# EDEXCEL A LEVEL BUSINESS YEAR 2 COURSE COMPANION

## Essential Topic-by-Topic Study Notes for the Edexcel A Level Business Year 2 Specification Content: Theme 3 & Theme 4

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**Topic: Corporate Objectives**
*3.1 Business Objectives and Strategy*

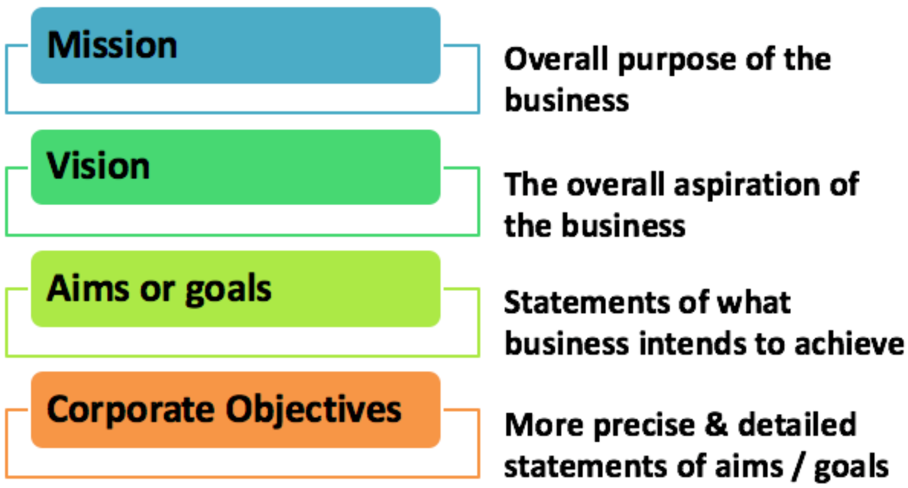
| What You Need to Know |
|---|
| Development of corporate objectives from mission statement / corporate aims |

**What are Objectives?**
Objectives are **statements of specific outcomes that are to be achieved**

Business objectives are:
- The specific intended outcomes of business strategy
- Targets which the business adopts in order to achieve its aims

**What are Corporate Objectives?**
Corporate objectives are those that relate to the **business as a whole**

Corporate objective are driven and influenced by the vision, mission and aims of a business:




The main purposes of corporate objectives include to:
- Provide strategic focus
- Measure performance of the firm as a whole
- Inform decision-making (which involves strategic choice!)
- Set the scene for more detailed functional objectives

**The Benefits of SMART Objectives**
It is often said that objectives are more likely to be taken seriously and perhaps even achieved if they comply with the requirements of the SMART acronym. SMART stands for:

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| | | |
|---|---|---|
| **S** | **Specific** | Objective should state exactly what is to be achieved |
| **M** | **Measurable** | Objective should be capable of measurement – so that it is possible to determine whether (or how far) it has been achieved |
| **A** | **Achievable** | Objective should be realistic given the circumstances in which it is set and the resources available to the business |
| **R** | **Relevant** | Objectives should be relevant to the people responsible for achieving them |
| **T** | **Time Bound** | Objectives should be set with a realistic time-frame in mind |

**The Hierarchy of Objectives in Business**
Corporate objectives are positioned towards the top of a hierarchy of business objectives, with the most important at the top, feeding down into more detailed tactical and operational objectives. The hierarchy can be illustrated like this:


**Key Areas for Corporate Objectives and How These Are Supported by Functional Objectives**

The most common aspects of a business that are impacted by corporate objectives include:

| Area | Examples |
|---|---|
| **Market** | Market share, customer satisfaction, product range |
| **Innovation** | New products, better processes, using technology |
| **Productivity** | Optimum use of resources, focus on core activities |
| **Physical & financial resources** | Factories, business locations, finance, supplies |
| **Profitability** | Level of profit, rates of return on investment |
| **Management** | Management structure; promotion & development |
| **Employees** | Organisational structure; employee relations |
| **Public responsibility** | Compliance with laws; social and ethical behaviour |

Lower down the objectives hierarchy, the role of functional objectives is to set targets for each key business function to help ensure that the corporate objectives are achieved.

