brands. It does not guarantee that they will stay loyal.

By creating promotions and loyalty programs that encourage the consumer to take some sort of action, companies are building brand loyalty by offering more than just an advertisement. Offering incentives like big prizes creates an environment in which customers see the advertiser as more than just the advertiser. Individuals are far more likely to come back to a company that uses interesting promotions or loyalty programs than a company with a static message of “buy our brand because we’re the best.”

Popular Loyalty Programs

Below are some of the most popular customer loyalty programs in use today by major companies as a means of engaging their customers beyond traditional advertising:

- Sweepstakes and Advergames
- Branded digital games that engage consumers with prize incentives
- Contests
- Skill tests and user-generated promotions such as video and photo contests

1142 | Reading: Branding
• Social media applications and management
• Social media promotions and offers
• Customer rewards programs (e.g. pay lower prices using a frequent buyer card)
• Points-based loyalty programs, awarding prizes for incremental purchase behavior (e.g., frequent flyer programs)
• Coupons (hard copy and/or digital)
• Promotional auctions—bid for prizes with points earned from incremental purchase behavior
• Email clubs
• Subscription databases—national and/or segmented by market
• SMS Promotions
• iPhone apps
• Branded web apps

**Brand Equity**

In marketing, brand equity refers to the value of a brand that is well-known and conjures positive mental and emotional associations. For any given product, service, or company, brand equity is considered a key asset because it helps the brand remain relevant and competitive. Brand equity can manifest itself in consumer recognition of logos or other visual elements, brand language associations made by consumers’ perception of quality, and value among other relevant brand attributes.

When consumers trust a brand and find it relevant, they may select the offerings associated with that brand over those of competitors even at a premium price. For example, Starbucks can sell its coffee at a higher price than solid market competitors because consumers associate the brand with quality and value. This is why brand equity often correlates directly with a brand’s profitability.
Measuring Brand Equity

Brand equity is strategically important, but also difficult to quantify. As a result, many experts have developed tools or metrics to analyze this asset, although there is no universally accepted way to measure it. For example, while it can be measured quantitatively using numerical values such as profit margins and market share, this approach fails to capture qualitative elements such as prestige and mental and emotional associations.

According to David Aaker, a marketing professor and brand consultant, the following are ten attributes of a brand that can be used to assess its strength:

1. Differentiation
2. Satisfaction or loyalty
3. Perceived quality
4. Leadership or popularity
5. Perceived value
6. Brand personality
7. Organizational associations
8. Brand awareness
9. Market share
10. Market price and distribution coverage

Brand Asset Valuator

Young & Rubicam, a marketing communications agency, has developed the brand asset valuator, a tool to diagnose the power and value of a brand. The agency uses this tool to survey and measure consumers’ perspectives along the following four dimensions:

- **Differentiation:** The defining characteristics of the brand and
its distinctiveness relative to competitors

- **Relevance**: The appropriateness and connection of the brand to a given consumer
- **Esteem**: Consumers’ respect for and attraction to the brand
- **Knowledge**: Consumers' awareness of the brand and understanding of what it represents

Below are other ways that brand equity can be measured. These can be used individually or in combination:

- **At the firm level**: Brand equity can be studied as a financial asset by making a calculation of a brand's worth as an intangible asset. For example, a company can estimate brand value on the basis of projected profits discounted to a present value. In turn, the present value can be used to calculate the risk profile, market leadership, stability, and global reach.
- **At the product level**: The price of an equivalent well-known brand can be compared to that of a competing, no-name or private label product.
- **At the consumer level**: This measure seeks to map the mind of the consumer to uncover associations with the given brand. For example, projective techniques can be used to identify tangible and intangible attributes, attitudes, and various perceptions about the brand. Under this approach, the brands with the highest levels of awareness and most favorable and unique associations are considered high equity brands.

**Types of Brands**

As alluded to earlier, different types of brands include: individual products, product ranges, services, organizations, individual persons, groups, events, geographic places, private label brands, media, and e-brands.
**Individual Brands.** The most common type of brand is a tangible, individual product, such as a car or drink. This can be very specific, such as the Kleenex brand of tissues, or can comprise a wide range of products. Product brands can also be associated with a range, such as the Mercedes S-class cars or all varieties of Colgate toothpaste.

**Service Brands.** A service brand develops as companies move from manufacturing products to delivering complete solutions and intangible services. Service brands are characterized by the need to maintain a consistently high level of service delivery. This category comprises the following:

- Classic service brands (such as airlines, hotels, car rentals, and banks).
- Pure service providers (such as member associations).
- Professional service brands (such as advisors of all kinds – accountancy, management consultancy).
- Agents (such as travel agents and estate agents).
- Retail brands (such as supermarkets, fashion stores, and restaurants).

**Organization Brands.** Organization brands are companies and other entities that deliver products and services. Mercedes and the US Senate each possess strong organization brands, and each has qualities associated with them that constitute their brand. Organizations can also be linked closely with the brand of an individual. For example, the U.S. Democratic party is closely linked with President Barack Obama.

**Personal Brands.** A person can be considered a brand. It can be comprised of one, as in the case of Oprah Winfrey, or a few individuals, where the branding is associated with different personalities, such as with the American Democratic Party.

**Group Brands.** Group branding happens when there is a small group of branded entities that have overlapping, interconnected brand equity. For example, the OWN brand of the Oprah Winfrey
Network and the brand of its known members (Oprah and her team) are strongly connected. The OWN group brand is closely linked to Oprah Winfrey herself.

**Event Brands.** Events can become brands when they strive to deliver a consistent experience that attracts consumer loyalty. Examples include conferences the TED series; music festivals like Coachella or SXSW; sporting events like the Olympics or NASCAR; touring Broadway musicals like Wicked. The strength of these brands depends on the experience of people attending the event. Savvy brand managers from product, service and other types of brands realize the power of event brands and seek to have their brands associated with the event brands through sponsorships. Event sponsorship is now a thriving big business.

**Geographic Place Brands.** Many places or areas of the world seek to brand themselves to build awareness of the essential qualities they offer. Branded places can range from countries and states to cities, streets and even buildings. Those who govern or represent these geographies work hard to develop the brand. Geographic branding is used frequently to attract commerce and economic investment, tourism, new residents, and so forth.

**Private Label Brands.** Private label brands, also called own brands, or store brands, exist among retailers that possess a particularly strong identity (such as Save-A-Lot). Interestingly, private labels may denote superior, “select” quality or lower cost for a quality product.
**Media Brands.** Media brands include newspapers, magazines, and television channels such as CNN.

![CNN Logo](image)

**E-Brands.** E-Brands exist only in the virtual world. Many e-brands, such as Amazon.com have a central focus on providing an online front end for delivering physical products or services. Others provide information and intangible services to benefit consumers. Typically a common denominator for e-brands is a focus on delivering a valued service or experience in the virtual environment.

**Brand Ownership**

Brand ownership is about building, developing and sustaining a brand that reflects your principles and values and which effectively persuades consumers to believe in and purchase your product/service.

In order to really own your brand, you must have a clear understanding of where your brand stands in the marketplace today, and a concrete strategy that outlines how you wish to manage and grow your brand moving forward in support of company strategy and objectives. Equally important is understanding what makes your brand different. You must also
create clear and persuasive messaging communication targeting your end consumer. You should also develop a plan to reach your goals in a realistic and organized fashion.

When you truly own your brand, your money is spent wisely on marketing that is targeted, sharp and effective because you have a sophisticated understanding of the marketplace, your product/service, your consumer base and your strategy. This will translate into disciplined and effective brand management that will enable you to remain relevant in a rapidly-changing [and oftentimes saturated] marketplace.

Brand ownership should also be considered the responsibility of its management and employees. Steve Jobs, for example, was considered a leader in shaping the identity of Apple, which has helped fuel a very high stock price for the company. As a result, the brand image and reputation has attracted some of the world’s best talent which, in turn, has yielded an variety of innovative mobile products that will undoubtedly be marked in the history of popular consumer culture.

A brand owner may seek to protect proprietary rights in relation to a brand by registering the trademark such that it becomes a “Registered Trademark.” Also, a firm or licensor can also grant the right to use their brand name, patents or sales knowledge in exchange for some form of payment.

The Registered Trademark symbol
A brand identifies a commercial product or service as distinct from those of other sellers, and therefore it is made up of all the things that create this distinction. A brand's name is an essential part of this package. A brand name may be a product name, or it may be the name under which the entire organization operates. Because the name is so integral to identity, naming a brand is crucial to its reputation, development, and future success – and to the brand owner's ability to differentiate the brand from its competitors.

**Naming a Brand**

Selecting a brand name is one of the most important product decisions a seller makes. A brand name reflects the overall product image, positioning and, ideally, its benefits. A successful brand name can enable a product to: be meaningfully advertised and distinguished from competitors, be tracked down by consumers, and be given legal protection. At its best, a brand can provide a carryover effect when customers are able to associate quality products with an established brand name.

Attention to naming also helps customers associate products within the same brand family. For example, Apple names its mobile products with a lowercase i—for example, iPad, iPod, iPhone. Starbucks names its coffee sizes in Italian.

Naming a brand is a systematic effort. It starts with defining the personality and distinctive attributes of the company or product to be named. A scan of the competitive landscape identifies brand names already active in the category, in order to avoid selecting a name that would easily be confused with competitors. Next, the naming team generates potential brand names, screens them to make sure they are available to use legally (no trademark conflicts) and perceptually (no mindshare conflicts with other known brands). It is always wise to conduct market research to test short-listed names among consumers. Ultimately the naming team selects the
name with the most potential for creating a strong brand, combined with the least risk from a trademark ownership perspective. Brand names are mandatory if the manufacturer or distributor plans to produce mass advertising for their product.

But before this process even begins, a basic branding strategy must be employed where a company or seller must select from among the following three viable options:

1. A strict manufacturer’s branding policy under which a producer can only manufacture merchandise under his own brand
2. An exclusive distributor’s brand policy where a producer does not have a brand of his own but agrees to sell his products only to a particular distributor and carry his brand name (typically employed by private brands)
3. A mixed brand policy, which allows elements of both extremes (options 1. and 2. ) and leads to the production of manufacturer’s as well as distributor’s brands

Apple's iPad—iPad is one of Apple's mobile products named with the distinctive “i.”

Brand Lines

What is a Brand Line? Brand line is a marketing term used to describe all the products sold under a single brand name.

Brand line is a marketing term used to describe all the products
sold under a single brand name. New flavors, package sizes, nutritional content, or products containing special additives are included in this definition. More than half of all new products introduced each year are brand line extensions. For example, when a coffee manufacturer adds decaffeinated coffee to the same brand line of coffee products already on the market (such as regular coffee and instant coffee), a line extension has been made. Line extensions do not compete with each other, since each answers different needs and thus appeals to a different market.

Another form of brand extension is a licensed brand extension. In this scenario, the brand-owner works with a partner (sometimes a competitor), who takes on the responsibility of manufacturing and sales of the new products, paying a royalty every time a product is sold.

A company introduces a brand line extension (also referred to as product line extension) by using an established product's brand name to launch a new or slightly different item which may or may not be in the same product category. For example, Diet Coke™ is a line extension of the parent brand Coke ™. While the products have distinct differences, they are in the same product category. The new product is oftentimes referred to as a spin-off.
Diet Coke is a brand line extension of the Coca Cola Brand.

What Is the Purpose of a Brand Line or Brand Extension?

Organizations use this strategy to increase and leverage brand equity. An example of a brand extension is Jell-O gelatin creating Jello pudding pops. It increases awareness of the brand name and increases profitability from offerings in more than one product category.

Brand line extensions are crucial because they reduce financial risk associated with new product development by leveraging the parent brand name to enhance consumers’ perception as a result of its core brand equity. Due to the established success of the parent
brand, consumers will have instant recognition of the product name and will be more likely to try the new line extension.

Also, launching a new product is time consuming and requires a generous budget to create awareness and to promote a product’s benefits. As a result, promotional costs are much lower for a line extension than for a completely new product. More products expand the company’s shelf space presence, thereby enhancing brand recognition. For example, consider Campbell’s Soups™ – the strength of the Campbell’s™ brand lowers costs of launching a new flavor of soup, such as Creamy Chicken Noodle™, due to the established brand name and package design. Consumers who have enjoyed Campbell’s Chicken Noodle Soup™ are likely to try Campbell’s Creamy Chicken Noodle Soup™, even with minimal impact from advertisements and promotions.

Overall, the main benefits of a brand line extension are:

- Expand company shelf space presence.
- Gain more potential customers.
- Offer customers more variety.
- Greater marketing efficiency.
- Greater production efficiency.
- Lower promotional costs.
- Increased profits.

Brand Line Extensions Can Also Represent Risk

While there can be significant benefits in brand extension strategies, there can also be significant risks, resulting in a diluted or severely damaged brand image. Poor choices for brand extension may dilute and deteriorate the core brand and damage the brand equity. Most of the literature focuses on the consumer evaluation and positive impact on a parent brand. In practical cases, the failures of brand extension are at a higher rate than the successes.
Some studies show that negative impact may dilute brand image and equity. In spite of the positive impact of brand extension, negative association and wrong communication strategy can do harm to the parent brand and even the brand family.

Brand line extensions do present two potential main threats. If the new line extension fails to satisfy, consumers’ attitudes toward other products carrying the same brand name may be damaged. Additionally, there is potential for intra-firm competition between the parent product and the line extension or between two or more line extensions. The key to avoiding intra-firm competition is to clearly differentiate between products. Although similar, the products must be different enough that they will not compete with one another as much as they will with the brands of rival companies.

**Branding Strategies**

A branding strategy helps establish a product within the market and to build a brand that will grow and mature in a saturated marketplace. Making smart branding decisions up front is crucial since a company may have to live with the decision for a long time. The following are commonly used branding strategies:

**“House Brand” Strategy**

A “House Brand” strategy uses a a strong brand, typically the company name, as the identifying brand name for a range of products (for example, Mercedes Benz or Black & Decker) or a range of subsidiary brands (such as Cadbury Dairy Milk or Cadbury Fingers in the United States). Because the primary focus and investment is in a single, dominant “house” brand, this approach can
be simpler and more cost effective in the long run when it is well-aligned with broader corporate strategy.

“House of Brands” Strategy

With the “House of Brands” strategy, a company invests in building out a variety of individual, product-level brands. Each of these brands has a separate name, and may not be associated with the parent company name at all. These brands may even be in de facto competition against other brands from the same company. For example, Kool-Aid and Tang are two powdered beverage products, both owned by Kraft Foods. The “House of Brands” strategy is well-suited to companies that operate across many product categories at the same time. It allows greater flexibility to introduce a variety of different products, of differing quality, to be sold without confusing the consumer’s perception of what business the company is in or diluting brand perceptions about products that target different tiers or types of consumers within the same product category.

Competitive Multi-Brand Strategy

In a very saturated market, a supplier can deliberately launch totally new brands in apparent competition with its own existing strong brand (and often with identical product characteristics) to soak up some of the share of the market. The rationale is that having 3 out of 12 brands in such a market will give a greater overall share than having 1 out of 10. Procter & Gamble is a leading exponent of this philosophy, running as many as ten detergent brands in the U.S. market. In the hotel business, Marriott uses the name Fairfield Inns for its budget chain.

Cannibalization is a particular problem of a multi-brands strategy
approach, in which the new brand takes business away from an established one which the organization also owns. This may be acceptable (indeed to be expected) if there is a net gain overall.

Attitude Branding and Iconic Brands

Attitude branding is the choice to represent a larger feeling a brand comes to represent, which transcends the specific products being consumed. Examples of companies that use this approach effectively include:

- Nike – “Just do it”
- Apple – “Think different”
- Harley Davidson – “Live to Ride”
- Starbucks – “Daily Inspiration”

Effective attitude branding can transform strong brands into iconic, “lifestyle” brands that contribute to the consumer's self-expression and personal identity.

Component Brands

Some suppliers of key components may wish to guarantee its own position by promoting that component as a brand in its own right. For example, Intel, positions itself in the PC market with the slogan (and sticker) “Intel Inside.”

Private Labels

Also called own brands, or store brands, these have become
increasingly popular. Where the retailer has a particularly strong identity this “own brand” may be able to compete against even the strongest brand leaders, and may outperform those products that are not otherwise strongly branded.

“No-brand” Branding

Recently a number of companies have successfully pursued “no-brand” strategies by creating packaging that imitates generic brand simplicity. “No brand” branding may be construed as a type of branding as the product is made conspicuous through the absence of a brand name. “Tapa Amarilla” or “Yellow Cap” in Venezuela during the 1980s is a prime example of no-brand strategy. It was simply recognized by the color of the cap of this cleaning products company.

Individual and Organizational Brands

These are types of branding that treat individuals and organizations as the products to be branded. Personal branding treats persons and their careers as brands. Faith branding treats religious figures and organizations as brands.

Crowdsourced Branding

These are brands that are created by the people for the business, which is opposite to the traditional method where the business creates a brand. This type of method minimizes the risk of brand failure, since the people that might reject the brand in the
traditional method are the ones who are participating in the branding process. However, the business itself typically cannot fully control these brands because they are the product of crowdsourcing.

One interesting example is the Timbers Army, the independent fan organization of the Portland Timbers Major League Soccer (MLS) Team. The Timbers Army was created by fans, and it operates independently from the MLS team and the Portland Timbers management. Although the organizations coordinate in many areas, ultimately the fan organization asserts its own brand identity.

Nation Branding

Nation branding is a field of theory and practice which aims to measure, build, and manage the reputation of countries. Typically aimed at attracting investment, commerce and/or tourism, it is closely related to geographic place branding, discussed above.

Brand Extension and Brand Dilution

The existing strong brand name can be used as a vehicle for new or modified products. For example, many fashion and designer companies extended brands into fragrances, shoes and accessories, furniture, and hotels. Frequently, the product is no different than what is already on the market, except it has a brand name marking. The risk of over-extension is brand dilution, which is when the brand loses its brand associations with a market segment, product area, or quality, price, or cachet.
KEY TAKEAWAYS

A brand consists of all the features that distinguish the goods and services of one seller from another: name, term, design, style, symbols, customer touch-points, and so forth. Branding is the set of activities designed to create a brand and position it relative to competing brands in the minds of consumers. Effective branding requires a sophisticated understanding of customers targeted, what they want from a brand, and how the brand delivers those benefits in ways that distinguish it from the competition. Brand is the ultimate touchstone to guide choices around messaging, visual design, packaging, marketing, communications and product strategy.

Naming is an important decision companies must make about how to market a new brand. A brand extension involves utilizing an existing brand name or brand mark for a new product or category (line) of products. Cannibalization occurs when a company's new offering eats into the sales of one of its older offerings. It is something to be avoided in most cases, but it can also be a sign of progress because it means a company is developing new and better products.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

1160 | Reading: Branding
229. Outcome: Pricing Strategies

What you’ll learn to do: explain pricing strategies for new and existing products

What determines the price you pay for products, goods, and services? Is it just that the price is the price? The answer to that is both yes and no. In fact, the price that companies charge for their products is the result of a well-planned strategy that uses price as an important component of the overall marketing mix. In this section you’ll learn about a variety of pricing strategies that companies can use to achieve their financial goals.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Introduction to Product Pricing
• Self Check: Pricing Strategies

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Price, the Only Revenue Generator

Price is the only marketing mix variable or part of the offering that generates revenue. Buyers relate the price to value. They must feel they are getting value for the price paid. Pricing decisions are extremely important. So how do organizations decide how to price their goods and services?

New Product Pricing

With a totally new product, competition does not exist or is minimal. Two general strategies are most common for setting prices: penetration pricing and skimming.

Penetration Pricing

In the introductory stage of a new product’s life cycle means accepting a lower profit margin and to price relatively low. Such a strategy should generate greater sales and establish the new product in the market more quickly. Penetration pricing is the pricing technique of setting a relatively low initial entry price, often lower than the eventual market price, to attract new customers. The strategy works on the expectation that customers will switch to the new brand because of the lower price. Penetration pricing is most commonly associated with a marketing objective of increasing
market share or sales volume, rather than to make profit in the short term.

The advantages of penetration pricing to the firm are the following:

- It can result in fast diffusion and adoption. This can achieve high market penetration rates quickly. This can take the competitors by surprise, not giving them time to react.
- It can create goodwill among the early adopters segment. This can create more trade through word of mouth.
- It creates cost control and cost reduction pressures from the start, leading to greater efficiency.
- It discourages the entry of competitors. Low prices act as a barrier to entry.
- It can create high stock turnover throughout the distribution channel. This can create critically important enthusiasm and support in the channel.
- It can be based on marginal cost pricing, which is economically efficient.
- A penetration strategy would generally be supported by the following conditions: price-sensitive consumers, opportunity to keep costs low, the anticipation of quick market entry by competitors, a high likelihood for rapid acceptance by potential buyers, and an adequate resource base for the firm to meet the new demand and sales.

**Skimming**

Skimming involves goods being sold at higher prices so that fewer sales are needed to break even. Selling a product at a high price and sacrificing high sales to gain a high profit is therefore “skimming” the market. Skimming is usually employed to reimburse the cost of investment of the original research into the product. It is commonly used in electronic markets when a new range, such as DVD players,
are firstly dispatched into the market at a high price. This strategy is often used to target “early adopters” of a product or service. Early adopters generally have a relatively lower price sensitivity and this can be attributed to their need for the product outweighing their need to economize, a greater understanding of the product’s value, or simply having a higher disposable income.

This strategy is employed only for a limited duration to recover most of the investment made to build the product. To gain further market share, a seller must use other pricing tactics such as economy or penetration. This method can have some setbacks as it could leave the product at a high price against the competition. A skimming strategy would generally be supported by the following conditions:

- Having a premium product. In this case, “premium” does not just denote high cost of production and materials—it also suggests that the product may be rare or that the demand is unusually high. An example would be a USD 500 ticket for the World Series or an USD 80,000 price tag for a limited-production sports car.
- Having legal protection via a patent or copyright may also allow for an excessively high price. Intel and their Pentium chip possessed this advantage for a long time. In most cases, the initial high price is gradually reduced to match new competition and allow new customers access to the product.

Psychological Pricing

Psychological pricing is a marketing practice based on the theory that certain prices have meaning to many buyers.

As with other elements in the marketing mix, price conveys meanings beyond the dollar amount it denotes. One such meaning is referred to as the psychological aspect of pricing.
Assuming quality with price is a common example of this psychological dimension. For instance, a buyer may assume that a suit priced at $500 is of higher quality than one priced at $300.

Products and services frequently have customary prices in the minds of consumers. A customary price is one that customers identify with particular items. For example, for many decades a five-stick package of chewing gum cost five cents, and a six-ounce bottle of Coca-Cola also cost five cents. Candy bars now cost 60 cents or more, which is the customary price for a standard-sized bar. Manufacturers tend to adjust their wholesale prices to permit retailers to use customary pricing.

**Odd Pricing**

Another manifestation of the psychological aspects of pricing is the use of odd prices. We call prices that end in digits like 5, 7, 8, and 9 “odd prices.” Examples of odd prices include: $2.95, $15.98, or $299.99. Odd prices are intended to drive demand higher than would be expected if consumers were perfectly rational.

Psychological pricing is one cause of price points. For a long time, marketers have attempted to explain why odd prices are used. It seemed to make little difference whether one paid $29.95 or $30.00 for an item. Perhaps one of the most often heard explanations concerns the psychological impact of odd prices on customers. The explanation is that customers perceive even prices such as $5.00 or $10.00 as regular prices. Odd prices, on the other hand, appear to represent bargains or savings and therefore encourage buying. There seems to be some movement toward even pricing; however, odd pricing is still very common. A somewhat related pricing strategy is combination pricing, such as two-for-one or buy-one-get-one-free. Consumers tend to react very positively to these pricing techniques.

The psychological pricing theory is based on one or more of the following hypotheses:
- Consumers ignore the least significant digits rather than do the proper rounding. Even though the cents are seen and not totally ignored, they may subconsciously be partially ignored.
- Fractional prices suggest to consumers that goods are marked at the lowest possible price.
- When items are listed in a way that is segregated into price bands (such as an online real estate search), the price ending is used to keep an item in a lower band, to be seen by more potential purchasers.

**Everyday Low Pricing**

Everyday low price (EDLP) is a pricing strategy promising consumers a low price without the need to wait for sale-price events or comparison shopping.

EDLP saves retail stores the effort and expense needed to mark down prices in the store during sale events, as well as to market these events. EDLP is believed to generate shopper loyalty. It was noted in 1994 that the Wal-Mart retail chain in America, which follows an EDLP strategy, would buy “feature advertisements” in newspapers on a monthly basis, while its competitors would advertise 52 weeks per year.

Procter & Gamble, Wal-Mart, Food Lion, Gordmans, and Winn-Dixie are firms that have implemented or championed EDLP. One 1992 study stated that 26% of American supermarket retailers pursued some form of EDLP, meaning the other 74% were Hi-Lo promotion-oriented operators.

One 1994 study of an 86-store supermarket grocery chain in the United States concluded that a 10% EDLP price decrease in a category increased sales volume by 3%, while a 10% Hi-Low price increase led to a 3% sales decrease; but that because consumer demand at the supermarket did not respond much to changes in
everyday price, an EDLP policy reduced profits by 18%, while Hi-Lo pricing increased profits by 15%.

An example of a successful brand (other than the infamous Wal-Mart) that uses the EDLP strategy is Trader Joe's. Trader Joe's is a private-brand label that conducts a Niche marketing strategy describing itself as the “neighborhood store.” The firm has been growing at a steady pace, offering a wide variety of organic and natural food items that are hard to find, enabling the business to enjoy a distinctive competitive advantage.

![Trader Joe's Storefront]

*Everyday Low Pricing at Trader Joe’s*

Trader Joe's is not an ordinary store. It's unique because of its commitment to quality and lower prices, which it makes available to everyone—no membership required. The company states that “every penny we save is every penny our customer saves” (Trader Joe's 2010). Trader Joe's has worked hard to manage this economic image of value for its products, which competitors, even giant retail stores, are unable to meet.
High/Low Pricing

High-low pricing is a method of pricing for an organization where the goods or services offered by the organization are regularly priced higher than competitors. However, through promotions, advertisements, and or coupons, lower prices are offered on other key items consumers would want to purchase. The lower promotional prices are designed to bring customers to the organization where the customer is offered the promotional product as well as the regular higher priced products.

High-low pricing is a type of pricing strategy adopted by companies, usually small and medium sized retail firms. The basic type of customers for the firms adopting high-low price will not have a clear idea about what a product's price would typically be or have a strong belief that “discount sales = low price.” Customers for firms adopting this type of strategy also have strong preference in purchasing the products sold in this type or by this certain firm. They are loyal to a specific brand.

Many big firms use this type of pricing strategy (e.g., Reebok, Nike, Adidas). The way competition prevails in the shoe industry is through high-low price. High-low pricing is also used extensively in the fashion industry by department stores (ex: Macy's and Nordstrom) This pricing strategy is not only in the shoe and fashion industry but also in many other industries. However, in these industries one or two firms will not provide discounts and works on fixed rate of earnings. Those firms will follow everyday low price strategy in order to compete in the market.

One pricing strategy does not fit all, thus adapting various pricing strategies to new scenarios is necessary for a firm to stay viable.
Other Pricing Strategies

Pricing strategies for products or services encompass three main ways to improve profits. The business owner can cut costs, sell more, or find more profit with a better pricing strategy. When costs are already at their lowest and sales are hard to find, adopting a better pricing strategy is a key option to stay viable. There are many different pricing strategies that can be utilized for different selling scenarios:

Cost-Plus Pricing

Cost-plus pricing is the simplest pricing method. The firm calculates the cost of producing the product and adds on a percentage (profit) to that price to give the selling price. This method although simple has two flaws: it takes no account of demand, and there is no way of determining if potential customers will purchase the product at the calculated price.

Limit Pricing

A limit price is the price set by a monopolist to discourage economic entry into a market, and is illegal in many countries. The limit price is the price that the entrant would face upon entering as long as the incumbent firm did not decrease output. The limit price is often lower than the average cost of production or just low enough to make entering not profitable. The quantity produced by the incumbent firm to act as a deterrent to entry is usually larger than would be optimal for a monopolist, but might still produce higher economic profits than would be earned under perfect competition.
**Dynamic Pricing**

A flexible pricing mechanism made possible by advances in information technology, and employed mostly by Internet based companies. By responding to market fluctuations or large amounts of data gathered from customers – ranging from where they live to what they buy to how much they have spent on past purchases – dynamic pricing allows online companies to adjust the prices of identical goods to correspond to a customer’s willingness to pay. The airline industry is often cited as a success story. In fact, it employs the technique so artfully that most of the passengers on any given airplane have paid different ticket prices for the same flight.

**Non-Price Competition**

Non-price competition means that organizations use strategies other than price to attract customers. Advertising, credit, delivery, displays, private brands, and convenience are all examples of tools used in non-price competition. Business people prefer to use non-price competition rather than price competition, because it is more difficult to match non-price characteristics.

**Pricing Above Competitors**

Pricing above competitors can be rewarding to organizations, provided that the objectives of the policy are clearly understood and that the marketing mix is used to develop a strategy to enable management to implement the policy successfully. Pricing above competition generally requires a clear advantage on some non-price element of the marketing mix. In some cases, it is possible due to a high price-quality association on the part of potential
buyers. Such an assumption is increasingly dangerous in today's information-rich environment. Consumer Reports and other similar publications make objective product comparisons much simpler for the consumer. There are also hundreds of dot.com companies that provide objective price comparisons. The key is to prove to customers that your product justifies a premium price.

**Pricing Below Competitors**

While some firms are positioned to price above competition, others wish to carve out a market niche by pricing below competitors. The goal of such a policy is to realize a large sales volume through a lower price and profit margins. By controlling costs and reducing services, these firms are able to earn an acceptable profit, even though profit per unit is usually less. Such a strategy can be effective if a significant segment of the market is price-sensitive and/or the organization's cost structure is lower than competitors. Costs can be reduced by increased efficiency, economies of scale, or by reducing or eliminating such things as credit, delivery, and advertising. For example, if a firm could replace its field sales force with telemarketing or online access, this function might be performed at lower cost. Such reductions often involve some loss in effectiveness, so the trade off must be considered carefully.

In summary, the price that we pay for any given product, good or service is the result of a series of thoughtful, well planned out strategies by the business.

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count
toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=261
231. Outcome: Product Distribution Strategies

What you’ll learn to do: explain product distribution strategies and how they contribute to business success

If you lived during the Middle Ages and managed to avoid dying from the plague, chances are that you met your daily needs by walking around your village going to the butcher, the baker, and the candlestick maker. You didn’t, that is, drive to a shopping mall twenty miles away. The reason for the close proximity of consumers and producers was that businesses had not yet discovered ways of moving their goods beyond the local village and connecting them with potential buyers. In short, they lacked product distribution strategies. In today’s competitive marketplace, effective distribution strategies can mean the difference between success and failure. If one baker is out of apple pies, the customer can go elsewhere and choose from dozens or even hundreds more (which wasn’t the case in medieval times). In this section we’ll look more closely at the “place” component of the four Ps.
LEARNING ACTIVITIES

The learning activities for this section include:

- Video: Placement: Distribution Channels
- Self Check: Product Distribution Strategies

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
232. Video: Placement: Distribution Channels

Placement: Distribution Channels

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=263
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=263
233. Outcome: Promotion Mix

What you’ll learn to do: explain the promotion mix, promotion strategies, and the process of developing a successful promotion for both traditional and digital channels

Ask yourself whether you’ve ever done any the following: used a coupon, entered a contest, watched a television advertisement, gotten a rebate, or used a loyalty card to earn points or discounts. If you have, then you’ve experienced the promotion component of the marketing mix without even realizing it! How and why companies use promotions to achieve market goals and objectives is the subject of this next section.

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: The Promotion Mix: The Fourth P
- Self Check: Promotion Mix

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Factors Influencing the Promotion Mix

Promotion is the art and science of communicating about and promoting a product. The “promotion mix” is the set of activities and media channels marketers use to communicate about and promote a product.

A marketing manager from one company might decide to focus on social media, whereas a marketing manager from another company might decide to focus her company’s efforts on television commercials. A third marketing manager might use both methods. Why do companies select different types of media for what may be perceived as similar messages? As Figure 1 shows, a number of factors affect the choice of promotion mix elements.

Figure 1. Factors That Influence Selection of Promotion Mix
Budget Available

For many companies, the budget available to market a product determines what elements of the promotion mix are utilized. The budget affects a promotion's reach (number of people exposed to the message) and frequency (how often people are exposed). For example, many smaller companies may lack the money to create and run commercials on top-rated television shows or during the Super Bowl. As a result, they may not get the exposure they need to be successful. Other firms such as McDonald's may come up with creative ways to reach different target markets. For example, McDonald's targeted college students with a special promotion that it filmed live in a Boston University lecture.

Stage in the Product Life Cycle

The stage in the product life cycle also affects the type and amount of promotion used. Products in the introductory stages typically need a lot more promotional dollars to create awareness in the marketplace. Consumers and businesses won't buy a product if they do not know about it. More communication is needed in the beginning of the product life cycle to build awareness and trial.

Type of Product and Type of Purchase Decision

Different products also require different types of promotion. Very technical products and very expensive products (high involvement) often need professional selling so the customer understands how the product operates and its different features. By contrast, advertising is often relied upon to sell convenience goods and products purchased routinely (low involvement) since customers
are familiar with the products and they spend relatively little time making purchase decisions.

Target Market Characteristics and Consumers’ Readiness to Purchase

In order to select the best methods to reach different target markets, organizations need to know what types of media different targets use, how often they make purchases, where they make purchases, and what their readiness to purchase is as well as characteristics such as age, gender, and lifestyle. Some people are early adopters and want to try new things as soon as they are available, and other groups wait until products have been on the market for a while. Some consumers might not have the money to purchase different products, although they will need the product later. For example, are most college freshmen ready to purchase new cars?

Consumers’ Preferences for Various Media

We’ve already explained that different types of consumers prefer different types of media. In terms of target markets, college-aged students may prefer online, cell phone, mobile marketing, and social media more than older consumers do. Media preferences have been researched extensively by academics, marketing research companies, and companies to find out how consumers want to be reached.

Regulations, Competitors, and Environmental
Factors

Regulations can affect the type of promotion used. For example, laws in the United States prohibit tobacco products from being advertised on television. In some Asian countries, controversial products such as alcohol cannot be advertised during Golden (prime) time on television. The hope is that by advertising late at night, young children do not see the advertisements. The strength of the economy can have an impact as well. In a weak economy, some organizations use more sales promotions such as coupons to get consumers into their stores. The risk is that consumers may begin to expect coupons and not want to buy items without a special promotion.

Availability of Media

Organizations must also plan their promotions based on availability of media. The top-rated television shows and Super Bowl ad slots, for example, often sell out quickly. Magazines tend to have a longer lead time, so companies must plan far in advance for some magazines. By contrast, because of the number of radio stations and the nature of the medium, organizations can often place radio commercials the same day they want them to be aired. Social media and online media may be immediate, but users must be careful about what they post and their privacy. Uncontrollable events can affect a company's promotions, too. For example, when a disaster occurs, TV stations often cut advertisements to make way for continuous news coverage. If there is a crisis or disaster and your company is in the middle of a promotion being advertised on TV, you will likely have to scramble to reach consumers via another medium.
The Communication Process

The goal of the communication process is to effectively reach the consumers you are targeting and convey your desired message. Achieving this is easier said than done.

Do you use TiVo or a digital video recorder (DVR) to record movies or television shows so you can watch them when you want without television commercials? Do you ever use the remote to skip the commercials or zap (change channels) to look at different shows? Think about which television shows you choose to watch, which magazines you read, which radio stations you select. The perceptual process is how a person decides what to pay attention to and how to interpret and remember different things, including information in advertising. By selecting a magazine, a television show, or even an elective class in school, you're selecting what you're exposed to and deciding what gets your attention. However, your selection does not insure you'll either pay attention or remember or correctly interpret what you see or hear.

Think about what else you are doing when you watch television, when you are studying, or when you are listening to the radio. It's a hot day in July and you're enjoying a day at the beach. Your friends brought a radio and the volume is turned up so you can hear all the music. If you're listening to the music or talking to a friend at the beach while you're listening to the radio, do you hear or pay attention to the commercials? Do you remember which products were advertised? If you're with a friend and hear someone else say your name, do you pay more attention to the person talking about you than to your friend?

The same thing happens when you are watching a television show, reading a magazine, or studying for a test. The phone rings or your friends show up and your attention shifts to them. With so many different types of distractions and technology (such as recording devices), imagine how difficult it is for an advertiser to get you to pay attention much less remember the message. Do you remember
the terms you memorized for a test a day later? Do you know your friends’ phone numbers and e-mail addresses or do you just find their names on your contact list? To increase retention, advertisers may repeat the same message multiple times in different places, but they must be careful that consumers don’t get so tired of the message that there is a negative effect.

The communication process illustrates how messages are sent and received, as shown in Figure 2 below. The source (or sender) encodes, or translates, a message so that it’s appropriate for the message channel—say, for a print advertisement, TV commercial, or store display—and shows the benefits and value of the offering. The receiver (customer or consumer) then decodes, or interprets, the message. For effective communication to occur, the receiver must 1) hear the message, and 2) interpret the message as the sender intended.

Feedback is the additional step in effective communication. Purchasing a product provides the sender with feedback. It tells the seller that a consumer saw information and wanted to try the product. If the consumer used any coupons or promotions when buying a product, the advertiser knows which vehicle was used to get the information. Market research and warranty registration also provide feedback.

Message Problems

Communicating a clear message – and having it heard – are key to a successful promotional mix.

Suppose you’re ready to go home on a Friday afternoon and you hear someone mention an upcoming event on Saturday. However, you did not listen to all the details and assume the event is the next day, not the following Saturday. Since you already made other plans for the next day, you don’t even consider showing up the following Saturday. Has this ever happened to you? If you do not
hear someone correctly, misread information, or if they fail to communicate clearly, you might think a product or service provides different benefits or is easier or harder to use than it really is.

Clear, relevant messaging is critical for effective communication. Marketing messages that try to pack in too much information or else don't say enough leave people wondering what is the point. We tend to purchase products and remember information that has some relevance to our personal situation or beliefs. If you have no need for a product or service, you might not pay attention to or remember the messages used to market it. Advertisers want you to remember their brands so that you'll think of their products and services when you need to make a purchase.

Interference, or noise, can distort marketing messages. Factors such as poor reception, poor print quality, problems with a server, or a low battery can interfere with your getting messages. Interference includes any distractions receivers and senders face during the transmission of a message. Think about what it's like to study for an exam while you're talking on the phone. The conversation interferes with remembering what you're reading. Likewise, if you miss class and borrow someone else's notes, do you understand what they mean? Not only must advertisers try to present consistent messages, they must also try to ensure that you interpret the message as they intended.
The Promotion Mix

Although the money organizations spend promoting their offerings may go to different media channels, a company still wants to send its customers and potential consumers a consistent message. The different types of marketing communications an organization uses compose its promotion or communication mix, which consists of advertising, sales promotions, direct marketing, public relations and publicity, sponsorships (events and experiences), social media and interactive marketing, and professional selling. The importance of integrated marketing communications (IMC) will be demonstrated throughout the discussion of traditional media as well as newer, more targeted, and often interactive online media.

Advertising involves paying to disseminate a message that identifies a brand (product or service) or an organization being promoted to many people at one time. The typical media that organizations utilize for advertising of course include television, magazines, newspapers, the Internet, direct mail, and radio.
Businesses also advertise on mobile devices and social media such as Facebook, blogs, and Twitter.

Consumer sales promotions consist of short-term incentives such as coupons, contests, games, rebates, and mail-in offers that supplement the advertising and sales efforts. Sales promotions include promotions that are not part of another component of the communication mix and are often developed to get customers and potential customers to take action quickly, make larger purchases, and/or make repeat purchases.

In business-to-business marketing, sales promotions are typically called trade promotions because they are targeted to channel members who conduct business or trade with consumers. Trade promotions include trade shows and special incentives given to retailers to market particular products and services, such as extra money, in-store displays, and prizes.

Direct marketing involves the delivery of personalized and often interactive promotional materials to individual consumers via channels such as mail, catalogs, Internet, e-mail, telephone, and direct-response advertising. By targeting consumers individually, organizations hope to get consumers to take action.

Professional selling is an interactive, paid approach to marketing that involves a buyer and a seller. The interaction between the two parties can occur in person, by telephone, or via another technology. Whatever medium is used, developing a relationship with the buyer is usually something the seller desires.

When you interview for internships or full-time positions and try to convince potential employers to hire you, you are engaging in professional selling. The interview is very similar to a buyer-seller situation. Both the buyer and seller have objectives they hope to achieve. Business-to-business marketers generally utilize professional selling more often than most business-to-consumer marketers. If you have ever attended a Pampered Chef party or purchased something from an Amway or Mary Kay representative, you've been exposed to professional selling.

Public relations (PR) involves communication designed to help
improve and promote an organization’s image and products. PR is often perceived as more neutral and objective than other forms of promotion because much of the information is tailored to sound as if it has been created by an organization independent of the seller. Public relations materials include press releases, publicity, and news conferences. While other techniques such as product placement and sponsorships, especially of events and experiences, tend to generate a lot of PR, the growth of expenditures and importance of sponsorships are so critical for so many companies that it is often considered a separate component in the communication mix. Many companies have internal PR departments or hire PR firms to find and create public relations opportunities for them. As such, PR is part of a company's promotion budget and their integrated marketing communications.

Sponsorships typically refer to financial support for events, venues, or experiences and provide the opportunity to target specific groups. Sponsorships enhance a company's image and usually generate public relations. With an increasing amount of money being spent on sponsorships, they have become an important component of the promotion mix.

Sales promotions are activities that supplement a company's advertising, public relations, and professional selling efforts. They create incentives for customers to buy products more quickly and make larger purchases. Sales promotions are often temporary, but when the economy is weak, sales promotions become even more popular for consumers and are used more frequently by organizations.

Consumer Sales Promotions

Samples, coupons, premiums, contests, and rebates are examples of consumer sales promotions. Do you like free samples? Most people do. A free sample allows consumers to try a small amount of a
product so that hopefully they will purchase it. The strategy encourages trial and builds awareness. You have probably purchased a product that included a small free sample with it—for example, a small amount of conditioner packaged with your shampoo. Have you ever gone to a store that provided free samples of different food items? Although sampling is an expensive strategy, it is usually very effective for food products. People try the product, and the person providing the sample tells them about the product and mentions any special prices for it.

In many retail grocery stores, coupons are given to consumers with the samples. Coupons provide an immediate price reduction off an item. The amount of the coupon is later reimbursed to the retailer by the manufacturer. The retailer gets a handling fee for accepting coupons. When the economy is weak, more consumers cut out coupons and look for special bargains such as double coupons and buy-one-get-one-free (BOGO) coupons. They may also buy more store brands.

While many consumers cut coupons from the inserts in Sunday newspapers, other consumers find coupons online or on their cell phones. Point-of-purchase displays, including coupon machines placed next to products in stores, encourage consumers to buy a brand or product immediately. When a consumer sees a special display or can get a coupon instantly, manufacturers hope the sales promotion increases sales. Stores may also provide coupons for customers with loyalty cards to encourage them to select particular brands and products.

Mobile marketing and the Internet provide consumers in international markets access to coupons and other promotions. In India, the majority of coupons used are digital, while paper coupons have the largest share in the United States. Over 80 percent of diapers are purchased with coupons; imagine how much easier and less wasteful digital coupons scanned from a mobile phone are for both organizations and consumers.

Other sales promotions may be conducted online and include incentives such as free items, free shipping, coupons, and
sweepstakes. For example, many online merchants such as Shoe Station and Zappos offer free shipping and free return shipping to encourage consumers to shop online. Some firms have found that the response they get to their online sales promotions is better than response they get to traditional sales promotions.