Examples of how functional objectives might work to support corporate objectives would include:

| Corporate Objective | Example Functional Objective |
|---|---|
| **Increase sales** | Successfully launch five new products in the next two years (**marketing**) |
| **Reduce costs** | Increase factory productivity by 10% (**operations**) |
| **Increase cash flow** | Reduce the average time taken by customers to pay invoices from 75 to 60 days (**finance**) |
| **Improve customer satisfaction** | Achieve a 95% level of high customer service (**people**) |

**Internal and External Influences on Corporate Objectives**
Corporate objectives are influenced by a variety of factors that are within the control of management (internal) as well as factors that a business can do nothing about – except respond to them if significant (external).

The key internal and external influences can be summarised as follows:

**Internal influences:**

| **Internal Influence** | **Comment** |
|---|---|
| **Business Ownership** | Who are the business owners and what do they want to achieve? |
| **Attitude to Profit** | Is the business run to earn profits or it is not-for profit? |
| **Ethical Stance** | Do ethics play a role in a business' decision-making? |
| **Organisational Culture** | How is the business structured? How are objectives set and decisions taken? |
| **Leadership** | How strong is the influence of leadership in the business in terms of objectives and how decisions are made? |
| **Strategic position & resources** | What options & choices does the business realistically have based on its existing market position & resources? |
| **Stakeholder influence** | How influential are internal stakeholders? |

**External influences:**

| **Internal Influence** | **Comment** |
|---|---|
| **Short-termism** | External investor pressure to focus on and achieve short-term objectives at the expense of long-term strategy? |
| **Economic environment** | Perspective on key economic indicators such as economic growth, consumer spending & interest rates? |
| **Political / legal environment** | Impact of uncertainty about changes in the political & legal environment? |
| **Competitors** | Do competitor actions & strategies shape what a business thinks it can achieve? |
| **Social & Technological change** | How rapid is the pace of social & technological change in a business' markets? Does this make objective-setting & decision-making easier or harder? |

**What is Short-termism?**
Short-termism is where a business **prioritises short-term rather than long-term performance.**

There are various reasons why the management of a business might be more concerned more with how the business performs in the short, rather than the long-term. These might include:

- Stock market (investor) focus on latest financial performance (e.g. shareholder pressure to see a rising share price)

- Bonuses and other financial incentives for management that are largely based on short-term performance
- Frequent changes in leadership & strategy (e.g. through takeover)

A short-termist approach is likely to involve management focusing on the following performance measures:

- Share price and market capitalisation
- Revenue growth
- Gross & operating profit
- Unit costs & productivity
- Return on capital employed

If you were looking for possible symptoms of short-termist management you might identify this from features such as:

- Low investment in R&D (particularly compared with competitors who make take a more long-term approach)
- High dividend payments rather than reinvesting profits
- Overuse of takeovers rather than internal growth

A common criticism of short-termism is that it does not focus a business on what it needs to do in order to build a sustainable competitive advantage. For example, some of the following performance measures might be considered to be more appropriate for a business taking a long-term rather than short-term perspective:

- Market share
- Quality (including reputation)
- Innovation
- Brand awareness and strength
- Employee skills & experience
- Social responsibility & sustainability

**What is the Difference between Strategy and Tactics?**
The key differences between strategy and tactics can be summarised as follows:

| **Strategy** | **Tactics** |
|---|---|
| How the business intends to achieve its objectives<br>Usually long-term<br>Made by senior management | Support achievement of specific targets<br>Usually routine and short-term<br>Often delegated to junior management |

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Some examples of decisions that are either strategic or tactical might include:

| Strategic Decision | Tactical Decision |
|---|---|
| External growth via takeover | Relocate staff from takeover HQ |
| Enter international market | Choose locations in new market |
| Adopt cost minimisation strategy | Identify specific cost savings |
| Rebrand the business | Launch rebranding campaign |
| Close a major business unit | Determine detailed closure plan |

**Key Terms**

| | |
|---|---|
| **Corporate objectives** | Business objectives that relate to the performance of the business as a whole, which for the focus for business strategy decisions |
| **Short-termism** | Where the management of a business is predominantly focused on the short-term performance of the business, potentially to the detriment of long-term performance |

## Topic: Mission Statements

*3.1 Business Objectives and Strategy*

| What You Need to Know |
|---|
| Critical appraisal of mission statements / corporate aims |

### What is a Mission Statement?

The mission of a business is the **overriding purpose of the business and the reason for its existence.** The concept of mission supports the stated "vision" for the future of the business.

Therefore, the business mission is not about:

- The goals or objectives of the business
- The core values that underpin the culture of the business
- How the business intends to compete or position itself in the market

**The mission of a business is usually expressed in a "mission statement"**

### Where the Mission Statement Fits with Objectives and Strategy

The mission is a key part of the hierarchy of business objectives, as illustrated below:


### What Makes for an Effective Mission Statement?

In order for a mission statement to be effective it needs to:

- Provide a clear sense of business purpose
- Excite, inspire, motivate & guide the intended audience
- Be easy to understand and remember
- Help differentiate the business from competitors
- Be designed for all relevant stakeholders - not just shareholders and managers

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**Example Mission Statements**
Here are some example mission statements for well-known businesses:

| **Business** | **Mission Statement** |
|---|---|
| Alibaba | To make it easy to do business everywhere |
| Amazon | To be Earth's most customer-centric company where people can find and discover anything they want to buy online. |
| Coca-Cola | To refresh the world in mind, body and spirit<br>To inspire moments of optimism and happiness through our brands and actions<br>To create value and make a difference. |
| HP | Our mission is to deliver seamless, secure, context-aware experiences for a connected world |
| Ikea | Our vision is to create a better everyday life for the many people |
| Microsoft | Our mission is to enable people and businesses throughout the world to realize their full potential |
| Nike | To bring inspiration and innovation to every athlete in the world |
| Oxfam | To create lasting solutions to poverty, hunger, and social injustice |
| Starbucks | To inspire and nurture the human spirit – one person, one cup and one neighborhood at a time |
| Uber | Transportation as reliable as running water, everywhere for everyone |

**Criticisms of Mission Statements**
Not every mission statement is as relevant or focused as the examples above.
Common criticisms of mission statements include:

- They are not always supported by actions of the business (i.e. there is a disconnect between what the mission states and what a business actually does)
- Often too vague and general or merely statements of the blindingly obvious
- They are created largely for public relations purposes rather than acting as a focus for business strategy
- Over time they are treated quite cynically by stakeholders, particularly employees

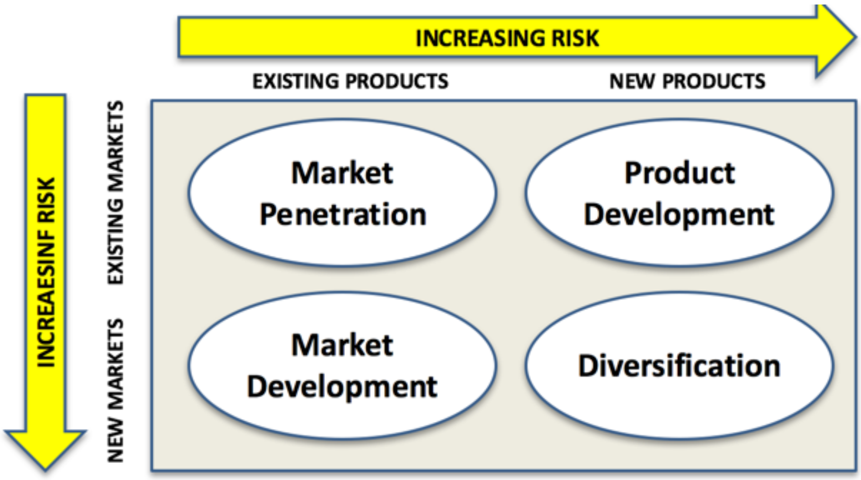
**Key Terms**

| | |
|---|---|
| **Mission Statement** | A statement of the defining purpose of a business or organisation |

**Topic: Ansoff's Matrix**
*3.1 Business Objectives and Strategy*

| What You Need to Know |
|---|
| Development of corporate strategy: Ansoff's Matrix |

**What is the Ansoff Matrix?**
The Ansoff is a famous marketing planning model that helps a business determine its **product and market** strategy.