Another very popular sales promotion for consumers is a premium. A premium is something you get either for free or for a small shipping and handling charge with your proof of purchase (sales receipt or part of package). Remember wanting your favorite cereal because there was a toy in the box? The toy is an example of a premium. Sometimes you might have to mail in a certain number of proofs of purchase to get a premium. The purpose of a premium is to motivate you to buy a product multiple times. What many people don’t realize is that when they pay the shipping and handling charges, they may also be paying for the premium.

Contests or sweepstakes also attract a lot of people. Contests are sales promotions people enter or participate in to have a chance to win a prize. The Publisher’s Clearing House Sweepstakes and the Monopoly Game at McDonald’s are both examples. The organization that conducts the sweepstakes or contest hopes you will not only enter its contest but buy some magazines (or more food) when you do.

Loyalty programs are sales promotions designed to get repeat business. Loyalty programs include things such as frequent flier programs, hotel programs, and shopping cards for grocery stores, drugstores, and restaurants. Sometimes point systems are used in conjunction with loyalty programs. After you accumulate so many miles or points, an organization might provide you with a special incentive such as a free flight, free hotel room, or free sandwich. Many loyalty programs, especially hotels and airlines, have partners to give consumers more ways to accumulate and use miles and points.

Rebates are popular with both consumers and the manufacturers that provide them. When you get a rebate, you are refunded part (or all) of the purchase price of a product back after completing a form.
and sending it to the manufacturer with your proof of purchase. The trick is completing the paperwork on time. Although different types of sales promotions work best for different organizations, rebates are very profitable for companies because many consumers forget or wait too long to send in their rebate forms. Consequently, they do not get any money back. Rebates sound great to consumers until they forget to send it back.

**Trade Promotions**

In business-to-business (B2B) marketing, sales promotions are typically called trade promotions because they are targeted to channel members who conduct business or “trade” with consumers. Trade promotions include trade shows, conventions, event marketing, trade allowances, training, and special incentives given to retailers to market particular products and services, such as extra money, in-store displays, and prizes.

Trade shows are one of the most common types of sales promotions in B2B markets. A trade show is an event in which firms in a particular industry display and demonstrate their offerings to other organizations they hope will buy them. There are typically many different trade shows in which one organization can participate. Using displays, brochures, and other materials, representatives at trade shows can identify potential customers (prospects), inform customers about new and existing products, and show them products and materials. Representatives can also get feedback from prospects about their company's products and materials and perhaps about competitors.

Companies also gather competitive information at trade shows because they can see the products other firms are exhibiting and how they are selling them. While approximately 75 percent of representatives attending trade shows actually buy the product(s) they see, 93 percent of attendees are influenced by what they see at
the trade shows. However, only 20 percent of organizations follow up on leads obtained at trade shows and only 17 percent of buyers are called upon after they express interest in a particular company’s products. (John F. Tanner, Jr., and Dennis Pitta, “Identifying and Creating Customer Value.” Special session presentation, Summer Educators’ Conference, Chicago, 2009). Trade shows can be very successful, although the companies that participate in them need to follow-up on the leads generated at the shows. With changing technology, webinars are being used to reach businesses that may not be able to attend trade shows. Follow-up after a Webinar is also essential.

Conventions, or meetings, with groups of professionals also provide a way for sellers to show potential customers different products. For example, a medical convention might be a good opportunity to display a new type of medical device. Sales representatives and managers often attend conventions to market their products.

Sales contests, which are often held by manufacturers or vendors, provide incentives for salespeople to increase their sales. Often, the contests focus on selling higher-profit or slow-moving products. The sales representative with the most sales of the product wins a prize such as a free vacation, company recognition, or cash.

Trade allowances give channel partners—for example, a manufacturer’s wholesalers, distributors, retailers, and so forth—different incentives to push a product. One type of trade allowance is an advertising allowance (money) to advertise a seller’s products in local newspapers. An advertising allowance benefits both the manufacturer and the retailer. Typically, the retailer can get a lower rate than manufacturers on advertising in local outlets, saving the manufacturer money. The retailer benefits by getting an allowance from the manufacturer.

Another sales promotion that manufacturers, such as those in the tool or high tech industries, offer businesses is training to help their salespeople understand how the manufacturers’ products work and how consumers can be enticed to buy them. Many manufacturers
also provide in-store product demonstrations to show a channel partner's customers how products work and answer any questions they might have. Demonstrations of new video game systems and computers are extremely popular and successful in generating sales.

Free merchandise, such as a tool, television, or other product produced by the manufacturer, can also be used to get retailers to sell products to consumers. In other words, a manufacturer of televisions might offer the manager of a retail electronics store a television to push its products. If a certain number of televisions are sold, the manager gets the television. Have you ever been to an electronics store or a furniture store and felt like the salesperson was pushing one particular television or one particular mattress? Perhaps the salesperson was getting push money, or a cash incentive from the manufacturer to push a particular item. The push to sell the item might be because there is a large amount of inventory of it, it is being replaced by a new model, or the product is not selling well. Figure 3, “Examples of Sales Promotions,” below recaps the different types of sales promotions designed for both consumers and businesses.
Push vs. Pull Strategy

Businesses must also decide whether to use a push strategy, a pull strategy, or both push and pull strategies. A push strategy involves promoting a product to businesses (middlemen), such as wholesalers and retailers, who then push the product through the channel promoting it to final consumers. Manufacturers may set up displays in retail outlets for new products or provide incentives such as price discounts to the retailer so the retailer can promote or push the product to consumers.

Companies use a pull strategy when they target final consumers with promotions. In other words, a company promotes its products and services to final consumers to pull consumers into the stores or get the consumers asking for the product. If a company sends coupons to the consumers, hopefully the consumers will take the

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**Figure 3. Examples of Sales Promotions**

<table>
<thead>
<tr>
<th>Consumer Sales Promotions</th>
<th>Business-to-Business Sales Promotions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coupons</td>
<td>Trade shows and conventions</td>
</tr>
<tr>
<td>Sweepstakes or contests</td>
<td>Sales contests</td>
</tr>
<tr>
<td>Premiums</td>
<td>Trade and advertising allowances</td>
</tr>
<tr>
<td>Rebates</td>
<td>Product demonstrations</td>
</tr>
<tr>
<td>Samples</td>
<td>Training</td>
</tr>
<tr>
<td>Loyalty programs</td>
<td>Free merchandise</td>
</tr>
<tr>
<td>Point-of-purchase displays</td>
<td>Push money</td>
</tr>
</tbody>
</table>

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1194 | Reading: The Promotion Mix: The Fourth P
coupons (sales promotion) to the store and buy the product. A manufacturer promotes its new product on television to consumers and places coupons in the newspaper inserts, hoping consumers will demand the product. Their pull causes wholesalers and retailers to buy the product to try to meet the demand.

Many manufacturers use both a push strategy and a pull strategy, promoting their products and services to both final consumers and their trade partners (e.g., retailers and wholesalers). Figure 4, “A Push vs. a Pull Strategy,” below shows how a push strategy differs from a pull strategy.

Figure 4. A Push vs. a Pull Strategy

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count.
toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=265
235. Outcome: Social Media Marketing

What you’ll learn to do: describe social media marketing, its advantages and disadvantages

Social media has changed the way that businesses sell, promote, and deliver their goods and services in ways that no one could have predicted ten years ago. Regardless of your level of involvement with social media, companies are using information gathered from these sources to target advertising, design promotions, and even create new products in almost real time. Social media is not the answer to all marketing woes, and although it brings great benefit to both the consumer and the company, there is an upside and downside to this communication approach that businesses need to realize. In this section you’ll learn more about the social media marketing revolution and then have a look at what social media reveals to marketers about you!

LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Introduction to Social Media Marketing
- Video: How Social Media Reveals the Hidden You
- Self Check: Social Media Marketing

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Introduction to Social Media Marketing

The internet has completely transformed the role of media in everyday life.

In the past, dominant media channels were television, radio, magazines and newspapers. All were well-suited to broadcasting out one-way communications from a central source. Media outlets distributed information and messages. People received information and messages.

Today, the internet and mobile technologies have made it simple for virtually anyone to not only receive but also publish and distribute information (also known as “content”). Access is simple and typically free. Social media channels have evolved to capitalize on this new, interactive relationship with information. The realm of social media is about collaborating, generating content, sharing, and most of all, connecting.

Social media use technology and mobility to provide an interactive means of communication among people, organizations, and communities who are interconnected and interdependent. Many channels and vehicles are available for social media just as there are many different television shows and magazines. With changing technology, new social media tools are continually available. The parade of popular and influential sites includes Facebook, Twitter, Instagram, LinkedIn, Pinterest, Flickr, Google+ and Vine, among many others.
Media Designed for Sharing

What’s different about social media? Most simply put, social media are media (including written, visual, audio, multimedia, and everything in between) that are designed to be shared. Sharing typically means that it is easy to create, publish, interact with, send and comment on these media creations, and there are no high costs associated with viewing the media. Because of the connected nature of the internet, it means that sharing, commenting, and viewing can all be tracked and measured.

Figure 1. The Differences between Traditional and Social Media

<table>
<thead>
<tr>
<th>Traditional Media</th>
<th>Social Media</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed, unchangable</td>
<td>Instantly updatable</td>
</tr>
<tr>
<td>Commentary limited and not real time</td>
<td>Unlimited real-time commentary</td>
</tr>
<tr>
<td>Limited, time-delayed bestseller list</td>
<td>Instant popularity gauge</td>
</tr>
<tr>
<td>Archive poorly accessible</td>
<td>Archives accessible</td>
</tr>
<tr>
<td>Limited media mix</td>
<td>All media can be mixed</td>
</tr>
<tr>
<td>Committee publishers</td>
<td>Individual publishers</td>
</tr>
<tr>
<td>Finite</td>
<td>Infinite</td>
</tr>
<tr>
<td>Sharing not encouraged</td>
<td>Sharing and participation encouraged</td>
</tr>
<tr>
<td>Control</td>
<td>Freedom</td>
</tr>
</tbody>
</table>

With more than half of all Americans participating in social networks, people and organizations who don't participate may be at a disadvantage with some groups in society. Not only does the majority of the population in the United States have a profile on a social network, but at least one-third of those people access the sites multiple times a day. Social media are popular for keeping in touch with friends,. Not surprisingly, companies tap into these same networks to promote their brands and as a tool for recruiting
and hiring. People follow companies and brands on social media, especially on Facebook, whereas LinkedIn generates millions of job referrals. Just as companies are allocating more of their promotion budget to social media, they are also increasing their expenditures on social recruiting.

**Social Media Zones**

Social media are complex and rapidly changing. While there is some overlap between uses of social media for personal and business purposes, one way to improve the understanding of social media is to think about social media zones. Social media zones include social communities, social publishing, social entertainment, and social commerce. Think about the different ways you use social media and which zones you utilize. You probably use all of the zones.

Social communities are channels that focus on activities and relationships and include social networking sites (online hosts such as Facebook and LinkedIn), forums, wikis, and message boards, channels where you may already participate. Think about your profile. Whatever you type becomes a digital version of you. In social communities, you communicate and socialize with others. While you may share information with others, you must be careful how much and which information you choose to post.

Social publishing helps distribute information to different audiences and includes channels such as blogs (web log sites with content that is updated regularly) and media sharing sites with searchable content featuring videos (YouTube), photos (Flickr), and music and podcasts (iTunes). Think about videos you may have posted. When companies pay to have product reviews posted or to promote contests or their brands, they may use social publishers to write blogs and generate word of mouth buzz. Many companies post their own commercials and other content on YouTube.

Opportunities for games and entertainment are part of the social
entertainment zone. Social games like FarmVille, entertainment networks, action games, puzzle games, and reality games have increased revenues in the social gaming industry. Social gaming appears to be growing in popularity.

Social commerce is e-commerce territory where people buy and sell products on the Internet. Social commerce provides a means for interactive shopping, including reviews, ratings, and social shopping websites where you can chat with merchant personnel or with friends while you are shopping. Think about the questions you may ask a customer service person in a chat room versus what you may ask at a store in a mall.

Using Social Media for Marketing

As more and more people around the planet become more and more connected through social media, the influence of these channels continues to grow. In response, organizations are allocating more of their promotion budgets to social media. This makes sense when social media strategies align with broader marketing strategy in support of corporate objectives.

What are the advantages of social media in marketing? When used effectively, they can generating a lot of buzz without a lot of expense. There are still costs associated with content creation, but the proliferation of online content creators and hungry media outlets means that on social media, content tends to be cheap.

The 24×7 cycle of global social media requires eyes, brains and analytical tools to stay on top of everything happening, but never before has it been so easy to tap into, listen and learn from individuals and communities interacting with your product or brand. It is undoubtedly exciting for your brand to become a trending topic among these networks, but it is important to remember social media attention can easily veer into positive or negative territory. Absolute control of the message is virtually
impossible with social media. Managing consumer perceptions in a fickle 24×7 media cycle requires attention and perseverance.

Because many people share immense amounts of information about themselves through social media, increasingly marketers can use this information to deliver highly targeted messages and offers. Navigational click-stream data from social media and other websites is another source of valuable information about consumer behavior, what makes them tick, and how they do or don’t choose to engage with your brand. At the same time, firms must be prepared to address increasingly complex challenges associated with cybersecurity and data privacy.

Reflection Questions

• How do you use social media for personal purposes, and how do you use it for business and professional purposes?
• How would social media allow you to target particular types of consumers for marketing or recruiting purposes?
In 2012, U.S. companies spent $170 billion on direct marketing campaigns, yet the response rate was only around 2 percent. To address this meager return, computer experts are using new approaches to profile individual users and do more efficient marketing online—especially through social media. The following video discusses these developments in greater detail.

A YouTube element has been excluded from this version of the text. You can view it online here:
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

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https://library.achievingthedream.org/
baycollegeintrobusiness/?p=268
Summary

This module covered the marketing function and its role in contributing to the success of a business. Below is a summary of the topics covered in this module.

What Is Marketing?

We define marketing as a set activities that a business undertakes in order to create an exchange between businesses and customers. In short, they are activities that create value in order to persuade customers to exchange their money for the product, good, or service.

The Four Ps of Marketing

The marketing mix contains four components, which are referred to as the four Ps: product, price, place, and promotion.

External Marketing Environment

When businesses send a product, good, or service out into the
market they have controlled what they send, how they send it, what they charge, and how they will promote it to consumers. What they cannot control is the market environment. Factors such as the state of the economy, changing technologies, cultural and social norms, the legal and regulatory environment, and competition make up the external marketing environment.

Market Research

The ultimate goal of market research is for companies to understand who their customers are and what they want. Using a six-step approach, the company can create a report that enables it to make informed decisions about products, goods, and services.

The Marketing Plan

Once a company has determined its objectives and the strategies needed to achieve those objectives, it crafts a marketing plan to execute against those strategies.

Branding

Branding is the most recognizable part of the marketing mix. A brand can be a mix of words, colors, symbols, or any other feature that distinguishes one product from another. Brands create value for the company, and if the brand is successful it will create brand loyalty among consumers.
Pricing

There are many strategies that companies can use to price their products. Penetration, skimming, odd pricing, everyday low prices, high/low, and cost-plus are just some of the strategies companies can adopt to achieve their financial goals.

Distribution

How companies get their products into the hands of consumers represents the “place” component of the four Ps. Companies can choose a direct, indirect, or specialty approach to product distribution.

Promotion

The promotion of a product can be a complex and broad set of activities that range from loyalty programs, coupons, celebrity endorsement, event sponsorship, sales, and discounts. How a product, good, or service is promoted to consumers is driven by the target market and the characteristics of potential buyers.

Social Media Marketing

The Internet and advances in mobile technologies have resulted in an explosion of social media such as Twitter, Facebook, and LinkedIn. Today companies are using social media as an integral part of their marketing activities and as a way of capturing real-time information about consumer behavior.
Synthesis

On February 1, 2015, a notable event occurred in the history of television: 114.5 million Americans watched a football game on TV, making it the most watched television program in U.S. history. Are there really 114.5 million football fans in the United States? Probably not. Why did so many people watch? Answer: the commercials!

Advertisers paid $4.5 million for 30 seconds of commercial airtime during this event. That works out to $150,000 per second. What were those companies doing when they made the decision to spend so much money? Marketing!

This is of course an extreme example of marketing in action, but if you begin to look closely at the world around you, you'll find that companies’ marketing efforts are everywhere. Why do you shop where you shop? Are you a Coke or a Pepsi drinker? Do you only purchase items when they are on sale? Is your keychain (real or virtual) full of customer-loyalty cards? Marketing efforts are at work practically every time a customer perceives the value of a product or service and decides to swap some hard-earned money for it. Such marketing triumphs are just not the happy result of arbitrary circumstances, though—they're the product of strategic planning and research. Understanding how marketing efforts are created and conducted can help you be a better-informed consumer of products, goods, services, and information.
PART XIV

MODULE 13: INFORMATION TECHNOLOGY AND BUSINESS
Why It Matters: Information Technology and Business

Why recognize the roles of data and information technology in supporting business operations?

In this module you will learn to distinguish between data and information technology and explore their use in business. Before we begin, it’s important to put the “information age” in perspective—to understand how far technology has come in a very short time and how rapidly it continues to change. The following video provides a good introduction and might help you think about the impact of technology in your own (rapidly changing) life.
Learning Outcomes

- Define and distinguish between “data” and “information”
- Describe the ways in which organizations warehouse and mine data
- Describe the ways in which businesses can share information via networks, including cloud computing
- Identify the ethical and social issues associated with network security, privacy, and data collection that businesses must address
- Describe the risks and challenges associated with information security and cybersecurity that businesses face
240. Outcome: Data vs. Information

What you’ll learn to do: define and distinguish between “data” and “information”

A Winning Hand for Caesars

If you enjoy gambling and want to be pampered, the Las Vegas Strip is the place for you. In November 2010, Harrah’s Entertainment, Inc. changed its name to Caesars Entertainment Corporation. The Harrah’s name will still be one of the newly named company’s primary brands, in addition to Caesars and Horseshoe. The four-mile stretch is home to some of the world’s most lavish hotels and casinos, each competing for its share of the thirty-seven million visitors who pack the city each year.¹ The strip offers a smorgasbord of attractions. At the luxurious Mirage, you can witness the eruption of a seventy-foot volcano every quarter hour. The five-star Bellagio resort boasts a $300 million art collection (including Picassos and Van Goghs). There are star-studded shows, upscale retailers, and posh restaurants with award-winning chefs. You can relax at pools and spas or try your luck in the casinos.

So how does a gaming and entertainment company compete in this environment? If you've ever been to Las Vegas, you know that a lot of them erect mammoth, neon-bathed, brick-and-mortar casino-resorts. A few, however, do what Caesars did in the late 1990s: they invest heavily in technology and compete through the effective use of information. What kind of information? Marketers at Caesars collect information about the casino's customers and then use it to entice the same people to return.²

Throughout this module, we'll refer back to the information needs of Caesars's top executives, managers, and other employees. We'll examine the ways in which companies use technology to collect data and generate information that can be used at every level of the organization.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Data vs. Information
• Self Check: Data vs. Information

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
By the time the company took the plunge and committed $100 million to marketing-related information technology (IT), Caesars had been collecting and storing data about customers for almost a decade. “While the company thought it important to collect customer information,” recalls a senior marketing executive, “the problem was we had millions of customers to collect information on, but we had no systematic way of turning it into a marketing decision. We didn’t know what to do with it.” In other words, Caesars was collecting a lot of data but not necessarily any information. So what’s the difference?

As an example, suppose that you want to know how you’re doing in a particular course. So far, you’ve taken two 20-question multiple-choice tests. On the first, you got questions 8, 11, and 14 wrong; on the second, you did worse, missing items 7, 15, 16, and
The items that you got wrong are merely data—unprocessed facts. What's important is your total score. You scored 85 on the first exam and 80 on the second. These two numbers constitute information—data that have been processed, or turned into some useful form. Knowing the questions that you missed simply supplied you with some data for calculating your scores.

Now let's fast-forward to the end of the semester. At this point, in addition to taking the two tests, you've written two papers and taken a final. You got a 90 and 95 on the papers and a 90 on the final. You now have more processed data, but you still want to organize them into more useful information. What you want to know is your average grade for the semester. To get the information you want, you need yet more data—namely, the weight assigned to each graded item. Fortunately, you've known from day one that each test counts 20 percent, each paper 10 percent, and the final exam 40 percent. A little math reveals an average grade of 87.

Though this is the information you're interested in, it may be mere data to your instructor, who may want different information: an instructor who intends to scale grades, for example, will want to know the average grade for the entire class. You're hoping that the class average is low enough to push your average of 87 up from a B+ to an A− (or maybe even an A—it doesn't hurt to hope for the best). The moral of the story is that what constitutes information at one stage can easily become data at another: or, one person's information can be another person's data.

As a rule, you want information; data are good only for generating the information. So, how do you convert data into information that's useful in helping you make decisions and solve problems? That's the question we'll explore in the next section.

Information Systems

To gather and process data into information and distribute it to
people who need it, organizations develop an information system (IS)—the combination of technologies, procedures, and people who collect and distribute the information needed to make decisions and coordinate and control company-wide activities. In most large organizations, the IS is operated by a senior management team that includes a chief information officer (CIO) who oversees information and telecommunications systems. There may also be a chief technology officer who reports to the CIO and oversees IT planning and implementation. As for information managers, their tasks include the following:

- Determining the information needs of members of the organization
- Collecting the appropriate data
- Applying technology to convert data into information
- Directing the flow of information to the right people

Differences in Information Needs

The job is complicated by the fact that information needs vary according to different levels, operational units, and functional areas. Consider, for instance, the following information needs of managers at several levels:

- **Top managers** need information for planning, setting objectives, and making major strategic decisions.
- **Middle managers** need information that helps them allocate resources and oversee the activities under their control.
- **First-line managers** require information that helps them supervise employees, oversee daily operations, and coordinate activities.

Figure 1, “Information Needs and Flows,” illustrates a hypothetical
hierarchy of information needs at Caesars. The president, for example, needs information to determine whether profitability is up or down or if the organization is facing any new competitive threats. At the vice-presidential level, executives need information that will help them in controlling and planning for specific areas of operations. The VP of casino operations, for example, might need to know which operations are most profitable—slots, table games, or other gaming activities. The VP of hotel operations might want to know whether room revenues are going up or down.