The matrix identifies four different approaches to product and market strategy based around whether a business chooses to focus on existing / new products and existing / new markets.

Each of the four sections of the matrix can be summarised as follows:

**Market Penetration**
This is a growth strategy where a business aims to sell **existing products into existing markets**

Key points:

- Aim: to **increase market share**
- By selling more existing products to the same target customers
- Get existing customers to buy more
- Widen the range of existing products

Evaluating market penetration:

- Business focuses on markets and products it knows well
- Can exploit insights on what customers want (and competitors)
- Unlikely to need significant new market research
- But will the strategy allow the business to achieve its growth objectives?

**Product Development**
This is a growth strategy where a business aims to introduce **new products into existing markets**

Key points:

- This strategy is driven by investment in new product development
- Usually requires consistent, long-term investment in research & development
- Technological innovation provides significant opportunities for product development strategies
- Brand extensions are also examples of product development

Evaluating product development:

- This is a strategy that often plays to the strengths of an established business
- Strong emphasis on effective market research (insights into customer needs) and successful innovation
- A great way of exploiting the existing customer base who may respond positively to new products

**Market Development**

This growth strategy involves a business seeking to sell its **existing products into new markets**.

Key points:

There are various ways of approaching a strategy of market development – such as

- New geographical markets; e.g. exporting to emerging markets
- New distribution channels (e.g. using e-commerce and mail order)
- Different pricing policies to attract new customers in different segments

Evaluating market development:

- A logical strategy where existing markets are saturated or in decline
- Often riskier than product development – particularly expansion into international markets
- Existing products may not suite new markets: depends on customer needs

**Diversification**

A growth strategy where a business markets **new products in new markets**.

Key points:

Possible approaches to diversification:

- Innovation & R&D: develop new solutions
- Acquire an existing business in the market
- Extend an existing brand into the new market

Evaluating product development:

- Inherently risky strategy
- No direct experience of the product or market
- Few economies of scale (initially)
- However, if successful, overall risk of the business is spread

| What You Need to Know |
|---|
| Achieving competitive advantage through distinctive capabilities |

**What is Competitive Advantage?**
The main challenge for business strategy is to find a way of achieving a **sustainable competitive advantage** over the other competing products and firms in a market.

A competitive advantage is an advantage over competitors gained by offering consumers greater value, either by means of lower prices or by providing greater benefits and service that justifies higher prices.

One way to explore competitive advantage is to study Porter's "generic" business strategies – these could be adopted in order to gain competitive advantage. The strategies relate to the extent to which the scope of a business' activities are narrow versus broad and the extent to which a business seeks to differentiate its products.

Two very similar approaches to Porter are outlined below:

- **Distinctive capabilities** (Kay)
- **Core Competencies** (Hamel & Prahalad)

**Distinctive Capabilities**
The concept of **distinctive capabilities** was developed by economist Professor John Kay (1993) who defined them as:

**"those capabilities a firm has which other firms cannot replicate even after they realize what the benefits are that owning the capability confers."**

Kay suggested that three distinctive capabilities are characteristics of successful firms:

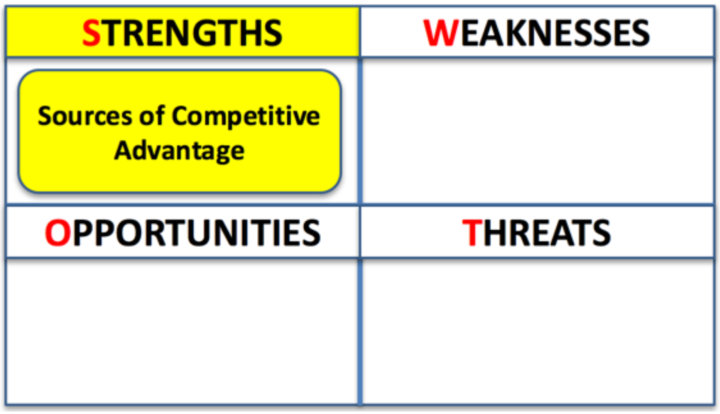
| | |
|---|---|
| **Innovation** | An obvious source of advantage for businesses that are able to demonstrate an ability to innovate (process and product)<br>However, successful innovation quickly attracts imitation from competitors! |
| **Architecture** | A system of relationships within the business, or between the business and its suppliers and customers, or both<br>These relationships are typically built on a culture of open communication, enabling a successful business to be more agile and flexible |
| **Reputation** | A powerful source of competitive advantage that is built over time<br>The foundation for reputation is quality<br>Businesses with an established reputation find is easier to capture new customer relationships<br>Reputation is easier to maintain than to create – it is hard-earned! |

## Topic: Competitive Advantage (Core Competencies / Distinctive Capabilities)
*3.1 Business Objectives and Strategy*

**Core Competencies**
A core competence is something **unique** that a business has, or can do, **strategically well**. The concept of core competencies was first developed by Hamel & Prahalad who argued that:

***"The key to competing in the future is building, deploying, protecting and defending core competencies…"***

You can see, therefore, that core competencies link closely with the idea of business strengths, which you have studied as part of SWOT analysis.




Core competencies are:

- The **collective learning** within the business
- The ability of a business to **integrate skills and technologies**
- The ability of a business to **deliver superior products and services**
- Ways a business is differentiated to be competitive

Some examples of ways that well-known businesses have developed and sustained core competencies are highlighted below:

| **Business** | **Core Competencies** |
|---|---|
| Ikea | Innovative design capabilities<br>Unique organisational culture |
| Apple | Integrated ecosystem of software & devices<br>Design built around the user |
| Dominos Pizza | Integration of multi-channel systems<br>A profitable and proven franchise model |
| Starbucks | Localised customer experience<br>Differentiated global brand |

**What Counts as a Core Competence?**
According to Hamel & Prahalad, a core competence need to satisfy three criteria:

- It provides benefits for consumers
- It is not easily copied by competitors

- It can be leveraged widely to many products & markets?

**Criticisms of the Idea of Core Competencies**
Whilst Hamel & Prahalad's work on core competencies is widely respected, their theory has come in for some criticism. The main criticisms are:

- By encouraging business to focus on their core competencies, many larger firms took this as a sign that they needed to outsource non-core business activities. It is argued that over-zealous outsourcing has damaged business competitiveness
- It is, of course, difficult to identify core competencies that are genuinely unique to any one particular business
- It is possible for a business to become complacent about its core competencies, believing them to be unique, only to find that a competitor has acquired the same abilities!

**Key Terms**

| | |
|---|---|
| **Distinctive capabilities** | The capabilities a business has which other firms cannot replicate even after they realise what the benefits are that owning the capability confers |
| **Core competencies** | Things that are unique that a business has, or can do, strategically well, which provide a source of competitive advantage. |

## Topic: Porter's Generic Strategies

*3.1 Business Objectives and Strategy*

| What You Need to Know |
|---|
| Strategic positioning to include: Porter's low cost, differentiation and focus strategies |