![Figure 1. Information Needs and Flows](image)

The information needs of middle-level and lower-level managers are different still. The slot-machine manager might want to know whether the placement of machines on the casino floor affects profitability. The poker manager might want to know whether all table games comply with state regulations. At a lower level, the pit manager (who’s in charge of table games in a particular area) needs to know whether there’s a card-counter at his blackjack table or whether a dealer’s activities are suspicious.
Even at a given level, information needs can vary. A manager on the hotel side of the business, for instance, doesn't care much about profitability at the poker tables, while a pit manager doesn't have much use for hotel housekeeping reports. The reports that an accountant needs would hardly be the same as those needed by a human resources manager.

The Need to Share Information

Having stressed the differences in information needs, we should pause to remind ourselves that the managerial levels, operations, and functions of every organization are intertwined, to a greater or lesser degree. If you'll glance again at Figure 1 above, you'll be reminded that organizations need to share information, that information must flow, and that it must flow in both directions, bottom-up and top-down. At Caesars, for instance, both casino and hotel managers are concerned about security, which is also of interest to managers in different functional areas. Information supplied by the security group is obviously vital to managers in the gaming areas, but HR managers also need it to screen potential employees. Marketing information is clearly important to both casino and hotel operations: to maximize overall profits, the company uses marketing data to fill hotel rooms with customers who spend big in the casinos.¹

Caesars's information needs entail more than allowing individuals in a given casino to share information; information has to be shared among all of Caesars's thirty-nine casinos. Thus, Caesars relies on

an integrated IT system that allows real-time communication among all its properties. Installing the system (in the mid-1990s) was complicated, and not everyone in the organization liked the idea. Some managers felt that information sharing threatened their independence. Others, including some in the IT group, doubted that a large number of separate IT systems could be adequately integrated. To get everyone on board, John Bushy, then senior VP of information technology, pledged that he wouldn’t cut his hair until the system was up and running. By the time it was operational in 1997, Bushy had hair down to his shoulders, but it was worth it: Caesars’s ability to share real-time information across all its properties has been a major factor in the company’s success. Caesars's new system cut costs by $20 million a year, increased brand recognition, and increased the number of customers playing at more than one Caesars property by 72 percent.²

Enterprise Systems

Many large and mid-size companies rely on a highly integrated system called an enterprise resource planning (ERP) system to channel information to multiple users. To understand what an ERP system does, forget about the P for planning (it really doesn't have much to do with planning) and the R for resource (it’s an imprecise

term). Focus on the E for enterprise. An ERP system integrates the computer needs of all activities across the enterprise into a single system that serves all users. Such broad integration isn't a simple task, and you wouldn't be the first person to wonder whether it wouldn't be easier to give each department its own computer system. Salespeople, for example, need a system that tracks sales and generates sales reports. Meanwhile, manufacturing personnel don't need to track sales but do need to track inventory. What's the problem with stand-alone computer systems? Quite simply, users in various departments can't share information or communicate with each other.

What If You Don’t Have ERP?

Imagine that you're a sales manager for a fairly large manufacturing company that produces and sells treadmills. Like every other department in the organization, you have your own computer system. A local sporting-goods store orders one hundred treadmills through a regional sales representative. It's your job to process the order. It wouldn't be much of a problem for you to go into your computer and place the order. But how would you know if the treadmills were actually in stock and when they could be delivered? How would you know if the customer's credit was any good? You could call the warehouse and ask if the treadmills are in stock. If they are, you'd tell the warehouse manager that you're placing an order and hope that the treadmills are still in stock by the time your order gets there two days later. While you're at it, you'd better ask for an expected delivery date. As a final precaution, you should probably call the finance department and ask about your customer's

credit rating. So now you've done your job, and it can hardly be your fault that because the cost of manufacturing treadmills has gone up, accounting has recommended an immediate price increase that hasn't shown up in your computer system yet.

What If You Do Have ERP?

Wouldn’t it be easier if you had an ERP system like the one illustrated below in Figure 2, “ERP System”—one that lets you access the same information as every other department? Then you could find out if there were one hundred treadmills in stock, the expected delivery date, your customer’s credit rating, and the current selling price—without spending most of the day exchanging phone calls, e-mails, text messages, and faxes. You'd be in a better position to decide whether you can give your customer credit, and you could promise delivery (at a correct price) on a specified date. Then, you'd enter the order into the system. The information that you entered would be immediately available to everyone else. The warehouse would know what needs to be shipped, to whom, and when. The accounting department would know that a sale had been made, the dollar amount, and where to send the bill. In short, everyone would have up-to-date information, and no one would have to reinput any data.
KEY TAKEAWAYS

- **Data** are unprocessed facts. **Information** is data that have been processed or turned into some useful form.
- To gather and process data into information and distribute it to people who need it, an organization develops an **information system (IS)**—the combination of technologies, procedures, and people who collect and distribute the information needed to make decisions and to coordinate and control company-wide activities.
- In most large organizations, the information system is operated by a senior management team that includes a **chief information officer (CIO)** who oversees information and telecommunications systems.
- There may also be a **chief technology officer** who reports to the CIO and oversees IT planning and implementation.
- The tasks of **information managers** include the following:
- Determining the information needs of people in the organization
- Collecting the appropriate data
- Applying technology to convert data into information
- Directing the flow of information to the right people

- The job is complicated by the fact that information needs vary according to different levels, operational units, and functional areas.
- In addition, information must be shared. To channel information to multiple users, large and mid-size companies often rely on a highly integrated system called an enterprise resource planning (ERP) system.
- An ERP system integrates the computer needs of all business activities across the enterprise into a single computer system that serves all users.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=273
242. Outcome: Managing Data

What you’ll learn to do: describe the ways that organizations warehouse and mine data

Billions and billions of bits of data flood into an organization's information system, but how does that data get utilized effectively? The challenge lies not so much with the collection or storage of the data: today, it is possible to collect and even store vast amounts of information relatively cheaply. The main difficulty is figuring out the best and most efficient way to extract and manage the relevant data. In this section you will learn how organizations not only warehouse but then mine the data they collect.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Managing Data
• Self Check: Managing Data

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Managing Data

Did you ever think about how much data you yourself generate? Just remember what you went through to start college. First, you had to fill out application forms asking you about test scores, high school grades, extracurricular activities, and finances, plus demographic data about you and your family. Once you’d picked a college, you had to supply data on your housing preferences, the curriculum you wanted to follow, and the party who’d be responsible for paying your tuition. When you registered for classes, you gave more data to the registrar’s office. When you arrived on campus, you gave out still more data to have your ID picture taken, to get your computer and phone hooked up, to open a bookstore account, and to buy an on-campus food-charge card. Once you started classes, data generation continued on a daily basis: your food card and bookstore account, for example, tracked your various purchases, and your ID tracked your coming and going all over campus. And you generated grades.

And all these data apply to just one aspect of your life. You also generated data every time you used your credit card and your cell phone. Who uses all these data? How are they collected, stored, analyzed, and distributed in organizations that have various reasons for keeping track of you?

Data and Databases

To answer such questions, let’s go back to our Caesars example. As we’ve seen, Caesars collects a vast amount of data. Its hotel system
generates data when customers make reservations, check in, buy food and beverages, purchase stuff at shops, attend entertainment events, and even relax at the spa. In the casino, customers apply for rewards programs, convert cash to chips (and occasionally chips back to cash), try their luck at the tables and slots, and get complimentary drinks. Then, there are the data generated by the activities of the company itself: employees, for instance, generate payroll and benefits data, and retail operations generate data every time they buy or sell something. Moreover, if we added up all these data, we'd have only a fraction of the amount generated by the company’s gaming operations.

How does Caesars handle all these data? First of all, it captures and stores them in several databases—electronic collections of related data that can be accessed by various members of the organization. Think of databases as filing cabinets that can hold massive amounts of organized information, such as revenues and costs from hotel activities, casino activities, and events reservations at each of Caesars facilities.

Warehousing and Mining Data

What if Caesars wants to target customers who generate a lot of revenue, by using a program designed to entice return visits? How would it identify and contact these people? Theoretically, it could search through the relevant databases—those that hold customer-contact information (such as name and address) and information about customer activity in the company’s hotels, casinos, and entertainment venues. It would be a start, perhaps, but it wouldn’t be very efficient. First of all, it would be time-consuming. Plus, what if the same data weren’t stored in a similar fashion in each database? In that case, it would be quite hard to combine the data in a meaningful way. To address this problem, Caesars managers will rely on a system like the one illustrated in Figure 1, “The Data
Mining Process,” which calls for moving all the relevant data into a data warehouse—a centralized database in which data from several databases are consolidated and organized so that they can be easily analyzed.

Figure 1. The Data Mining Process

Data Mining

With the data in one central location, management can find out everything it needs to about a particular group of customers. It can also use the data to address some pretty interesting questions. Why do people come to our casinos? How can we keep customers coming back? How can we increase the number of visits per customer? How can we increase the amount they spend on each visit? What incentives (such as free dinners, hotel rooms, or show tickets) do our customers like most? To come up with answers to these questions, they’ll perform a technique called data mining—the
process of searching and analyzing large amounts of data to reveal patterns and trends that can be used to predict future behavior.

Data Mining and Customer Behavior

By data-mining its customer-based data warehouse, Caesars’s management can discover previously unknown relationships between the general behavior of its customers and that of a certain group of customers (namely, the most profitable ones). Then, it can design incentives to appeal specifically to those people who will generate the most profit for the company.

To get a better idea of how data mining works, let’s simplify a
description of the process at Caesars. First, we need to know how
the casino gathered the data to conduct its preliminary analysis.
Most customers who play the slots use a Caesars player’s card that
offers incentives based on the amount of money that they wager
on slot machines, video poker, and table games. To get the card, a
customer must supply some personal information, such as name,
address, and phone number. From Caesars’s standpoint, the card
is extremely valuable because it can reveal a lot about the user’s
betting behavior: actual wins and losses, length of time played,
preferred machines and coin denominations, average amount per
bet, and—most important—the speed with which coins are
deposited and buttons pushed. Caesars’s primary data source was
internal—generated by the company itself rather than provided by
an outside source—and drew on a marketing database developed for
customer relationship management (CRM).

What does the casino do with the data that it’s mined? Caesars
was most interested in “first trippers”—first-time casino customers.
In particular, it wanted to know which of these customers should be
enticed to return. By analyzing the data collected from player's-card
applications and from customer's actual play at the casino (even if
for no more than an hour), Caesars could develop a profile of a
profitable customer. Now, when a first-timer comes into any of its
casinos and plays for a while, Caesars can instantly tell whether
he or she fits the profitable-customer profile. To lure these people
back for return visits, it makes generous offers of free or reduced-
rate rooms, meals, entertainment, or free chips (the incentive of
choice for Caesars’s preferred customers). These customers make
up 26 percent of all Caesars's customers and generate 82 percent
of its revenues. Surprisingly, they're not the wealthy high rollers to
whom Caesars had been catering for years. Most of them are regular
working people or retirees with available time and income and a
fondness for slots. They generally stop at the casino on the way
home from work or on a weekend night and don't stay overnight.
They enjoy the thrill of gambling, and you can recognize them
because they're the ones who can't push the button or pump tokens in fast enough.

KEY TAKEAWAYS

- Organizations capture and store data in **databases**—electronic collections of related data that can be accessed by various people in the organization.
- To facilitate data analysis, IS managers may move data from various databases into a **data warehouse**—a centralized database in which data are consolidated and organized for efficient analysis.
- To come up with answers to a huge range of questions, managers perform a technique called **data mining**—the process of searching and analyzing large amounts of data to reveal patterns and trends that can be used to predict future behavior.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
244. Outcome: Information in Networks

What you’ll learn to do: describe the ways in which businesses can share information via networks, including cloud computing

If a tree falls in the forest and no one is present to hear it fall, does it make a sound? Likewise, if data is collected by an organization and no one knows it exists, is it really there? Well, of course the data is there, but how much is it worth if it can’t be shared? What if marketing collects data about consumer behavior, but there is no way to share that data with the research and development department that controls new product development? In this section you will learn how organizations share data using networks and cloud computing.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Computer Networks and Cloud Computing
- Self Check: Information in Networks

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Once it's grown beyond just a handful of employees, an organization needs a way of sharing information. Imagine a flower shop with twenty employees. The person who takes phone orders needs access to the store’s customer list, as do the delivery person and the bookkeeper. Now, the store may have one computer and everyone could share it. It's more likely, however, that there are a number of computers (several for salespeople, one for delivery, and one for bookkeeping). In this case, everyone needs to be sure that customer records have been updated on all computers every time that a change is required.

Networks

Likewise, many companies want their personal computers to run their own software and process data independently. But they also want people to share databases, files, and printers, and they want them to share applications software that performs particular tasks, including word processing, creating and managing spreadsheets, designing graphical presentations, and producing high-quality printed documents (desktop publishing).

The solution in both cases is networking—linking computers to
one another. The two major types of networks are distinguished according to geographical coverage:

- A local area network (LAN) links computers that are in close proximity—in the same building or office complex. They can be connected by cables or by wireless technology. Your university might have a LAN system that gives you access to resources, such as registration information, software packages, and printers. Figure 1, “Local Area Network (LAN),” below, illustrates a LAN that’s connected to another network by means of a gateway—a processor that allows dissimilar networks to communicate with one another.

![Figure 1. Local Area Network (LAN)](image)

- Because a wide area network (WAN) covers a relatively large geographical area, its computers are connected by telephone lines, wireless technology, or even satellite.

Like the one above in Figure 1, “Local Area Network (LAN),” some
networks are client-server systems, which include a number of client machines (the ones used by employees for data input and retrieval) and a server (which stores the database and the programs used to process the data). Such a setup saves time and money and circulates more-accurate information.

Cloud Computing

What is cloud computing? Watch the following video, which describes some of the uses and benefits of cloud computing.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=277

A cloud is a “visible mass of condensed water vapor floating in
the atmosphere, typically high above the ground.” The term “cloud computing” means performing computer tasks using services provided over the Internet. So how do you connect the two definitions? When IT professionals diagrammed computer systems, they used a cloud symbol to represent the Internet. So when you hear or read that an individual or company is using the “cloud” or technology firms, such as IBM, Hewlett-Packard, and Salesforce.com, are offering cloud services, just substitute the word “Internet” for “cloud” and things will make sense.

You might be surprised to learn that you’re already using the cloud—that is if you use Facebook (which is very likely—in fact, just mentioning Facebook here might prompt you to stop studying and check out your friends’ pages). How do you know that Facebook is a cloud application? Remember the trick: just substitute the word “Internet” for “cloud.” The Facebook computer application lets you store information about yourself and share it with others using the Internet.

**Business Applications**

Think about the functional areas of business you’ve explored in this text: accounting, finance, human resources, management, marketing, operations, and product design. Now imagine you’re Katrina Lane, senior vice president and chief technology officer for Caesars Entertainment, who is responsible for the information technology needed to handle multiple tasks in all these functional areas. You’re sitting at your desk when Gary Loveman, chief executive officer of Caesars, walks in and gives you the news. Caesars just purchased the Planet Hollywood Casino and Resort in Las Vegas and will open up two new casinos in Ohio in 2012. This is good news for the company, but it means a lot of work for you and your staff.

You wonder whether this might be the time to outsource some
of your computing tasks to a technology firm specializing in cloud computing. You remember an example that really makes sense. Right now, whenever Microsoft comes out with a new version of Word, Caesars has to pay $350 per PC for the latest version. Wouldn't it make more sense to rent the use of the Microsoft Word program from a cloud vendor for say $5 a month (or $60 a year)? Given that the average time between new releases of Word is two years, your total cost per PC would be $120 ($60 × 2)—a savings of about $230 per PC ($350 − $120). Your employees wouldn't mind; instead of working offline, they would just login to the Internet and work with their online version using the files that were saved for them. And the members of your IT staff would be pleased that they wouldn't need to install the new version of Word on all your PCs.

The As-A-Service Group

Companies can contract for various cloud computing services. The Microsoft Word example discussed previously is classified as software as a service (SaaS). This type of service gives companies access to a large assortment of software packages without having to invest in hardware or install and maintain software on its own computers. The available software, which includes e-mail and collaboration systems and customer relationship management programs, can be customized and used by an individual client or shared among several clients. A second type of service is called infrastructure as a service (IaaS). Instead of providing users with software, a technology firm offering infrastructure as a service provides hardware, including servers, central processing units, network equipment, and disk space. The most successful IaaS provider is Amazon Web Services. The company rents computer power and storage to users who access their data via the Internet. The last as-a-service model is called platform as a service (PaaS). Those offering platform as a service provide services that enable
users to develop customized web applications. Because they don’t have to start from scratch but rather build on existing platforms made available by the service provider, the web applications can be developed quickly.

Advantages and Disadvantages of Cloud Computing

In making your final decision (as the pretend chief technology officer for Caesars) you should consider these advantages and disadvantages of cloud computing:

Advantages

Shifting some of Caesars’s IT functions to the cloud would produce a number of advantages:

1. **Cost Savings**—By “renting” software rather than buying it, Caesars can reduce its costs. The monthly fee to “use” the software is generally less than the combined cost of buying, installing, and maintaining the software internally. On the hardware site, housing Caesars’s data in a service provider’s facilities, rather than in-house, reduces the large outlay of cash needed to build and maintain data centers.
2. **Speed of Delivery**—Purchasing and installing software and data processing equipment can be time consuming. A cloud computing service provider could get Caesars’s applications up and running in only a few weeks.
3. **Scalable**—Caesars is constantly expanding both in the number of casinos it owns and geographically. In this ever-changing environment, it’s difficult to gauge the level of our technology
needs. If we overestimate our requirements, we end up paying for technology we don't need. If we underestimate, efficiency goes down, and the experience for our customers diminishes. By using cloud computing we are able to have exactly what we need at our disposal at any point in time.

4. **Employees Can Be Mobile**—The use of cloud computing will free workers from their desks and allow them to work wherever they are. As applications move to the cloud, all that is needed for our employees to connect to their “offices” is the Internet. This mobility benefit also makes it easier for employees to collaborate on projects and connect with others in the company.

5. **Information Technology Staff**—Although our current staff is extremely qualified and dedicated, finding experienced and knowledgeable staff is a continuing problem particularly in the casino industry which suffers from historically high turnover. By using cloud computing, we reduce our human resource needs by shifting some of our work to outside vendors who are able to hire and keep well qualified individuals (in part because IT professionals enjoy working for technology companies).

**Disadvantages**

Although the advantages of moving to a cloud environment outnumber the disadvantages, the following disadvantages are cause for concern:

1. **Disruption in Internet Service**—If Caesars moves some of its applications to the cloud, its employees can work on these applications on any device and in any location as long as they have an Internet connection. But what if the Internet is unavailable because of a disruption? Depending on the length of the disruption, this could create serious problems for
Caesars.

2. **Security**—Many companies are reluctant to trust cloud service providers with their data because they're afraid it might become available to unauthorized individuals or criminals. This is a particular problem for Caesars, which collects and stores sensitive client information and has to constantly be on the lookout for fraudulent activity of staff and customers.

3. **Service Provider System Crash**—Organizations considering moving to the cloud are justifiably concerned about the possibility of a computer service crash at their service providers’ facilities. It looks like this concern was warranted. In April of 2011, Amazon Web Service (a leading cloud services provider) experienced an outage in one of its large web-connected data centers. The outage crashed its system and brought down the Web sites of a number of companies, including the location-based social network, Foursquare. It took more than thirty-six hours to get all seventy or so of the crashed sites up and running.

**Go or No Go?**

So, pretend chief technology officer for Caesars, what's your decision: will you get on the cloud or stay on the ground? If you are curious about what the real chief technology officer did, she took the high road and transferred a number of applications to Salesforce.com's Web-based Force.com's cloud applications service.

**KEY TAKEAWAYS**

- Once an organization has grown to more than a few employees, it needs to network individual computers to allow
them to share information and technologies.

- A **client-server system** links a number of client machines (for data input and retrieval) with a server (for storing the database and the programs that process data).
- Many companies want personal computers to run their own software and process data independently.
- But they also want individuals to share databases, files, printers, and **applications software** that perform particular types of work (word processing, creating and managing spreadsheets, and so forth).
- There are two systems that can satisfy both needs.

1. A **local area network (LAN)** links computers in close proximity, connecting them by cables or by wireless technology.
2. A **wide area network (WAN)** covers a relatively large geographical area and connects computers by telephone lines, wireless technology, or satellite.

- The term “**cloud computing**” means performing computer tasks using services provided over the Internet.
- The **software as a service (SaaS)** category of cloud computing gives companies access to a large assortment of software packages without having to invest in hardware or install and maintain software on its own computers.
- A technology firm offering **infrastructure as a service** provides users with hardware, including servers, central processing units, network equipment, and disk space.
- Those offering the **platform as a service** category of cloud computing provide services that enable users to develop customized web applications.
- Shifting IT functions to the cloud produces a number of advantages, including cost savings, speedy delivery of software, scalability (you pay for only what you need), employee mobility, and a reduction in information technology staff.
The following disadvantages of cloud computing are cause for concern: disruption in internet service, security issues, and unreliability of service provider systems.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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246. Outcome: Ethical and Social Issues

What you’ll learn to do: identify the ethical and social issues associated with network security, privacy, and data collection that businesses must address

As you’ll recall, the industrial revolution of the nineteenth century gave rise to a number of unforeseen ethical and social issues—for instance, concerns about workplace safety, wages, discrimination, and child labor—which led to real changes in worker protections, labor practices, and law. Similarly, the technology revolution of the twentieth century—starting with the widespread use of the Internet and home computers—has spawned a new set of ethical and social concerns that people a hundred years ago couldn't have imagined: for example, how should personal information and online privacy be protected? Who gets to own the information about our habits and “likes”? Before the advent of the Internet, people thought about and controlled their personal information in very different ways. Today, many of us lead complex online lives, and we may not even realize how our personal information is being collected and used. Companies like Caesars can collect data on the purchasing patterns, personal preferences, and professional/social affiliations of their customers without their even knowing about it. In this section we’ll explore some of the ethical and social issues related to network security, privacy, and data collection that businesses must address.
LEARNING ACTIVITIES

The learning activities for this section include:

- Reading: Ethical and Social Issues
- Self Check: Ethical and Social Issues

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Technoethics

Ethical and social issues arising from the use of technology in all areas of our lives— and in business, in particular— have led to the creation of a new branch of ethics: technoethics.

Technoethics (TE) is an interdisciplinary research area concerned with all moral and ethical aspects of technology in society. It draws on theories and methods from multiple knowledge domains (such as communications, social sciences information studies, technology studies, applied ethics, and philosophy) to provide insights on ethical dimensions of technological systems and practices for advancing a technological society.¹

Technoethics views technology and ethics as socially embedded enterprises and focuses on discovering the ethical use of technology, protecting against the misuse of technology, and devising common principles to guide new advances in technological development and application to benefit society. Typically, scholars in technoethics have a tendency to conceptualize technology and ethics as interconnected and embedded in life and society. Technoethics denotes a broad range of ethical issues revolving around technology—from specific areas of focus affecting professionals working with technology to broader social, ethical,

and legal issues concerning the role of technology in society and everyday life.²

Recent advances in technology and their ability to transmit vast amounts of information in a short amount of time has changed the way information is being shared amongst co-workers and managers throughout organizations across the globe. Starting in the 1980s with information and communications technologies (ICTs), organizations have seen an increase in the amount of technology that they rely on to communicate within and outside of the workplace. However, these implementations of technology in the workplace create various ethical concerns and in turn a need for further analysis of technology in organizations. As a result of this growing trend, a subsection of technoethics known as organizational technoethics has emerged to address these issues.

Technoethical perspectives are constantly changing as technology advances into areas unseen by creators and users engage with technology in new ways.

Technology, Business, and Your Data

Technology makes businesses more efficient, makes tasks faster and easier to complete, and ultimately creates value from raw data. However, as much as technology impacts the way that companies do business, it also raises important new issues about the employer-employee relationship. If you send personal emails from your office computer, do you have the right to expect that they’re private? Does your employer have a legal and ethical right to “cyber-peek” at what you are doing with company assets? Twenty years ago this was not an issue; today it’s a case before the Supreme Court.

Social Media

Employers want to use technology to help them screen applicants and verify information about their workforce, which is understandable. In the module on Human Resource Management you learned about the cost of recruiting, hiring, and training employees. However, what if the company believes that one of the quickest ways to gather information about an employee is to access their social media accounts? A company would never ask for your login credentials for Facebook, Twitter, InstaGram, LinkdIn . . . or would they? And if they did, is it legally and ethically justified? What
would you do if you found yourself in the situation presented in the following video?

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Information As a Business

The fact is that technology has put our information at the fingertips of businesses—there for the taking and, in some cases, the selling. Is it ethical for a business to collect data about a person and then sell that information to another business? Many organizations collect data for their own purposes, but they also realize that your data has value to others. As a result, selling data has become an income stream for many organizations. If you didn’t realize that your data
was collected by Company A, it’s even less likely you knew that it was sold to Company B.

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We have discussed just a few of the emerging ethical issues surrounding business, technology, and personal data. We have yet to touch on security issues and the responsibility business has to protect your data once it has been collected.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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Now that we have acknowledged the amount of data that businesses collect about people, what are the risks and challenges associated with keeping that information secure? Businesses stand to lose consumer confidence and respect if they allow unauthorized access to customer data. For this reason, businesses take information security and cybersecurity seriously. Despite the importance of protecting customer data, breaches and hacks seem to be more and more common. Is this a result of inadequate security measures on the part of the businesses, or are hackers getting better at accessing so-called “secure networks”? The answer is probably both. In this section you’ll learn about some of the ongoing security issues...
businesses face in trying to safeguard their (and their customers’) electronic communications and data.

LEARNING ACTIVITIES

The learning activities for this section include:

• Reading: Security Issues in Electronic Communication
• Self Check: Information Security and Cybersecurity

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
E-commerce has presented businesses with opportunities undreamt of only a couple of decades ago. But it also has introduced some unprecedented challenges.

For one thing, companies must now earmark more than 5 percent of their budgets for security measures. This includes not only protecting their own systems from external threats, but also ensuring that their customers’ data is secure. This can be a significant expense, especially for small businesses with limited resources.

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their annual IT budgets for protecting themselves against disrupted operations and theft due to computer crime and sabotage. The costs resulting from cyber crimes—criminal activity done using computers or the Internet—are substantial and increasing at an alarming rate. A 2010 study of forty-five large U.S. companies revealed that the median cost of cybercrime for the companies in the study was $3.8 million a year. And some cybercrimes involve viruses that can spread rapidly from computer to computer creating enormous damage. It’s estimated, for example, that damage to 50,000 personal computers and corporate networks from the so-called Blaster worm in August 2003 totaled $2 billion, including $1.2 billion paid by Microsoft to correct the problem. The battle against technology crime is near the top of the FBI’s list of priorities, behind only the war against terrorism and espionage. In addition to protecting their own operations from computer crime, companies engaged in e-commerce must clear another hurdle: they must convince consumers that it’s safe to buy things over the Internet—that credit-card numbers, passwords, and other personal information are protected from theft or misuse. In this section, we’ll explore some of these challenges and describe a number of the efforts being made to meet them.

Data Security

In some ways, life was simpler for businesspeople before computers. Records were produced by hand and stored on paper. As long as you were careful to limit access to your records (and remembered to keep especially valuable documents in a safe), you faced little risk of someone altering or destroying your records. In some ways, storing and transmitting data electronically is a little riskier. Let’s look at two data-security risks associated with electronic communication: malicious programs and spoofing.
Malicious Programs

Some people get a kick out of wreaking havoc with computer systems by spreading a variety of destructive programs. Once they're discovered, they can be combated with antivirus programs that are installed on most computers and that can be updated daily. In the meantime, unfortunately, they can do a lot of damage, bringing down computers or entire networks by corrupting operating systems or databases.

Viruses, Worms, and Trojan Horses

The cyber vandal's repertory includes "viruses," "worms," and "Trojan horses." Viruses and worms are particularly dangerous because they can copy themselves over and over again, eventually using up all available memory and closing down the system. Trojan horses are viruses that enter your computer by posing as some type of application. Some sneak in by pretending to be virus-scanning programs designed to rid your computer of viruses. Once inside, they do just the opposite.

Spoofing

It's also possible for unauthorized parties to gain access to restricted company Web sites—usually for the purpose of doing something illegal. Using a technique called "spoofing," culprits disguise their identities by modifying the address of the computer from which the scheme has been launched. Typically, the point is to make it look as if an incoming message has originated from an authorized source. Then, once the site's been accessed, the perpetrator can commit fraud, spy, or destroy data. You could, for
example, spoof a manufacturing firm with a false sales order that seems to have come from a legitimate customer. If the spoof goes undetected, the manufacturer will incur the costs of producing and delivering products that were never ordered (and will certainly never be paid for).

Every day, technically savvy thieves (and dishonest employees) steal large sums of money from companies by means of spoofing or some other computer scheme. It's difficult to estimate the dollar amount because many companies don't even know how much they've lost.

Revenue Theft

In addition to the problems of data security faced by every company that stores and transmits information electronically, companies that sell goods or provide services online are also vulnerable to activities that threaten their revenue sources. Two of the most important forms of computer crime are denial of service and piracy.

Denial of Service

A denial-of-service attack does exactly what the term suggests: it prevents a Web server from servicing authorized users. Consider the following scenario. Dozens of computers are whirring away at an online bookmaker in the offshore gambling haven of Costa Rica. Suddenly a mass of blank incoming messages floods the company's computers, slowing operations to a trickle. No legitimate customers can get through to place their bets. A few hours later, the owner gets an e-mail that reads, “If you want your computers to stay up and running through the football season, wire $40,000 to each of 10 numbered bank accounts in Eastern Europe.”
You're probably thinking that our choice of online gambling as an example of this scheme is a little odd, but we chose it because it's real: many companies in the online-gambling industry suffer hundreds of such attacks each year. Because most gambling operations opt to pay the ransom and get back to business as usual, denial of service to businesses in the industry has become a very lucrative enterprise.

Online gambling operations are good targets because they're illegal in the United States, where they can't get any help from law-enforcement authorities. But extortionists have been known to hit other targets, including Microsoft and the Recording Industry Association of America. The problem could become much more serious if they start going after e-commerce companies and others that depend on incoming orders to stay afloat.

Piracy

Technology makes it easier to create and sell intellectual property, but it also makes it easier to steal it. Because digital products can be downloaded and copied almost instantly over the Internet, it's a simple task to make perfect replicas of your favorite copyright-protected songs, movies, TV shows, and computer software, whether for personal use or further distribution. When you steal such materials, you're cheating the countless musicians, technicians, actors, programmers, and others involved in creating and selling them. Theft cuts into sales and shrinks corporate profits, often by staggering amounts. Entertainment-industry analysts estimate that $30 billion worth of songs were illegally downloaded in the five year period ending in 2009. The software industry estimates that the global market for pirated software reached $59 billion in 2010.

So, what's being done to protect the victimized companies? Actually, quite a lot, even though it's a daunting task, both in the
United States and abroad. In 1998, Congress passed the Digital Millennium Copyright Act, which outlaws the copying of copyright-protected music (unless you're copying legally acquired music for your own use). The penalties are fairly stiff: up to three years in prison and $250,000 in fines. To show that it means business, the music industry is also hauling offenders into court, but legal action is costly and prosecuting teenage music lovers doesn't accomplish much. Some observers believe that the best solution is for the industry to accelerate its own efforts to offer its products online. Initial attempts seem to be working: people who are willing to obey copyright laws have downloaded more than ten billion songs from the iTunes site alone.

Firewalls

Builders install firewalls (or fireproof walls) in structures to keep a fire that starts in one part of a building from entering another part. Companies do something similar to protect their computer systems from outside intruders: they install virtual firewalls—software and hardware systems that prevent unauthorized users from accessing their computer networks.

You can think of the firewall as a gatekeeper that stands at the entry point of the company's network and monitors incoming and outgoing traffic. The firewall system inspects and screens all incoming messages to prevent unwanted intruders from entering the system and causing damage. It also regulates outgoing traffic to prevent employees from inappropriately sending out confidential data that shouldn't leave the organization.
Risks to Customers

Many people still regard the Internet as an unsafe place to do business. They worry about the security of credit-card information and passwords and the confidentiality of personal data. Are any of these concerns valid? Are you really running risks when you shop electronically? If so, what’s being done to make the Internet a safer place to conduct transactions? Let’s look a little more closely at the sort of things that tend to bother some Internet users (or, as the case may be, nonusers), as well as some of the steps that companies are taking to convince people that e-commerce is safe.

Credit-Card Theft

One of the more serious barriers to the growth of e-commerce is the perception of many people that credit-card numbers can be stolen when they're given out over the Internet. Though virtually every company takes considerable precautions, they're not entirely wrong. Cyber criminals, unfortunately, seem to be tirelessly creative. One popular scheme involves setting up a fraudulent Internet business operation to collect credit-card information. The bogus company will take orders to deliver goods—say, Mother's Day flowers—but when the day arrives, it will have disappeared from cyberspace. No flowers will get delivered, but even worse, the perpetrator can sell or use all the collected credit-card information.

Password Theft

Many people also fear that Internet passwords—which can be valuable information to cyber criminals—are vulnerable to theft. Again, they're not altogether wrong. There are schemes dedicated
entirely to stealing passwords. In one, the cyber thief sets up a Web site that you can access only if you register, provide an e-mail address, and select a password. The cyber criminal is betting that the site will attract a certain percentage of people who use the same password for just about everything—ATM accounts, e-mail, employer networks. Having finagled a password, the thief can try accessing other accounts belonging to the victim. So, one day you have a nice cushion in your checking account, and the next you're dead broke.

Invasion of Privacy

If you apply for a life-insurance policy online, you may be asked to supply information about your health. If you apply for a mortgage online, you may be asked questions about your personal finances. Some people shy away from Internet transactions because they're afraid that such personal information can be stolen or shared with unauthorized parties. Once again, they're right: it does happen.

How Do “Cookies” Work?

In addition to data that you supply willingly, information about you can be gathered online without your knowledge or consent. Your online activities, for example, can be captured by something called a cookie. The process is illustrated below in Figure 1, “How Cookies Work.” When you access a certain Web site, it sends back a unique piece of information to your browser, which proceeds to save it on your hard drive. When you go back to the same site, your browser returns the information, telling the site who you are and confirming that you've been there before. The problem is not that the cookie can identify you in the same way as a name or an address. It is,
however, linked to other information about you—such as the goods you've bought or the services you've ordered online. Before long, someone will have compiled a profile of your buying habits. The result? You'll soon be bombarded with advertisements targeted to your interests. For example, let's suppose you check out the Web site for an online diet program. You furnish some information but decide that the program is not for you. The next time you log on, you may be greeted by a pop-up pushing the latest miracle diet.

![Diagram showing how cookies work](image)

> **Figure 1. How Cookies Work**

Cookies aren't the only form of online espionage. Your own computer, for example, monitors your Internet activities and keeps track of the URLs that you access.

**Shoring up Security and Building Trust**

So, what can companies do to ease concerns about the safety of Internet transactions? First, businesses must implement internal controls for ensuring adequate security and privacy. Then, they must reassure customers that they're competent to safeguard credit-card numbers, passwords, and other personal information.
Among the most common controls and assurance techniques, let’s look at encryption and seals of assurance.

Encryption

The most effective method of ensuring that sensitive computer-stored information can’t be accessed or altered by unauthorized parties is encryption—the process of encoding data so that only individuals (or computers) armed with a secret code (or key) can decode it. Here’s a simplified example: You want to send a note to a friend on the other side of the classroom, but you don’t want anyone else to know what it says. You and your friend could devise a code in which you substitute each letter in the message with the letter that’s two places before it in the alphabet. So you write A as C and B as D and so on. Your friend can decode the message, but it’ll look like nonsense to anyone else. This is an oversimplification of the process. In the real world, it’s much more complicated: data are scrambled using a complex code, the key for unlocking it is an algorithm, and you need certain computer hardware to perform the encryption/decryption process.

Certificate Authorities

The most commonly used encryption system for transmitting data over the Internet is called secure sockets layer (SSL). You can tell whether a Web site uses SSL if its URL begins with https instead of http. SSL also provides another important security measure: when you connect to a site that uses SSL (for example, your bank’s site), your browser will ask the site to authenticate itself—prove that it is who it says it is. You can be confident that the response is correct if it’s verified by a certificate authority—a third-party (such
as VeriSign) that verifies the identify of the responding computer and sends you a digital certificate of authenticity stating that it trusts the site.

KEY TAKEAWAYS

• Though a source of vast opportunities, e-commerce—conducting business over the Internet—also presents some unprecedented challenges, particularly in the area of security.
  ◦ Malicious programs, such as viruses and worms, can wreak havoc with computer systems.
  ◦ Unauthorized parties may gain access to restricted company Web sites in order to steal funds or goods.
  ◦ Firewalls—software and hardware systems that prevent unauthorized users from accessing computer networks—help to reduce the risks of doing business online.

• Companies that do business online are also vulnerable to illegal activities.
  ◦ A denial-of-service attack, for example, prevents a Web server from servicing authorized users; the culprit demands a ransom to stop the attack.
  ◦ Companies that use the Internet to create and sell intellectual property (such as songs, movies, and software) face the problem of piracy.
  ◦ The theft of digital products, which can be downloaded and copied almost instantly over the Internet, not only cheats the individuals and organizations that create them, but also reduces sales and shrinks corporate profits.

• Finally, online businesses must convince consumers that it’s safe to buy things over the Internet—that credit-card numbers, passwords, and other personal information are protected from...
• One effective method for protecting computer-stored information is **encryption**—the process of encoding data so that only individuals (or computers) armed with a secret code (or key) can decode it.
  ◦ A commonly used encryption scheme is a **secure sockets layer (SSL)**, which directs the user’s browser to ask a site to authenticate itself.
  ◦ Often, the user receives a digital certificate of authenticity, verifying that a third-party security provider called a **certificate authority** has identified a computer.

**Check Your Understanding**

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

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Summary

In this module you learned about the roles of data and information technology in business operations. Following is a summary of the key points we covered.

Data vs. Information

Technology has made it easy for businesses to gather facts about their customers and business operations. However, data are just facts and figures in their raw form. It’s not until the data are processed—i.e., converted into information—that businesses can use them to improve their operations.

Managing Data

Being able to collect data is central to most businesses; however, all that data needs to be stored somewhere so users can retrieve it and use it. The creation of databases—virtual warehouses where data is stored—allows businesses to take the first step in managing and using data. Since the creation of “cloud computing,” businesses have been able to store their data offsite but still access it from anywhere.
in the world. Businesses mine data in order to find valuable patterns and answers to questions.

Information in Networks

In order to make the greatest use of data, it must be shared. In business this means that data collected by marketing needs to be shared with other departments—finance, production, research, and development—via networks. Again, this is where businesses must make decisions about the best way to share data: through internal networks (LANS), wide-area networks, (WANS) or the cloud. Each has its own set of advantages and disadvantages.

Ethical and Social Issues

Who owns your information? This question is at the heart of many of the ethical and social issues that arise when businesses collect data. The debate about how best to balance the benefits of information technology with the costs to personal privacy has led to a new field of study called technoethics.

Information Security and Cybersecurity

With big data comes big responsibility. This responsibility is about keeping customer and employee data safe from the threat of cyber criminals and illicit users. Large data security breaches have become more prevalent in recent years, and businesses are constantly working to find better and more effective ways to protect their data.
Synthesis

Each of us can be represents by hundreds of data points about our daily activities, our likes and dislikes, shopping habits, income, zip code, mobile phone use, age, gender, marital status, and so on—the list is nearly endless. We are in many respects the sum of the data collected about us. How businesses use that information will continue to evolve as technology changes. It's clear, though, that collecting, storing, managing, and using our data are vital components of virtually all business operations. The issues associated with the use of data and information technology are evolving just as quickly. Society now finds itself torn between the benefits that data can provide and the toll it takes on individual privacy. Most people believe that the organizations collecting our data have a responsibility to protect it against unauthorized access and use. Regardless of whether you pursue a career in business or not, the topics you learned about in this module will apply to you as a citizen, an employee, and an individual. As technology and data collection methods become ever more sophisticated and complex, the burden is on all of us—consumers and businesses alike—to devise effective ways of managing and controlling them.
PART XV

MODULE 14: FINANCIAL MARKETS AND SYSTEM
251. Why It Matters: Financial Markets and System

Why explain the institutions and markets that make up the financial system and how they impact the economy and the money supply?

All of the words that appear in the word cloud image refer to the same thing: MONEY.

Have you heard the saying “Money makes the world go around”? In many ways money drives almost all of our endeavors. Consider why you are here taking this course. You are obtaining knowledge in order to get a better job, to obtain a degree or other credential, or to be more informed in your daily life so that you can support
yourself and provide for those you love. Even if you are interested in charitable endeavors to improve the human condition, such efforts to support a cause will require money—even indirectly. Understanding the institutions and markets that make up our financial system is the first step in being able to comprehend how these institutions control the money supply and ultimately the economy of our nation.

Learning Outcomes

• Explain the types, characteristics, and functions of money
• Describe the purpose of the Federal Reserve System and its role in controlling the money supply and influencing interest rates
• Describe the differences between the types of financial institutions including banks, credit unions, finance companies, securities markets
• Explain how technology is affecting the traditional monetary system and the definition of “money”
• Identify the securities exchanges (NYSE, OTC, NASDAQ) and the types of transactions that occur at each exchange
• Identify the potential risks and rewards to businesses and individuals associated with the issuance, purchase and sale of securities
What you’ll learn to do: explain the types, characteristics, and functions of money

Traditionally when we think of money we immediately think of the paper bills in our wallet or the coins that are in our pockets. But money is much more than that, and how we define money determines where and how we use it to obtain the goods and services that businesses offer the consumer. Consider how far money has come since we first began creating villages and living within a societal structure. In the past (the very distance past), if you wanted shoes, you went to the shoemaker and traded him a chicken for shoes. Money has come a long way since then and is clearly a much more efficient way of transacting business than carrying around a coop full of chickens when you go shopping. Let’s look at what money is, the functions of money, and even what may be the future of money.

Learning Activities

The learning activities for this section include:

- Reading: The Functions of Money
- Video: What Is Money?
- Self Check: Money

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
253. Reading: The Functions of Money

The Functions of Money

So our first question is, what is money? If you happen to have one on you, take a look at a $5 bill. What you'll see is a piece of paper with a picture of Abraham Lincoln on one side and the Lincoln Memorial on the other. Though this piece of paper—indeed, money itself—has no intrinsic value, it's certainly in demand. Why? Because money serves three basic functions. Money is the following:

1. A medium of exchange
2. A measure of value
3. A store of value

To get a better idea of the role of money in a modern economy, let's imagine a system in which there is no money. In this system, goods and services are bartered—traded directly for one another. Now, if you're living and trading under such a system, for each barter exchange that you make, you'll have to have something that another trader wants. For example, say you're a farmer who needs help clearing his fields. Because you have plenty of food, you might enter into a barter transaction with a laborer who has time to clear fields but not enough food: he'll clear your fields in return for three square meals a day.

This system will work as long as two people have exchangeable assets, but needless to say, it can be inefficient. If we identify the functions of money, we'll see how it improves the exchange for all the parties in our hypothetical set of transactions.
Medium of Exchange

Money serves as a medium of exchange because people will accept it in exchange for goods and services. Because people can use money to buy the goods and services that they want, everyone's willing to trade something for money. The laborer will take money for clearing your fields because he can use it to buy food. You'll take money as payment for his food because you can use it not only to pay him but also to buy something else you need (perhaps seeds for planting crops).