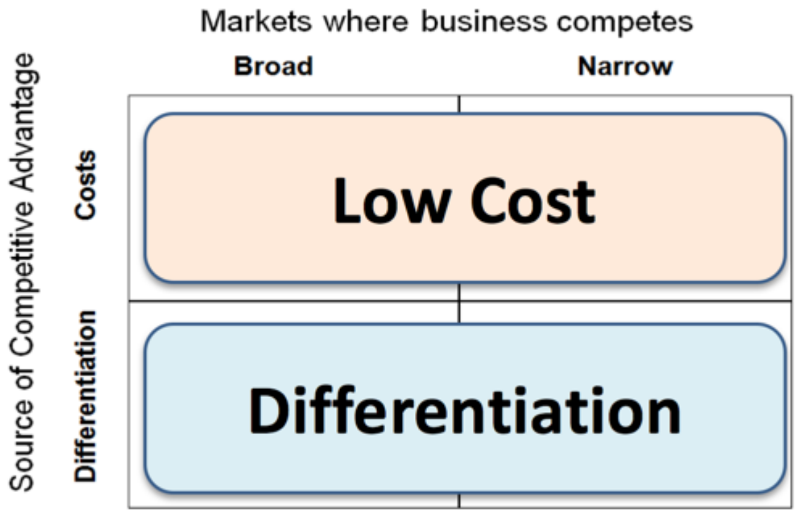
### What Porter Wrote About Strategic Positioning

Porter suggested two overall business strategies that could be followed in order to gain competitive advantage:

Porter argued that **differentiation** and **low cost** are effective strategies for firms to gain competitive advantage.

Remember that a competitive advantage is:

**An advantage over competitors gained by offering consumers greater value, either by means of lower prices or by providing greater benefits and service that justifies higher prices**




### Strategic Positioning with a Low-Cost Strategy

With this strategy, the objective is to become the **lowest-cost operator** in a market or industry.

This typically involves production or operations on a **large scale** which enables the business to **exploit economies of scale** (which therefore reduces unit costs).

Why is cost leadership potential such a effective strategic positioning? The answer lies in the marketing advantage of being able to offer lowest prices:

- If selling prices are broadly similar, the lowest-cost operator will enjoy the highest profits
- Lowest-cost operator can also offer the lowest prices (gain market share)

What are suitable markets for a low-cost strategy? They tend to be markets with:

- A standard product

- Little product differentiation
- Where branding is relatively unimportant (though many successful low-cost operators build brands that emphasise and are associated with low-cost positioning!)

The key features of businesses that successfully position themselves using a low-cost strategy typically include:

- High levels of productivity & efficiency
- High capacity utilisation
- Large scale = economies of scale
- Use bargaining power to negotiate (or demand) lowest prices from suppliers
- Lean production methods and low-cost culture
- Access to the widest and most important distribution channels

Some examples of such businesses are shown below:

**Strategic Positioning through Differentiation**
With a differentiation strategy, businesses aim to offer a product that is **distinctively different from the competition**, and where the customer values (i.e. is prepared to pay for) that differentiation.

There are various ways in which a business can attempt to differentiate its product or service:

- **Superior product quality** (features, benefits, durability, reliability)
- **Branding** (strong customer recognition & desire; brand loyalty)
- **Wide distribution across all major channels** (i.e. the product or brand is an essential item to be stocked by retailers)
- **Sustained promotion** - often dominated by advertising, sponsorship etc.

Some examples of businesses who position themselves through differentiation are shown below:

**Hybrid Strategies – Positioning as Both Low-Cost and Differentiation**

Is it possible to adopt a hybrid positioning strategy and attempt to be both low-cost and differentiated? Some businesses believe this is possible. Ikea is a good example of how it might be possible:

| **Low Cost of Ikea** | **Differentiation at Ikea** |
|---|---|
| Achieves its low prices via cost leadership:<br>Furniture is flat packed to reduce storage space<br>Large out of town retail units spread fixed costs<br>Products are made in China and Malaysia reducing unit costs<br>Low margins/ high volume allows economies of scale | Unique / unusual design<br>Localisation of product range<br>Targeting (mainly) the young, global middle class |

**Key Terms**

| | |
|---|---|
| **Low-cost positioning** | Where a business is able to operate at the lowest unit cost in the market, enabling it to charge lower prices than the competition or earn higher profit margins |
| **Differentiation positioning** | Where a business is able to distinguish its product or service in the minds of consumers as offering better value – perhaps through quality, branding or other attributes that consumers value. |

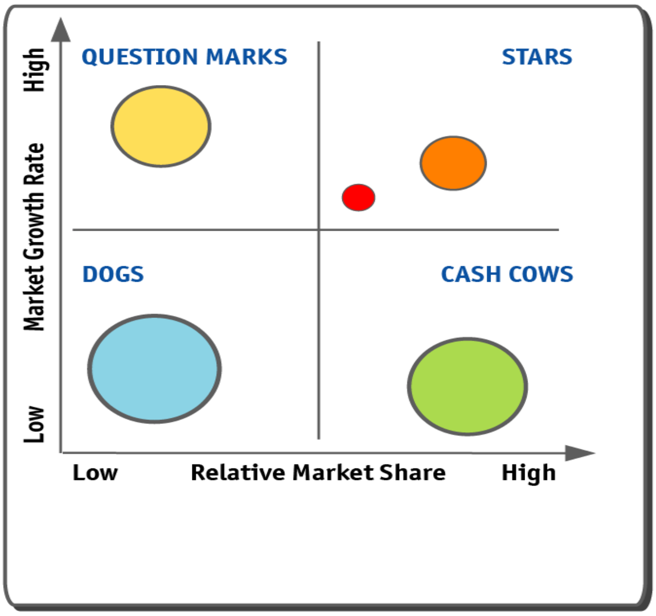
## Topic: Portfolio Analysis
*3.1 Business Objectives and Strategy*

| What You Need to Know |
| --- |
| Aim of portfolio analysis |

**Product Portfolio Analysis**
Most businesses of any size or complexity have more than one product. The most complex have thousands of products, many brands and individual business units.

Product portfolio analysis assesses the position of each product or brand in a firm's portfolio to help determine the right marketing strategy for each. Perhaps the best-known and most popular model for portfolio analysis is the Boston Matrix.

**The Boston Matrix Model of Portfolio Analysis**




The **Boston Matrix** categorises the products into one of four different areas, based on:

- **Market share** – does the product being sold have a low or high market share?
- **Market growth** – are the numbers of potential customers in the market growing or not

How does the Boston Matrix work? The four categories can be described as follows:

- **Stars** are **high growth products** competing in markets where they are strong compared with the competition. Often Stars need heavy investment to sustain growth. Eventually growth will slow and, assuming they keep their market share, Stars will become Cash Cows
- **Cash cows** are **low-growth products** with a high market share. These are mature, successful products with relatively little need for investment. They need to be managed for continued profit - so that they continue to generate the strong cash flows that the company needs for its Stars
- **Question marks** are products with low market share operating in high growth markets. This suggests that they have potential, but may need substantial investment to grow market share at the expense of larger competitors. Management have to think hard about "Question Marks" - which ones should they invest in? Which ones should they allow to fail or shrink?
- Unsurprisingly, the term **"dogs"** refers to products that have a low market share in unattractive, low-growth markets. Dogs may generate enough cash

to break-even, but they are rarely, if ever, worth investing in. Dogs are usually sold or closed.

Ideally a business would prefer products in all categories (apart from Dogs!) to give it a balanced portfolio of products.

How valuable is the Boston Matrix?

- It is a useful tool for analysing product portfolio decisions
- But it is only a snapshot of the current position
- It has little or no predictive value
- Focus on market share and market growth ignores issues such as developing a sustainable competitive advantage

## Topic: SWOT Analysis

*3.1 Business Objectives and Strategy*

| **What You Need to Know** |
|---|
| SWOT analysis<br>- Internal considerations: strengths & weaknesses<br>- External considerations: opportunities & threats |

**Introduction to SWOT Analysis**

SWOT analysis is a method for **analysing a business, its resources, and its environment.**