For money to be used in this way, it must possess a few crucial properties:

1. It must be *divisible*—easily divided into usable quantities or fractions. A $5 bill, for example, is equal to five $1 bills. If something costs $3, you don't have to rip up a $5 bill; you can pay with three $1 bills.
2. It must be *portable*—easy to carry; it can't be too heavy or bulky.
3. It must be *durable*. It must be strong enough to resist tearing and the print can't wash off if it winds up in the washing machine.
4. It must be difficult to counterfeit; it won't have much value if people can make their own.

Measure of Value

Money simplifies exchanges because it serves as a measure of value. We state the price of a good or service in monetary units so that potential exchange partners know exactly how much value we want in return for it. This practice is a lot better than bartering because it's much more precise than an ad hoc agreement that a day's work in the field has the same value as three meals.
Store of Value

Money serves as a store of value. Because people are confident that money keeps its value over time, they're willing to save it for future exchanges. Under a bartering arrangement, the laborer earned three meals a day in exchange for his work. But what if, on a given day, he skipped a meal? Could he “save” that meal for another day? Maybe, but if he were paid in money, he could decide whether to spend it on food each day or save some of it for the future. If he wanted to collect on his “unpaid” meal two or three days later, the farmer might not be able to “pay” it; unlike money, food could go bad.

The Money Supply

Now that we know what money does, let’s tackle another question: How much money is there? How would you go about “counting” all the money held by individuals, businesses, and government agencies in this country? You could start by counting the money that’s held to pay for things on a daily basis. This category includes cash (paper bills and coins) and funds held in demand deposits—checking accounts, which pay given sums to “payees” when they demand them.

Then, you might count the money that’s being “saved” for future use. This category includes interest-bearing accounts, time deposits (such as certificates of deposit, which pay interest after a designated period of time), and money market mutual funds, which pay interest to investors who pool funds to make short-term loans to businesses and the government.
M-1 and M-2

Counting all this money would be a daunting task (in fact, it would be impossible). Fortunately, there's an easier way—namely, by examining two measures that the government compiles for the purpose of tracking the money supply: M-1 and M-2.

- The narrowest measure, M-1, includes the most liquid forms of money—the forms, such as cash and checking-accounts funds, that are spent immediately.
- M-2 includes everything in M-1 plus near-cash items invested for the short term—savings accounts, time deposits below $100,000, and money market mutual funds.

So what's the bottom line? How much money is out there? To find the answer, you can go to the Federal Reserve Board Web site. The Federal Reserve reports that in September 2011, M-1 was about $2.1 trillion and M-2 was $9.6 trillion. Figure 1, “The U.S. Money Supply, 1980–2010,” shows the increase in the two money-supply measures since 1980.

Figure 1. The U.S. Money Supply, 1980–2010
If you're thinking that these numbers are too big to make much sense, you're not alone. One way to bring them into perspective is to figure out how much money you'd get if all the money in the United States were redistributed equally. According to the U.S. Census Population Clock, there are more than three hundred million people in the United States. Your share of M-1, therefore, would be about $6,700 and your share of M-2 would be about $31,000.

What, Exactly, Is “Plastic Money”?

Are credit cards a form of money? If not, why do we call them plastic money? Actually, when you buy something with a credit card, you're not spending money. The principle of the credit card is buy-now-pay-later. In other words, when you use plastic, you're taking out a loan that you intend to pay off when you get your bill. And the loan itself is not money. Why not? Basically because the credit card company can't use the asset to buy anything. The loan is merely a promise of repayment. The asset doesn't become money until the bill is paid (with interest). That's why credit cards aren't included in the calculation of M-1 and M-2.

KEY TAKEAWAYS

- Money serves three basic functions:
  - *Medium of exchange*: because you can use it to buy the goods and services you want, everyone's willing to trade things for money.
  - *Measure of value*: it simplifies the exchange process because it's a means of indicating how much something costs.
• Store of value: people are willing to hold onto it because they're confident that it will keep its value over time.

• The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.
What Is Money?

The following video defines money from an economist’s perspective in a way that goes beyond just the “functions” of money. The idea of “coincidence of once” allows us to exchange our dollars (money) for goods and services when we meet someone (just once) who has something that we want. In essence, beyond the functions of money, this video explains in more depth that how we use money really defines what it is and is not.

A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=287
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=287
What you’ll learn to do: describe the purpose of the Federal Reserve System and its role in controlling the money supply and influencing interest rates

Take a dollar bill out of your wallet (or borrow one from a friend) and look at the very top of the bill. What does it read? The money we use every day is actually Federal Reserve Notes, so as students of business we need to find out more about the Federal Reserve System and what it does to control money supply and interest rates.

Learning Activities

The learning activities for this section include:

- Reading: The Federal Reserve System
• Simulation: Chair the Fed
• Self Check: Federal Reserve System

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
What Is the Federal Reserve System?

The Federal Reserve System was established by Congress nearly a century ago to serve as the U.S. central bank. President Woodrow Wilson signed the Federal Reserve Act into law on December 23, 1913. Prior to the creation of the Fed, the U.S. economy was plagued by frequent episodes of panic, bank failures, and credit scarcity. The history of the Federal Reserve is bound up in the effort to build a more stable and secure financial system.

The American colonists were limited to using European coinage, barter, and commodity money as their primary means of exchange before independence from British rule. Troubled by foreign coin shortages and the inefficiencies of barter and commodity money, many colonies began minting coins and issuing paper currency by the end of the 17th century. This was ineffective. People lacked faith in colonial currency and the authority of the colonies to issue money was periodically interrupted by their British rulers.

Colonial banks were not like modern banks. They did not take deposits from the public or make loans. Instead, they issued paper currency backed by land or precious metals such as gold. Merchants and other individuals were the primary sources of credit.

The origins of central banking in the United States began with the ratification of the Constitution in 1789. Secretary of the Treasury Alexander Hamilton developed a plan for a federal banking system to solve the nation's credit problems after the War of Independence. This was controversial. Hamilton's plan, backed by commercial and financial interests centered in the northeastern states, called for the creation of a federal bank to provide credit to government and
businesses, and to establish a national currency. The federal bank would act as the government's fiscal agent and provide a safe place to store government funds.

Secretary of State Thomas Jefferson led the opposition to Hamilton’s plan. Jefferson represented the country’s agrarian interests, which looked with suspicion at a central government bank and generally favored state over federal powers. He argued that the Constitution did not expressly authorize the federal government to charter a national bank or issue paper currency.

Hamilton, supported by the Federalist Party, won the debate. The First Bank of the United States was chartered in 1791. A bill to re-charter the bank failed in 1811. Without a centralized banking and credit structure, state banks filled the vacuum, issuing a multitude of paper currencies of questionable value. Congress attempted to solve the country’s financial problems by chartering the Second Bank of the United States in 1816. This second bank lasted until President Andrew Jackson declared it unconstitutional and vetoed its re-charter in 1836.

A period known as the Free Banking Era followed the demise of the Second Bank of the United States. Over the next quarter century, U.S. banking was a hodgepodge of state-chartered banks not subject to federal regulation. By 1860, nearly 8,000 state banks operated, each issuing its own paper notes. Some of the more marginal institutions were known as “wildcat banks” supposedly because they maintained offices in remote areas (“where the wildcats are”) in order to make it difficult for customers to redeem their notes for precious metals.

The need for reliable financing during the Civil War prompted the passage of the National Banking Act in 1863. The legislation created a uniform national currency and permitted only nationally chartered banks to issue bank notes, but did not create a strong central banking structure.

As the industrial economy expanded, the weaknesses of the nation’s decentralized banking system became more acute. Bank panics or “runs” occurred frequently. Many banks did not keep
enough cash on hand to meet unusually heavy demand. Panics and runs often occurred when customers lost confidence in their banks after hearing news of failures of other banks. Fearful customers would rush to their banks to withdraw money, which often could not meet the sudden demand for cash. That sometimes created a contagion that triggered a succession of bank failures. A particularly severe panic took place in 1907 that abated only when a private individual, the financier J.P. Morgan, personally intervened to arrange emergency loans for financial institutions. This episode fueled a reform movement, which prompted Congress to establish the Federal Reserve System in 1913.

Since the creation of the Federal Reserve, other pieces of legislation have shaped the structure and operation of the nation’s central bank. Following the Great Depression, Congress passed the Banking Act of 1935, which established the Federal Open Market Committee (FOMC) as the Fed’s monetary policymaking body. The Federal Reserve Reform Act of 1977 was enacted during a period of surging inflation. It explicitly set price stability as a national policy goal for the first time. The Full Employment and Balanced Growth Act, approved in 1978 and known informally as the Humphrey–Hawkins Act, established full employment as a second goal of monetary policy and required the Fed to report to Congress on its policy twice a year. Most recently, following the severe financial crisis of 2007-08, Congress passed the Wall Street Reform and Consumer Protection Act of 2010. The law, known as the Dodd–Frank Act, affects the Fed in many ways. It changes the Fed’s governance, increases its transparency, expands its regulatory responsibilities, and transfers most Fed consumer protection responsibilities to a new Consumer Financial Protection Bureau.

The Tools of the Fed

Now that we understand some of the history of the Federal Reserve,
The Fed seeks to stabilize prices by regulating the money supply and interest rates. In turn, stable prices promote economic growth and full employment—at least in theory. To conduct monetary policy, the Fed relies on three tools: reserve requirements, the discount rate, and open market operations. Remember, these tools are used to help the Fed achieve three major goals:

1. Price stability
2. Sustainable economic growth
3. Full employment

**Reserve Requirements**

Under what circumstances would the Fed want to change the reserve requirement for banks? The purpose of controlling the money supply is primarily to lessen the threat of inflation (a rise in the overall price level) or recession (an economic slowdown gauged by a decline in gross domestic product). Here’s how it works (again, in theory). If the Fed raises the reserve requirement (for example, from 10 percent to 11 percent), banks must set aside more money. Consequently, they have less to lend and so raise their interest rates. Under these conditions, it's harder and more expensive for people to borrow money, and if they can't borrow as much, they can't spend as much, and if people don't spend as much, prices don't go up. Thus, the Fed has lessened the likelihood of inflation.

Conversely, when the Fed lowers the reserve requirement (for example, from 10 percent to 9 percent), banks need to set aside less money. Because they have more money to lend, they keep interest rates down. Borrowers find it easier and cheaper to get money for buying things, and the more consumers buy, the higher prices go. In this case, the Fed has reduced the likelihood of a recession.

A 1 percent change in the reserve requirement, whether up to 11 percent or down to 9 percent, may not seem like much, but
remember our earlier discussion of the money multiplier: because of the money-multiplier effect, a small change in the reserve requirement has a dramatic effect on the money supply. (For the same reason, the Fed changes reserve requirements only rarely.)

The Discount Rate

To understand how the Fed uses the discount rate to control the money supply, let's return to our earlier discussion of reserves. Recall that banks must keep a certain fraction of their deposits as reserves. The bank can hold these reserve funds or deposit them into a Federal Reserve Bank account. Recall, too, that the bank can lend out any funds that it doesn’t have to put on reserve. What happens if a bank’s reserves fall below the required level? The Fed steps in, permitting the bank to “borrow” reserve funds from the Federal Reserve Bank and add them to its reserve account at the Bank. There's a catch: the bank must pay interest on the borrowed money. The rate of interest that the Fed charges member banks is called the discount rate. By manipulating this rate, the Fed can make it appealing or unappealing to borrow funds. If the rate is high enough, banks will be reluctant to borrow. Because they don’t want to drain their reserves, they cut back on lending. The money supply, therefore, decreases. By contrast, when the discount rate is low, banks are more willing to borrow because they're less concerned about draining their reserves. Holding fewer excess reserves, they lend out a higher percentage of their funds, thereby increasing the money supply.

Even more important is the carryover effect of a change in the discount rate to the overall level of interest rates. Robert Heilbroner and Lester Thurow, Economics Explained (New York: Simon & Schuster, 1998), 134. When the Fed adjusts the discount rate, it’s telling the financial community where it thinks the economy is headed—up or down. Wall Street, for example, generally reacts
unfavorably to an increase in the discount rate. Why? Because the increase means that interest rates will probably rise, making future borrowing more expensive.

Open Market Operations

The Fed's main tool for controlling the money supply and influencing interest rates is called open market operations: the sale and purchase of U.S. government bonds by the Fed in the open market. To understand how this process works, we first need to know a few facts:

- The Fed's assets include a substantial dollar amount of government bonds.
- The Fed can buy or sell these bonds on the open market (consisting primarily of commercial banks).
- Because member banks use cash to buy these bonds, they decrease their reserve balances when they buy them.
- Because member banks receive cash from the sale of the bonds, they increase their reserve balances when they sell them.
- Banks must maintain a specified balance in reserves; if they dip below this balance, they have to make up the difference by borrowing money.

If the Fed wants to decrease the money supply, it can sell bonds, thereby reducing the reserves of the member banks that buy them. Because these banks would then have less money to lend, the money supply would decrease. If the Fed wants to increase the money supply, it will buy bonds, increasing the reserves of the banks that sell them. The money supply would increase because these banks would then have more money to lend.
The Federal Funds Rate

In conducting open market operations, the Fed is trying to do the same thing that it does in using its other tools—namely, to influence the money supply and, thereby, interest rates. But it also has something else in mind. To understand what that is, you need to know a few more things about banking. When a bank’s reserve falls below its required level, it may, as we’ve seen, borrow from the Fed (at the discount rate). But it can also borrow from other member banks that have excess reserves. The rate that banks pay when they borrow through this channel is called the federal funds rate.

How does the federal funds rate affect the money supply? As we’ve seen, when the Fed sells bonds in the open market, the reserve balances of many member banks go down. To get their reserves back to the required level, they must borrow, whether from the Fed or from other member banks. When Bank 1 borrows from Bank 2, Bank 2’s supply of funds goes down; thus, it increases the interest rate that it charges. In short, the increased demand for funds drives up the federal funds rate.

All this interbank borrowing affects you, the average citizen and consumer. When the federal funds rate goes up, banks must pay more for their money, and they’ll pass the cost along to their customers: banks all over the country will raise the interest rates charged on mortgages, car loans, and personal loans. Figure 1, “Key Interest Rates, 2002–2011,” charts ten-year fluctuations in the discount rate, federal funds rate, and prime rate—the rate that banks charge their best customers. Because all three rates tend to move in the same direction, borrowers—individuals, as well as organizations—generally pay more to borrow money when banks have to pay more and less when banks have to pay less. Notice that the prime rate (which banks charge their customers) is higher than both the federal funds and discount rates (which banks must pay when they need to borrow). That’s why banks make profits when they make loans. Note, too, that the Fed lowered the discount rate
and federal funds rate drastically in 2008 in an attempt to stimulate a weakening economy. Despite continued low rates through 2011, the economy is still very weak.

![Figure 1. Key Interest Rates, 2002–2011](image)

**The Banker’s Bank and the Government’s Banker**

The Fed performs another important function: it serves its member banks in much the same way as your bank serves you. When you get a check, you deposit it in your checking account, thereby increasing your balance. When you pay someone by check, the dollar amount of the check is charged to your account, and your balance goes down. The Fed works in much the same way, except that its customers are member banks. Just as your bank clears your check, the Fed clears the checks that pass through its member banks. The monumental task of clearing more than fifteen billion checks a year is complicated by the fact that there are twelve district banks. If someone in one district (for example, Boston) writes a check to a payee in another district (say, San Francisco), the check must be processed through both districts.

Prior to 2004, clearing checks took days because the checks themselves needed to be physically moved through the system. But
thanks to the passage of Check 21 (a U.S. federal law), things now move much more quickly. Instead of physically transporting checks, banks are allowed to make an image of the front and back of a check and send the digital version of the original check, called a “substitute” check, through the system electronically. The good news is that Check 21 shortened the time it takes to clear a check, often down to one day. The bad news is that Check 21 shortened the time it takes to clear a check, which increases the risk that a check you write will bounce. So be careful: don’t write a check unless you have money in the bank to cover it.

In performing the following functions, the Fed is also the U.S. government’s banker:

• Holding the U.S. Treasury’s checking account
• Processing the paperwork involved in buying and selling government securities
• Collecting federal tax payments
• Lending money to the government by purchasing government bonds from the Treasury

The Fed also prints, stores, and distributes currency and destroys it when it’s damaged or worn out. Finally, the Fed, in conjunction with other governmental agencies, supervises and regulates financial institutions to ensure that they operate soundly and treat customers fairly and equitably.

**KEY TAKEAWAYS**

• Most large banks are members of the central banking system called the **Federal Reserve System** (commonly known as “the Fed”).
• The Fed’s goals include price stability, sustainable economic growth, and full employment. It uses monetary policy to
regulate the money supply and the level of interest rates.
• To achieve these goals, the Fed has three tools:

1. it can raise or lower reserve requirements—the percentage of its funds that banks must set aside and can’t lend out;
2. it can raise or lower the discount rate—the rate of interest that the Fed charges member banks to borrow “reserve” funds;
3. it can conduct open market operations—buying or selling government securities on the open market.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=289
Achieve Low Unemployment AND Low Inflation Rates

We have now seen that the Fed has three primary goals and a set of tools at its disposal to help it achieve these goals. If YOU were the Chairperson of the Federal Reserve, do you think that you could accomplish these goals? Let's find out!

After reading the following information, click on the Chair the Fed link below, which will take you to the Federal Reserve Bank of San Francisco website where YOU will act as the Chair of the Fed. By manipulating the fed funds rate, your goal is to keep inflation and unemployment at target rates.

Instructions for Playing the Game:

The game puts the player in the role of setting monetary policy as Chair of the Fed. The goals are as follows: inflation (2%) and unemployment (5%). Remember that the fed funds rate is the primary tool for monetary policy and is shown on the game screen (green line in the chart area is initially set at 4% rate).

Record the starting levels for inflation, unemployment, and the fed funds rate (2.11%, 4.68%, and 4.00%, respectively) in your notes by making a small table with four columns labeled: Quarters Remaining, Inflation, Unemployment, and Fed Funds Rate.

Review the “rules” and functions of the simulation by clicking on “YOUR JOB.” Once you have familiarized yourself with the way the simulation works, you are ready to “GO.”

Start the game by clicking on the “Go” button. Once the first
quarter is completed (15 quarters remaining), record all three rates. Using the “raise” and “cut” buttons, make adjustments to the fed funds rate. The information in the headline reflects changes in the levels of inflation and unemployment.

Work through the remaining 15 quarters, pausing to review each headline and record the new values of inflation and unemployment.

The game ends on an announcement screen indicating “Congratulations” if the Chair has kept the economy on track (close to the goals for inflation and unemployment) or “Sorry” if the goals have not been met.

Good Luck!

**Play the Chair the Fed Simulation**
258. Outcome: Financial Institutions

What you’ll learn to do: describe the differences between the types of financial institutions including banks, credit unions, finance companies, and securities markets

Not all financial institutions serve the same purposes, customers, or functions within the U.S. Monetary System. Understanding the differences between the various financial institutions will provide you with a glimpse into the bigger picture beyond your own local bank or ATM. These financial institutions serve as the intermediaries between the savers and the borrowers. Imagine if you had to drive to the nearest Federal Reserve bank to get $20 in cash to go to the movies on Saturday night? Not nearly as efficient as the network of institutions that comprise our banking system!

Learning Activities

The learning activities for this section include:

• Reading: Financial Institutions
• Self Check: Financial Institutions

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
259. Reading: Financial Institutions

Financial Institutions

For financial transactions to happen, money must change hands. How do such exchanges occur? At any given point in time, some individuals, businesses, and government agencies have more money than they need for current activities; some have less than they need. Thus, we need a mechanism to match up savers (those with surplus money that they're willing to lend out) with borrowers (those with deficits who want to borrow money). We could just let borrowers search out savers and negotiate loans, but the system would be both inefficient and risky. Even if you had a few extra dollars, would you lend money to a total stranger? If you needed money, would you want to walk around town looking for someone with a little to spare?

Depository and Nondepository Institutions

Now you know why we have financial institutions: they act as intermediaries between savers and borrowers and they direct the flow of funds between them. With funds deposited by savers in checking, savings, and money market accounts, they make loans to individual and commercial borrowers. In the next section, we will discuss the most common types of depository institutions (banks that accept deposits), including commercial banks, savings banks, and credit unions. We'll also discuss several nondepository institutions (which provide financial services but don't accept
deposits), including finance companies, insurance companies, brokerage firms, and pension funds.

Commercial Banks

Commercial banks are the most common financial institutions in the United States, with total financial assets of about $13.5 trillion (85 percent of the total assets of the banking institutions). They generate profit not only by charging borrowers higher interest rates than they pay to savers but also by providing such services as check processing, trust- and retirement-account management, and electronic banking. The country’s 7,000 commercial banks range in size from very large (Bank of America, J.P. Morgan Chase) to very small (local community banks). Because of mergers and financial problems, the number of banks has declined significantly in recent years, but, by the same token, surviving banks have grown quite large. If you’ve been with one bank over the past ten years or so, you’ve probably seen the name change at least once or twice.

Savings Banks

Savings banks (also called thrift institutions and savings and loan associations, or S&Ls) were originally set up to encourage personal saving and provide mortgages to local home buyers. Today, however, they provide a range of services similar to those offered by commercial banks. Though not as dominant as commercial banks, they’re an important component of the industry, holding total financial assets of almost $1.5 trillion (10 percent of the total assets of the banking institutions). The largest S&L, Sovereign Bancorp, has close to 750 branches in nine Northeastern states. Savings banks
can be owned by their depositors (mutual ownership) or by shareholders (stock ownership).

Credit Unions

To bank at a credit union, you must be linked to a particular group, such as employees of United Airlines, employees of the state of North Carolina, teachers in Pasadena, California, or current and former members of the U.S. Navy. Credit unions are owned by their members, who receive shares of their profits. They offer almost anything that a commercial bank or savings and loan does, including savings accounts, checking accounts, home and car loans, credit cards, and even some commercial loans. Collectively, they hold about $812 billion in financial assets (around 5 percent of the total assets of the financial institutions).

![Figure 1. Where Our Money Is Deposited](image)
Finance Companies

Finance companies are nondeposit institutions because they do not accept deposits from individuals or provide traditional banking services, such as checking accounts. They do, however, make loans to individuals and businesses, using funds acquired by selling securities or borrowed from commercial banks. They hold about $1.9 trillion in assets. Those that lend money to businesses, such as General Electric Capital Corporation, are commercial finance companies, and those that make loans to individuals or issue credit cards, such as Citigroup, are consumer finance companies. Some, such as General Motors Acceptance Corporation, provide loans to both consumers (car buyers) and businesses (GM dealers).

Insurance Companies

Insurance companies sell protection against losses incurred by illness, disability, death, and property damage. To finance claims payments, they collect premiums from policyholders, which they invest in stocks, bonds, and other assets. They also use a portion of their funds to make loans to individuals, businesses, and government agencies.

Brokerage Firms

Companies like A.G. Edwards & Sons and T. Rowe Price, which buy and sell stocks, bonds, and other investments for clients, are brokerage firms (also called securities investment dealers). A mutual fund invests money from a pool of investors in stocks, bonds, and other securities. Investors become part owners of the fund. Mutual funds reduce risk by diversifying investment: because assets are
invested in dozens of companies in a variety of industries, poor performance by some firms is usually offset by good performance by others. Mutual funds may be stock funds, bond funds, and money market funds, which invest in safe, highly liquid securities. (Liquidity is the speed with which an asset can be converted to cash.)

Finally, pension funds, which manage contributions made by participating employees and employers and provide members with retirement income, are also nondeposit institutions.

**Financial Services**

You can appreciate the diversity of the services offered by commercial banks, savings banks, and credit unions by visiting their Web sites. For example, Wells Fargo promotes services to four categories of customers: individuals, small businesses, corporate and institutional clients, and affluent clients seeking “wealth management.” In addition to traditional checking and savings accounts, the bank offers automated teller machine (ATM) services, credit cards, and debit cards. It lends money for homes, cars, college, and other personal and business needs. It provides financial advice and sells securities and other financial products, including individual retirement account (IRA), by which investors can save money that’s tax free until they retire. Wells Fargo even offers life, auto, disability, and homeowners insurance. It also provides electronic banking for customers who want to check balances, transfer funds, and pay bills online.

**Bank Regulation**

How would you react if you put your life savings in a bank and then, when you went to withdraw it, learned that the bank had
failed—that your money no longer existed? This is exactly what happened to many people during the Great Depression. In response to the crisis, the federal government established the Federal Depository Insurance Corporation (FDIC) in 1933 to restore confidence in the banking system. The FDIC insures deposits in commercial banks and savings banks up to $250,000. So today if your bank failed, the government would give you back your money (up to $250,000). The money comes from fees charged member banks.

To decrease the likelihood of failure, various government agencies conduct periodic examinations to ensure that institutions are in compliance with regulations. Commercial banks are regulated by the FDIC, savings banks by the Office of Thrift Supervision, and credit unions by the National Credit Union Administration. As we'll see later in the chapter, the Federal Reserve System also has a strong influence on the banking industry.

How Banks Expand the Money Supply

When you deposit money, your bank doesn’t set aside a special pile of cash with your name on it. It merely records the fact that you made a deposit and increases the balance in your account. Depending on the type of account, you can withdraw your share whenever you want, but until then, it’s added to all the other money held by the bank. Because the bank can be pretty sure that all its depositors won’t withdraw their money at the same time, it holds on to only a fraction of the money that it takes in—its reserves. It lends out the rest to individuals, businesses, and the government, earning interest income and expanding the money supply.
The Money Multiplier

Precisely how do banks expand the money supply? To find out, let’s pretend you win $10,000 at the blackjack tables of your local casino. You put your winnings into your savings account immediately. The bank will keep a fraction of your $10,000 in reserve; to keep matters simple, we’ll use 10 percent. The bank’s reserves, therefore, will increase by $1,000 ($10,000 × 0.10). It will then lend out the remaining $9,000. The borrowers (or the parties to whom they pay it out) will then deposit the $9,000 in their own banks. Like your bank, these banks will hold onto 10 percent of the money ($900) and lend out the remainder ($8,100). Now let’s go through the process one more time. The borrowers of the $8,100 (or, again, the parties to whom they pay it out) will put this amount into their banks, which will hold onto $810 and lend the remaining $7,290. As you can see in Figure 2, “The Effect of the Money Multiplier,” total bank deposits would now be $27,100. Eventually, bank deposits would increase to $100,000, bank reserves to $10,000, and loans to $90,000. A shortcut for arriving at these numbers depends on the concept of the money multiplier, which is determined using the following formula:

\[
\text{Money multiplier} = \frac{1}{\text{Reserve requirement}}
\]

In our example, the money multiplier is \(1/0.10 = 10\). So your initial deposit of $10,000 expands into total deposits of $100,000 ($10,000 \times 10), additional loans of $90,000 ($9,000 \times 10), and increased bank reserves of $10,000 ($1,000 \times 10). In reality, the multiplier will actually be less than 10. Why? Because some of the money loaned out will be held as currency and won’t make it back into the banks.
KEY TAKEAWAYS

- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Those that accept deposits from customers—depository institutions—include commercial banks, savings banks, and credit unions; those that don’t—nondepository institutions—include finance companies, insurance companies, and brokerage firms.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
- A bank holds onto only a fraction of the money that it takes in—an amount called its reserves—and lends the rest out to individuals, businesses, and governments. In turn, borrowers
put some of these funds back into the banking system, where they become available to other borrowers. The **money multiplier** effect ensures that the cycle expands the money supply.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

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https://library.achievingthedream.org/baycollegeintrobusiness/?p=292
260. Outcome: Technology and Money

What you’ll learn to do: explain how technology is affecting the traditional monetary system and the definition of “money”

Virtual wallets, Near Field Communications (NFC), and “Tap to Pay” are all terms that pepper everyday conversation among those who are embracing the “new cash.” As an alternative to traditional “paper money and coinage,” more people around the globe are finding that their money is as close as their smart phone. This advance in technology challenges the traditional monetary system in a way that the Founding Fathers never imagined possible. The marketplace is full of new apps, new systems and new ways to pay for goods and services, and as is the case with any emerging technology, who will be the winner and who will be the loser in this fight for the “virtual currency” market is unknown. In order to understand what is occurring in this space, we will look at several of the leaders of the movement and define some of the terms used to describe the new “virtual wallet.”

Learning Activities

The learning activities for this section include the following:

• Reading: Electronic Alternatives to Raw Cash: The Advent of Cashless Society
• Reading: Bitcoin and Virtual Currencies
• Reading: Mobile Commerce and Mobile Payment Systems
• Self Check: Technology and Money

Take time to review and reflect on each of these activities in order to improve your performance on the assessment for this section.
Money makes the world go ‘round, but not always as conveniently as you might wish. There is never enough cash in your wallet; the coins in your purse often weigh you down. Then, in the advanced countries, there is the pile of bank cards to squeeze in, and as if that weren’t enough, store cards just keep multiplying. But that is all set to change. A raft of new technologies is arriving to suck up that cash and dump it into a handy electronic device, liberating one’s pockets from crumpled notes, jangling change, and stacks of cards.

Implementation of electronic commerce based on e-cash as the main engine driving global economic activity will determine the future shape of society. These electronic alternatives are promising
to bring about an explosion in the number of ways of paying for things and perhaps usher in currencies that work quite differently from dollars, pounds, yen, or euros. In the advanced industrialized countries and some developing economies people are already used to paying with credit or debit cards rather than checks or cash. But what if one wants to make a payment on the Internet that is as anonymous as cash? An international system being developed could do the trick. Other times one might buy goods with one’s frequent-flier miles. Or if you commute every day, you might use a payment card that will net you a discount on your next underground railway ride. You might even choose a payment system that is designed to benefit your community. And because it’s all computerized, the pain of managing all these accounts is handled automatically.

We will examine this trend further in the next sections of the module.
Background Information and Key Technical and Legal Issues

Bitcoin, a peer-to-peer digital currency, operates without the involvement of traditional financial institutions and provides a direct digital alternative to physical currencies and commodities. Governments worldwide generally do not yet see it and other digital currencies as a destabilizing “threat,” and some scholars have argued that it may best be seen as a speculative investment. Bitcoin has certainly had its ups and downs: As of April 1, 2015, its value stood at $242 per bitcoin, after a January 14 low of $177 and a March 11 high of $296.

The currency has also had a long run of troubles with hackers and fraud, most spectacularly in 2014 when the exchange Mt. Gox declared bankruptcy after bitcoins worth $460 million at the time were apparently stolen. Bitcoin’s decentralized model and degree of anonymity have also raised concerns over its use in illegal money transfers, fueling potential illicit commerce across the “dark web” and on sites such as Silk Road.

The organization Bitcoin.org, meanwhile, touts the currency’s potential for opening up a “whole new platform for innovation”:

Basic truths about Bitcoin can be hard to discern amid the hype and turmoil, but a 2015 Congressional Research Service (CRS) report, “Bitcoin: Questions, Answers and Analysis of Legal Issues,” provides key background information as well as an overview of major issues.

Bitcoin transactions take place online directly between the buyer and seller, with each having a unique encryption. Transactions are
recorded on a decentralized public ledger available for network users to verify valid transactions. Special users on the network ("miners") oversee this verification process. After verifying a block of transactions, miners are paid with 25 newly generated bitcoins and the transactions are processed and approved; this is how the total number of bitcoins grows. The number in circulation as of January 2015 was approximately 13.7 million, with the maximum set at 21 million. As of April 2015, their total value was $3 to $4 billion. This relatively small figure prevents bitcoins from having a significant effect on the Federal Reserve's monetary policy (an argument that is frequently, and incorrectly, brought up as one of the dangers of Bitcoin).

The CRS report explores the following technical, functional and legal issues:

Bitcoin advantages:

- Lower transaction costs: Because Bitcoin operates without a third-party intermediary, merchants are able to avoid the fees traditionally charged by payment systems such as credit cards.
- The possibility of increased privacy: Bitcoin provides a heightened degree of privacy for purchases and transactions, though by the system’s nature, a complete list of all transactions is forever recorded to each user's encrypted identity.
- Protection from inflation: Since Bitcoin's circulation is not linked to currency or government regulation, it is not subject to standard inflation. However, it more than makes up for this in volatility.

Bitcoin disadvantages:

- Severe price volatility: The value of a bitcoin is determined by supply and demand, and as a result, can fluctuate rapidly. The value was as high as $1,100 in December 2013, then hit a low of $177 in January 2015. This extreme fluctuation is more
characteristic of a commodity than a currency.

- Not legal tender: Debtors are not required to accept it, and without any formal backing other than the computer program to which it is linked, Bitcoin can be seen as an “unattractive vehicle” for holding and accumulating wealth.

- Uncertain security from theft and fraud: While the counterfeiting of bitcoins is allegedly impossible, the system has at times found itself vulnerable to large security breaches and cyber-attacks. Most recently, Bitstamp, a large European Bitcoin exchange, lost 19,000 bitcoins (valued at about $5 million) in a digital security breach. This follows the massive problems with Mt. Gox in 2014 and the collapse of other exchanges in 2011.

- Vulnerability of Bitcoin “wallets”: Purchased or mined bitcoins are stored in a digital wallet on the user’s computer or mobile device, and digital keys can be lost, damaged or stolen. Paper or offline storage is an option, but not always practiced.

The CRS report notes that, given the powers articulated in the U.S. Constitution, specifically the authority “to coin money” and “regulate the value thereof,” the responsibility to oversee digital currency falls upon Congress. As of now, Congressional actions remain in the exploratory phase, with the Senate Finance Committee having only recently asked the Government Accountability Office (GAO) to review tax requirements and compliance risks. The tax code lacks clarity on how such currency should be treated: Is it digital currency, property, barter or foreign currency? Early concerns have focused more on tackling consumer protection issues than tax ambiguities, and as a result, the GAO recommended increased inclusion of the Consumer Financial Protection Bureau in questions related to Bitcoin.

Federal banking regulators have yet to issue guidance or regulations governing how banks are to deal with bitcoins. In a February 2014 statement, Federal Reserve chair Janet Yellen said: “Bitcoin is a payment innovation that's taking place outside the
banking industry.... There's no intersection at all, in any way, between Bitcoin and banks that the Federal Reserve has the ability to supervise and regulate.” (See a 2014 paper from the Federal Reserve on technical background and data analysis.) Some state financial authorities have taken steps to devise regulations, with New York’s Department of Financial Services (NYDFS) in the lead.

According to the CRS report, other legal issues with Bitcoin include:

• Counterfeiting criminal statutes: It is illegal to counterfeit both U.S. and foreign currency, but current monetary laws do not mention digital currency. Given that Bitcoin is a peer-to-peer transaction without any formal involvement by a regulatory body or a government, it is unclear if there is a role or responsibility for the U.S. legal system to intervene if counterfeiting occurred in such a situation.

• Federal tax laws: To date, the IRS has done little to address the tax implications of virtual currencies. Instead, the IRS has focused on public education by issuing guidelines indicating that for now, virtual currency will be treated as property for tax purposes, and within that framework, all corresponding tax laws apply.

• Federal anti-money laundering laws: To fight illegal and terrorist-related financial transactions, the Bank Secrecy Act (BSA) requires financial institutions to keep records. This allows suspicious withdrawals and transactions to be tracked. These requirements would conceivably be placed on any business that engages in the exchange of bitcoins for U.S. or foreign currency.
A YouTube element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/baycollegeintrobusiness/?p=295
Mobile Commerce

The phrase **mobile commerce** was originally coined in 1997 by Kevin Duffey at the launch of the Global Mobile Commerce Forum, to mean “the delivery of electronic commerce capabilities directly into the consumer's hand, anywhere, via wireless technology.” Many choose to think of Mobile Commerce as meaning “a retail outlet in your customer’s pocket.”

Mobile commerce is worth US$230 billion, with Asia representing almost half of the market, and has been forecast to reach US$700 billion in 2017. According to BI Intelligence in January 2013, 29% of mobile users have now made a purchase with their phones. Walmart estimated that 40% of all visits to their internet shopping site in December 2012 was from a mobile device. Bank of America predicts $67.1 billion in purchases will be made from mobile devices by European and U.S. shoppers in 2015. Mobile retailers in UK alone are expected to increase revenues up to 31% in FY 2013–14.

Mobile Payment

**Mobile payment**, also referred to as mobile money, mobile money transfer, and mobile wallet generally refer to payment services operated under financial regulation and performed from or via a mobile device. Instead of paying with cash, cheque, or credit
cards, a consumer can use a mobile phone to pay for a wide range of services and digital or hard goods. Although the concept of using non-coin-based currency systems has a long history, it is only recently that the technology to support such systems has become widely available.

Mobile payment is being adopted all over the world in different ways. In 2008, the combined market for all types of mobile payments was projected to reach more than $600B globally by 2013, which would be double the figure as of February, 2011. The mobile payment market for goods and services, excluding contactless Near Field Communication or NFC transactions and money transfers, is expected to exceed $300B globally by 2013.

In developing countries mobile payment solutions have been deployed as a means of extending financial services to the community known as the “unbanked” or “underbanked,” which is estimated to be as much as 50% of the world’s adult population, according to Financial Access’s 2009 Report “Half the World is Unbanked.”

Near Field Communications (NFC)

Have you ever wondered what makes tap-and-go services like Apple Pay, Google Wallet and Amiibo work? As much as it seems like pure magic, it isn’t. So what is it exactly? Simply put, it’s a method of wireless data transfer that detects and then enables technology in close proximity to communicate without the need for an Internet connection. It’s easy, fast, and works automagically.

No pairing code is necessary to link up and because it uses chips that run on very low amounts of power (or passively, using even less), it’s much more power-efficient than other wireless communication types. At its core, NFC works to identify us by our enabled cards and devices (and by extension, our bank accounts and other personal info.)
NFC chips stocked inside credit cards for contactless payments is nothing new. But a more recent and admittedly more enticing use case for NFC is with your smartphone, which can digitize your entire wallet. Virtually every mobile OS maker has their own apps that offer unique NFC functionality. Android users have the widest variety to choose from. First off, US users can nab Google Wallet, which accesses your funds for contactless payments. Samsung Pay, which operates similarly, is on the way for Samsung phone users in the United States and Korea this Summer.

However, a feature that all Android owners have been able to enjoy is called Android Beam. It was implemented in Ice Cream Sandwich 4.0 as a nifty, simple process that allows for the transfer of photos, contacts and directions that works by holding two phones together.

Apple's iPhone 6 and iPhone 6 Plus received NFC functionality, albeit with limited use so far, only for Apple Pay. It’s a lot like Google Wallet, in that it’s an app which gives users the ability to pay for goods and services at participating retailers. Lastly, those who prefer Microsoft's Windows Phone will be able to use Microsoft Payments when it launches likely around the launch of Windows 10.

Whichever device you have, it’s likely that a local supermarket, train station, taxi or coffee shop supports contactless payments via your phone's NFC chip. Go try it out! Simply hold it close to a contactless payment terminal and instantly, like swiping a credit card, the payment will complete.

Looking toward the future, it’s possible that NFC chips could be used to replace every card in your wallet. That means the unique info on your frequent shopper loyalty cards, library card, business cards and the like could be contained and transmitted simply via NFC.
Forms of Mobile Payment

**Apple Pay** is a mobile payment service that lets certain Apple mobile devices make payments at retail and online checkout. It digitizes and replaces the credit or debit magnetic stripe card transaction at credit card terminals. The service lets Apple devices wirelessly communicate with point of sale systems using a near field communication (NFC) antenna, a “dedicated chip that stores encrypted payment information” (known as the Secure Element), and Apple's Touch ID and Passbook. The service is compatible with the iPhone 6, iPhone 6 Plus, and the Apple Watch. Users with iPhone 5, 5C, 5S, 6, or 6 Plus can use the service through an Apple Watch, though the watch lacks the added Touch ID security. By default, Apple Pay is disabled, and the owner must enter a code to enable Apple Pay after putting on the watch. The watch’s sensors will then ensure that it is still being worn by its owner. If the watch is removed at any point, then Apple Pay is disabled again.

The service keeps customer payment information private from the retailer, and creates a “dynamic security code [. . .] generated for each transaction.” Apple added that they would not track usage, which would stay between the customers, the vendors, and the banks. Users can also remotely halt the service on a lost phone via the Find My iPhone service.

To check out at brick and mortar stores, users hold their authenticated Apple device to the point of sale system. iPhone users authenticate by holding their fingerprint to the phone’s Touch ID sensor, and Apple Watch users authenticate by double clicking a button on the device. There will be 220,000 participating vendors at the time of launch, including department stores Macy's and Bloomingdales, drugstores Walgreens and Duane Reade, restaurants Subway and McDonald's, and other retailers including Target and Whole Foods. To check out online in supported mobile apps, users choose “Apple Pay” as their payment method and authenticate with Touch ID. Groupon, Panera Bread,
and Uber apps will be compatible with Apple Pay at the service’s launch. Users can add credit cards to the service in any of three ways: through their iTunes accounts, by taking a photo of the card, or by entering the card information manually. The service will only work in the United States, though Apple plans to expand to other countries.

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**Google Wallet** is a mobile payment system developed by Google that allows its users to store debit cards, credit cards, loyalty cards, and gift cards among other things, as well as redeeming sales promotions on their mobile phone. Google Wallet can use near field communication (NFC) to “make secure payments fast and convenient by simply tapping the phone on any PayPass-enabled terminal at checkout.”
Google demonstrated the app at a press conference on May 26, 2011. The app was released in the United States only on September 19, 2011. The service works with the 300,000 plus MasterCard PayPass merchant locations, with Visa licensing their Visa payWave system to Google for use in Wallet as of September 20, 2011. On May 15, 2013, Google announced the integration of Google Wallet and Gmail, allowing users to send money through Gmail attachments. Like the main service, Google Wallet’s Gmail integration is also currently only available in the United States, to those 18 or older. On February 23, 2015, Google announced that it would acquire the intellectual property of the carrier-backed competitor Softcard and integrate it into Google Wallet, and that AT&T Mobility, T-Mobile U.S., and Verizon Wireless would bundle the Google Wallet app on their compatible devices later in the year. The effective merger aims to build a stronger competitor to the recently introduced Apple Pay mobile payment service. The new service will be known as Android Pay.

Where this new technology will lead the world economy and its impact on the existing monetary system remains to be seen, but we are certain it will continue to evolve rapidly!

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
What you’ll learn to do: identify the securities exchanges (NYSE, OTC, NASDAQ) and the types of transactions that occur at each exchange

Money (and wealth) are transferred not only through financial institutions such as banks, credit unions, insurance companies, and other institutions but also through the purchase and sale of securities. Securities (primarily stocks and bonds) are traded (bartered) on exchanges established for this specific purpose. Although they are not a part of or regulated by the Fed, they are still an essential part of the monetary and financial system that drives the economy. Three of the most active and common exchanges are the NYSE (New York Stock Exchange), OTC (Over the Counter), and NASDAQ (National Association of Securities Dealers Automated Quotations). In this section of the module you will learn more about these exchanges and what each one contributes to the financial system of the United States economy.

Learning Activities

The learning activities for this section include:

- Reading: Investments and Markets: A Brief Overview
- Self Check: Securities Exchanges
Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Investments and Markets: A Brief Overview

Investing is primarily about using the capital markets to invest surplus cash for long-term growth of wealth.

The following video, “Electronic Trading,” will give you an idea of what trading stocks, bonds, mutual funds, and other investments looks like and how it impacts the financial wealth of the world economy.

A YouTube element has been excluded from this version of the text. You can view it online here:
What you saw in the video was an example of how “capital markets” work. The capital markets developed as a way for buyers to buy liquidity. In Western Europe, where many of our ideas of modern finance began, those early buyers were usually monarchs or members of the nobility, raising capital to finance armies and navies to conquer or defend territories or resources. Many devices and markets were used to raise capital, but the two primary methods that have evolved into modern times are the bond and stock markets. These bonds and stocks are traded on the exchanges mentioned earlier (NYSE, OTC, NASDAQ). So, what are stocks and bonds?

Bonds and Bond Markets

Bonds are debt. The bond issuer borrows by selling a bond, promising the buyer regular interest payments and then repayment of the principal at maturity. If a company wants to borrow, it could just go to one lender and borrow. But if the company wants to borrow a lot, it may be difficult to find any one investor with the capital and the inclination to make large a loan, taking a large risk on only one borrower. In this case the company may need to find a lot of lenders who will each lend a little money, and this is done through selling bonds.

A bond is a formal contract to repay borrowed money with interest (often referred to as the coupon) at fixed intervals. Corporations and (e.g., federal, state, municipal, and foreign) governments borrow by issuing bonds. The interest rate on the
bond may be a fixed interest rate or a floating interest rate that changes as underlying interest rates—rates on debt of comparable companies—change. (Underlying interest rates include the prime rate that banks charge their most trustworthy borrowers and the target rates set by the Federal Reserve Bank.)

There are many features of bonds other than the principal and interest, such as the issue price (the price you pay to buy the bond when it is first issued) and the maturity date (when the issuer of the bond has to repay you). Bonds may also be “callable”: redeemable before maturity (paid off early). Bonds may also be issued with various covenants or conditions that the borrower must meet to protect the bondholders, the lenders. For example, the borrower, the bond issuer, may be required to keep a certain level of cash on hand, relative to its short-term debts, or may not be allowed to issue more debt until this bond is paid off.

Because of the diversity and flexibility of bond features, the bond markets are not as transparent as the stock markets; that is, the relationship between the bond and its price is harder to determine. The U.S. bond market is now more than twice the size (in dollars of capitalization) of all the U.S. stock exchanges combined, with debt of more than $27 trillion by the end of 2007. Financial Industry Regulatory Authority (FINRA), (accessed May 20, 2009).

U.S. Treasury bonds are auctioned regularly to banks and large institutional investors by the Treasury Department, but individuals can buy U.S. Treasury bonds directly from the U.S. government. To trade any other kind of bond, you have to go through a broker. The brokerage firm acts as a principal or dealer, buying from or selling to investors, or as an agent for another buyer or seller.

** Stocks and Stock Markets **

Stocks or equity securities are shares of ownership. When you buy a share of stock, you buy a share of the corporation. The size of your
share of the corporation is proportional to the size of your stock holding. Since corporations exist to create profit for the owners, when you buy a share of the corporation, you buy a share of its future profits. You are literally sharing in the fortunes of the company.

Unlike bonds, however, shares do not promise you any returns at all. If the company does create a profit, some of that profit may be paid out to owners as a dividend, usually in cash but sometimes in additional shares of stock. The company may pay no dividend at all, however, in which case the value of your shares should rise as the company’s profits rise. But even if the company is profitable, the value of its shares may not rise, for a variety of reasons having to do more with the markets or the larger economy than with the company itself. Likewise, when you invest in stocks, you share the company’s losses, which may decrease the value of your shares.

Corporations issue shares to raise capital. When shares are issued and traded in a public market such as a stock exchange, the corporation is “publicly traded.” There are many stock exchanges in the United States and around the world. The two best known in the United States are the New York Stock Exchange (now NYSE Euronext), founded in 1792, and the NASDAQ, a computerized trading system managed by the National Association of Securities Dealers (the “AQ” stands for “Automated Quotations”).

Only members of an exchange may trade on the exchange, so to buy or sell stocks you must go through a broker who is a member of the exchange. Brokers also manage your account and offer varying levels of advice and access to research. Most brokers have Web-based trading systems. Some discount brokers offer minimal advice and research along with minimal trading commissions and fees.

The Shanghai Stock Exchange (SSE), one of three exchanges in China, is not open to foreign investors. It is the sixth largest stock exchange in the world. The other exchanges in China are the Shenzhen Stock Exchange (SZSE) and the Hong Kong Stock Exchange (HKE). The Hang Seng is an index of Asian stocks on the
HKE that is popular with investors interested in investing in Asian companies.

**Commodities**

Commodities are resources or raw materials, including the following:

- Agricultural products (food and fibers), such as soybeans, pork bellies, and cotton
- Energy resources such as oil, coal, and natural gas
- Precious metals such as gold, silver, and copper
- Currencies, such as the dollar, yen, and euro

Commodity trading was formalized because of the risks inherent in producing commodities—raising and harvesting agricultural products or natural resources—and the resulting volatility of commodity prices. As farming and food production became mechanized and required a larger investment of capital, commodity producers and users wanted a way to reduce volatility by locking in prices over the longer term.

For example, suppose it is now July 2013. If you know that you will want to have wheat in May of 2015, you could wait until May 2015 and buy the wheat at the market price, which is unknown in July 2013. Or you could buy it now, paying today’s price, and store the wheat until May 2015. Doing so would remove your future price uncertainty, but you would incur the cost of storing the wheat.

Alternatively, you could buy a futures **contract** for May 2015 wheat in July 2013. You would be buying May 2015 wheat at a price that is now known to you (as stated in the futures contract), but you will not take delivery of the wheat until May 2015. The **value** of the futures contract to you is that you are removing the future price uncertainty without incurring any storage costs. In July 2013
the value of a contract to buy May 2015 wheat depends on what the price of wheat actually turns out to be in May 2015. Investors are hoping it will be substantially higher, allowing them to sell the contract, make a profit and never actually take possession of the wheat!

**Mutual Funds, Index Funds, and Exchange-Traded Funds**

A mutual fund is an investment **portfolio** consisting of securities that an individual investor can invest in all at once without having to buy each investment individually. The fund thus allows you to own the performance of many investments while actually buying—and paying the transaction cost for buying—only one investment. Mutual funds have become popular because they can provide diverse investments with a minimum of transaction costs. In theory, they also provide good returns through the performance of professional portfolio managers.

An index fund is a mutual fund designed to mimic the performance of an index, a particular collection of stocks or bonds whose performance is tracked as an indicator of the performance of an entire class or type of security. For example, the Standard & Poor’s (S&P) 500 is an index of the five hundred largest publicly traded corporations, and the famous Dow Jones Industrial Average is an index of thirty stocks of major industrial corporations. An index fund is a mutual fund invested in the same securities as the index and so requires minimal management and should have minimal management fees or costs.

Mutual funds are created and managed by mutual fund companies or by brokerages or even banks. To trade shares of a mutual fund you must have an account with the company, brokerage, or bank. Mutual funds are a large component of individual retirement accounts and of defined contribution plans.
Mutual fund shares are valued at the close of trading each day and orders placed the next day are executed at that price until it closes. An exchange-traded fund (ETF) is a mutual fund that trades like a share of stock in that it is valued continuously throughout the day, and trades are executed at the market price.

The ways that capital can be bought and sold is limited only by the imagination. When corporations or governments need financing, they invent ways to entice investors and promise them a return. The last thirty years has seen an explosion in financial engineering, the innovation of new financial instruments through mathematical pricing models. This explosion has coincided with the ever-expanding powers of the computer, allowing professional investors to run the millions of calculations involved in sophisticated pricing models. The Internet also gives amateurs instantaneous access to information and accounts.

For individual investors, investing is a process of balancing the demands and desires of returns with the costs of risk, before time runs out.

KEY TAKEAWAYS

- Bonds are
  - a way to raise capital through borrowing, used by corporations and governments;
  - an investment for the bondholder that creates return through regular, fixed or floating interest payments on the debt and the repayment of principal at maturity;
  - traded on bond exchanges through brokers.

- Stocks are
  - a way to raise capital through selling ownership or equity;
  - an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value;
• traded on stock exchanges through member brokers.

• Commodities are
  ◦ natural or cultivated resources;
  ◦ traded to hedge revenue or production needs or to speculate on resources’ prices;
  ◦ traded on commodities exchanges through brokers.

• Mutual funds are portfolios of investments designed to achieve maximum diversification with minimal cost through economies of scale.
  ◦ An index fund is a mutual fund designed to replicate the performance of an asset class or selection of investments listed on an index.
  ◦ An exchange-traded fund is a mutual fund whose shares are traded on an exchange.

• Institutional and individual investors differ in the use of different investment instruments and in using them to create appropriate portfolios.

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.
What you’ll learn to do: identify the potential risks and rewards to businesses and individuals associated with the issuance, purchase, and sale of securities

The trading of securities is a primary source of wealth creation for both businesses and individuals. However, with the opportunity for financial gain also comes the peril of loss—risk versus reward. On May 18, 2012, Facebook made its IPO (initial public offering) of stock in the social media giant. When the markets opened that morning and individuals were able to “own” a piece of Facebook, a single share sold for an average of $42 per share. Sounds like a great deal to be one of the first to have a financial stake in the premier provider of social media—less than $50! By September, 2012, that same share of Facebook was selling for approximately $21—a loss of 50 percent of the initial investment. It took more than a year for the share price to rise back to the IPO price of $42. How can such a “sure thing” go so badly? There was a series of unfortunate and unseen events that led to this disastrous IPO, but those events only serve to underscore that, even with the “sure thing,” where there is reward there is also risk. In this section we will explore some of the potential risks and rewards to businesses and individuals with the issuance, purchase, and sale of securities.
Learning Activities

The learning activities for this section include:

• Reading: Measuring Return
• Reading: Measuring Risk
• Self Check: Risks and Rewards

Take time to review and reflect on this activity in order to improve your performance on the assessment for this section.
Return

You want to choose investments that will combine to achieve the return objectives and level of risk that's right for you, but how do you know what the right combination will be? You can't predict the future, but you can make an educated guess based on an investment's past history. To do this, you need to know how to read or use the information available. Perhaps the most critical information to have about an investment is its potential return and susceptibility to types of risk.

Returns are typically calculated as annual rates of return, or the percentage of return created for each unit (dollar) of original value. If an investment earns 5 percent, for example, that means that for every $100 invested, you would earn $5 per year (because $5 = 5% of $100).

Returns are created in two ways: the investment creates income or the investment gains (or loses) value. To calculate the annual rate of return for an investment, you need to know the income created, the gain (loss) in value, and the original value at the beginning of the year. The percentage return can be calculated as follows:

\[
\text{Percentage rate of return} = \frac{\text{Income} + \text{Gain}}{\text{Original value}}
\]

\[
\text{Percentage rate of return} = \frac{\text{Income} + (\text{Ending value} - \text{Original value})}{\text{Original value}}
\]

Note that if the ending value is greater than the original value, then \( \text{Ending value} - \text{Original value} > 0 \) (is greater than zero), and you have a gain that adds to your return. If the ending value is less, then \( \text{Ending value} - \text{Original value} < 0 \) (is less than zero), and you have
a **loss** that detracts from your return. If there is no gain or loss, if \( \text{Ending value} - \text{Original value} = 0 \) (is the same), then your return is simply the income that the investment created.

For example, if you buy a share of stock for $100, and it pays no dividend, and a year later the market price is $105, then your return \( = \frac{0 + (105 - 100)}{100} = \frac{5}{100} = 5\% \). If the same stock paid a dividend of $2, then your return \( = \frac{2 + (105 - 100)}{100} = \frac{7}{100} = 7\% \).

While information about current and past returns is useful, investment professionals are more concerned with the expected return for the investment, that is, how much it may be expected to earn in the future. Estimating the expected return is complicated because many factors (i.e., current economic conditions, industry conditions, and market conditions) may affect that estimate.

For investments with a long history, a strong indicator of future performance may be past performance. Economic cycles fluctuate, and industry and firm conditions vary, but over the long run, an investment that has survived has weathered all those storms. So you could look at the average of the returns for each year. There are several ways to do the math, but if you look at the average return for different investments of the same asset class or type (e.g., stocks of large companies) you could compare what they have returned, on average, over time. Figure 2 shows average returns on investments in the S&P 500, an index of large U.S. companies since 1990.

**Figure 2. S&P 500 Average Annual Return**

If the time period you are looking at is long enough, you can reasonably assume that an investment’s average return over time is the return you can expect in the next year. For example, if a company’s stock has returned, on average, 9 percent per year over the last twenty years, then if next year is an average year, that investment should return 9 percent again. Over the eighteen-year span from 1990 to 2008, for example, the average return for the S&P 500 was 9.16 percent. Unless you have some reason to believe that next year will not be an average year, the average return can be your expected return. The longer the time period you consider, the less volatility there will be in the returns, and the more accurate your prediction of expected returns will be.

Returns are the value created by an investment, through either income or gains. Returns are also your compensation for investing, for taking on some or all of the risk of the investment, whether it is a corporation, government, parcel of real estate, or work of art. Even if there is no risk, you must be paid for the use of liquidity that you give up to the investment (by investing).

Returns are the benefits from investing, but they must be larger than its costs. There are at least two costs to investing: the opportunity cost of giving up cash and giving up all your other uses of that cash until you get it back in the future and the cost of the risk you take—the risk that you won’t get it all back.
Risk

Investment risk is the idea that an investment will not perform as expected, that its actual return will deviate from the expected return. Risk is measured by the amount of volatility, that is, the difference between actual returns and average (expected) returns. This difference is referred to as the standard deviation. Returns with a large standard deviation (showing the greatest variance from the average) have higher volatility and are the riskier investments.

Figure 2. S&P 500 Average Annual Return

As Figure 2 shows, an investment may do better or worse than its average. Thus, standard deviation can be used to define the expected range of investment returns. For the S&P 500, for example, the standard deviation from 1990 to 2008 was 19.54 percent. So, in any given year, the S&P 500 is expected to return 9.16 percent

but its return could be as high as 67.78 percent or as low as −49.46 percent, based on its performance during that specific period.

What risks are there? What would cause an investment to unexpectedly over- or underperform? Starting from the top (the big picture) and working down, there are

- economic risks,
- industry risks,
- company risks,
- asset class risks,
- market risks.

Economic risks are risks that something will upset the economy as a whole. The economic cycle may swing from expansion to recession, for example; inflation or deflation may increase, unemployment may increase, or interest rates may fluctuate. These macroeconomic factors affect everyone doing business in the economy. Most businesses are cyclical, growing when the economy grows and contracting when the economy contracts.

Consumers tend to spend more disposable income when they are more confident about economic growth and the stability of their jobs and incomes. They tend to be more willing and able to finance purchases with debt or with credit, expanding their ability to purchase durable goods. So, demand for most goods and services increases as an economy expands, and businesses expand too. An exception is businesses that are countercyclical. Their growth accelerates when the economy is in a downturn and slows when the economy expands. For example, low-priced fast food chains typically have increased sales in an economic downturn because people substitute fast food for more expensive restaurant meals as they worry more about losing their jobs and incomes.

Industry risks usually involve economic factors that affect an entire industry or developments in technology that affect an industry’s markets. An example is the effect of a sudden increase in the price of oil (a macroeconomic event) on the airline industry.
Every airline is affected by such an event, as an increase in the price of airplane fuel increases airline costs and reduces profits. An industry such as real estate is vulnerable to changes in interest rates. A rise in interest rates, for example, makes it harder for people to borrow money to finance purchases, which depresses the value of real estate.

Company risk refers to the characteristics of specific businesses or firms that affect their performance, making them more or less vulnerable to economic and industry risks. These characteristics include how much debt financing the company uses, how well it creates economies of scale, how efficient its inventory management is, how flexible its labor relationships are, and so on.

The asset class that an investment belongs to can also bear on its performance and risk. Investments (assets) are categorized in terms of the markets they trade in. Broadly defined, asset classes include

- corporate stock or equities (shares in public corporations, domestic, or foreign);
- bonds or the public debts of corporation or governments;
- commodities or resources (e.g., oil, coffee, or gold);
- derivatives or contracts based on the performance of other underlying assets;
- real estate (both residential and commercial);
- fine art and collectibles (e.g., stamps, coins, baseball cards, or vintage cars).

Within those broad categories, there are finer distinctions. For example, corporate stock is classified as large cap, mid cap, or small cap, depending on the size of the corporation as measured by its market capitalization (the aggregate value of its stock). Bonds are distinguished as corporate or government and as short-term, intermediate-term, or long-term, depending on the maturity date.

Risks can affect entire asset classes. Changes in the inflation rate can make corporate bonds more or less valuable, for example, or more or less able to create valuable returns. In addition, changes in
a market can affect an investment’s value. When the stock market fell unexpectedly and significantly, as it did in October of 1929, 1987, and 2008, all stocks were affected, regardless of relative exposure to other kinds of risk. After such an event, the market is usually less liquid; that is, there is less trading and less efficient pricing of assets (stocks) because there is less information flowing between buyers and sellers.

As you can see, the link between risk and return is reciprocal. The question for investors and their advisors is: How can you get higher returns with less risk?

KEY TAKEAWAYS

• There is a direct relationship between risk and return because investors will demand more compensation for sharing more investment risk.
• Actual return includes any gain or loss of asset value plus any income produced by the asset during a period.
• Actual return can be calculated using the beginning and ending asset values for the period and any investment income earned during the period.
• Expected return is the average return the asset has generated based on historical data of actual returns.
• Investment risk is the possibility that an investment’s actual return will not be its expected return.
• Investment risk is exposure to
  ◦ economic risk,
  ◦ industry risk,
  ◦ company- or firm-specific risk,
  ◦ asset class risk, or
  ◦ market risk.
Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does not count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

An interactive or media element has been excluded from this version of the text. You can view it online here:
https://library.achievingthedream.org/
baycollegeintrobusiness/?p=301
Summary

This module covered the financial markets and system. Below is a summary of the topics covered in this module.

Money

Money serves three basic functions:

- **Medium of exchange**: because you can use it to buy the goods and services you want, everyone’s willing to trade things for money.
- **Measure of value**: it simplifies the exchange process because it’s a means of indicating how much something costs.
- **Store of value**: people are willing to hold on to it because they’re confident that it will keep its value over time.
- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.
Federal Reserve System

- Most large banks are members of the central banking system called the Federal Reserve System (commonly known as “the Fed”).
- The Fed’s goals include price stability, sustainable economic growth, and full employment. It uses monetary policy to regulate the money supply and the level of interest rates.
- To achieve these goals, the Fed has three tools:
  - it can raise or lower reserve requirements—the percentage of its funds that banks must set aside and can’t lend out;
  - it can raise or lower the discount rate—the rate of interest that the Fed charges member banks to borrow “reserve” funds;
  - it can conduct open market operations—buying or selling government securities on the open market.

Financial Institutions

- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Those that accept deposits from customers—depository institutions—include commercial banks, savings banks, and credit unions; those that don’t—nondepository institutions—include finance companies, insurance companies, and brokerage firms.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
• A bank holds on to only a fraction of the money that it takes in—an amount called its reserves—and lends out the rest to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The money multiplier effect ensures that the cycle expands the money supply.

Technology and Money

• Virtual currencies, such as BitCoin, are using the traditional concept of “money” but as an alternative to the established Federal Reserve System. Although gaining in popularity, these virtual currencies are unregulated and pose some serious risks to those using this medium of exchange.
• Cashless payment systems such as Google Wallet and ApplePay leverage NFC technologies to allow consumers to carry their “cash” in their mobile devices. As more retailers move to “tap to pay” or scanning QR codes to complete transactions, the need to carry conventional paper money and coin diminishes. The question raised by this technology is not whether it will lead to a cashless society, but rather which mobile payment service will rise to the top and capture the market.

Securities Exchanges

• The NYSE (New York Stock Exchange) is the oldest established securities exchange in the United States. It is considered the largest equities-based exchange in the world, based on total market capitalization of its listed securities. The NYSE relied for many years on floor trading only. Today, more than half of
all NYSE trades are conducted electronically, although floor traders still set pricing and deal in high-volume institutional trading.

- The **NASDAQ** is an electronic exchange where stocks are traded through an automated network. It stands for National Association of Securities Dealers Automated Quotations System. As a general rule of thumb, it is where most technology stocks are traded. The first electronic stock market, and the successor to the over-the-counter (OTC) system of trading, the NASDAQ differs from the NYSE in that it is a fully automated network. The NASDAQ is also recognized for its high relative concentration of technology-sector stocks.

- Some of the common securities most investors choose are:
  
  **Bonds**: a way to raise capital through borrowing, used by corporations and governments; an investment for the bondholder that creates return through regular, fixed or floating interest payments on the debt and the repayment of principal at maturity; traded on bond exchanges through brokers.

  **Stocks**: a way to raise capital by selling ownership or equity; an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value; traded on stock exchanges through member brokers.

  **Commodities**: natural or cultivated resources; traded to hedge revenue or production needs or to speculate on resources' prices; traded on commodities exchanges through brokers.

  **Mutual funds**: portfolios of investments designed to achieve maximum diversification with minimal cost through economies of scale. An index fund is a mutual fund designed to replicate the performance of an asset class or selection of investments listed on an index. An
exchange-traded fund is a mutual fund whose shares are traded on an exchange.

Risks and Rewards

- There is a direct relationship between risk and return because investors will demand more compensation for sharing more investment risk. **Actual return** includes any gain or loss of asset value plus any income produced by the asset during a period. **Expected return** is the average return the asset has generated based on historical data of actual returns.
- **Investment risk** is the possibility that an investment’s actual return will not be its expected return. Investment risk is exposure to economic risk, industry risk, company- or firm-specific risk, asset-class risk, or market risk.

Synthesis

Still have that dollar bill handy that you pulled out earlier when you learned about the Federal Reserve System? Do you think about
it the same way you did before you completed this module? Perhaps you do, but now you should have a better understanding of what that dollar bill represents, how it came into existence, and where its value comes from. Money will always exist in some form, whether it's based on NFC technology in your iPhone or we go back to a barter system where we trade seashells for bread. It will still motivate people to work, study, achieve, and unfortunately even break the law. But, as you consider everything you have read and heard in this module, is it the money itself that is the motivator or the “store of value” that we work to obtain? In fact, you can look at that dollar bill and, really, it's just a piece of paper with a picture of a dead president on its face—it has no intrinsic value. So where is the value in the dollar bill you're holding? Is it that our society recognizes it as having value, and business and individuals are willing to “trade” you dollars for shoes, cars, houses, food, and the other things that you need or want in your day-to-day life? Yes, we could go back to trading chickens for shoes, but technology is pushing us further and further away from that model, and as the monetary system evolves, it's unlikely that it will become less complex. That's one big reason you've spent all this time understanding this thing that “makes the world go 'round.”