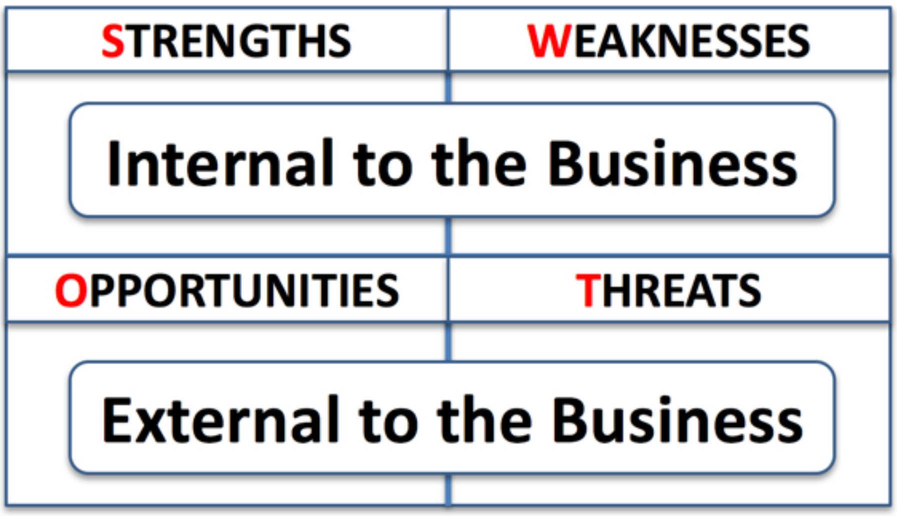
SWOT is commonly used as part of strategic planning and looks at:

- Internal strengths
- Internal weaknesses
- Opportunities in the external environment
- Threats in the external environment

SWOT analysis can help management in a business discover:

- What the business does better than the competition
- What competitors do better than the business
- Whether the business is making the most of the opportunities available
- How a business should respond to changes in its external environment

The result of the analysis is a **matrix** of positive and negative factors for management to address:




The key point to remember about SWOT is that:

***Strengths and weaknesses***

- Are internal to the business – they are within the control of the business
- Relate to the present situation

***Opportunities and threats***

- Are external to the business
- Relate to changes in the environment which will impact the business

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**Strengths**
Strengths are:
- Things a business is good at
- A characteristic giving a business an important capability
- Sources of clear advantage over rivals
- Distinctive competencies and resources that will help the business achieve its objectives

Importantly, when it comes to determining strategy:
- Strengths help to build up competitive advantage and serve as a cornerstone of strategy
- Strengths should be protected and built upon

Here are some examples of possible business strengths:

| **Examples of Potential Business Strengths** | |
|---|---|
| High market share<br>Achieving economies of scale<br>High quality<br>Leadership & management skills<br>Financial resources<br>Research and development capabilities | Technological leadership<br>Brand reputation<br>Protected IP<br>Distribution network<br>Employee skills<br>High productivity<br>Flexibility of production |

**Weaknesses**
Weaknesses are:
- A source of **competitive disadvantage**
- Things the business lacks or does poorly
- Factors that place a business at a disadvantage
- Issues that may hinder or constrain the business in achieving its objectives

Management should seek ways to reduce or eliminate weaknesses before they are exploited further by the competition. Importantly, **weakness should be seen as areas for improvement.**

Here are some examples of possible business weaknesses:

| **Examples of Potential Business Weaknesses** | |
|---|---|
| Low market share<br>Inefficient plant<br>Outdated technology<br>Poor quality<br>Lack of innovation<br>A weak brand name<br>High costs | Cash flow problems<br>Undifferentiated products<br>Inadequate distribution<br>Low productivity<br>Skills shortages<br>De-motivated staff<br>Products at the decline stage of product life cycle |

## Topic: SWOT Analysis
*3.1 Business Objectives and Strategy*

**Opportunities**
An opportunity is any feature of the external environment which **creates positive potential for the business to achieve its objectives**.

Possible sources of business opportunities in most industries and markets include:

| **Potential Business Opportunities** | |
|---|---|
| Technological innovation<br>New demand<br>Market growth<br>Demographic change<br>Social or lifestyle change<br>Government spending programmes | Higher economic growth<br>Trade liberalisation<br>Diversification opportunities<br>Deregulation of the market or other legislative change |

**Threats**
Threats are any **external development** that may hinder or prevent the business from achieving its objectives.

Possible sources of business threats include:

| **Potential Business Threats** | |
|---|---|
| New market entrants<br>Change in customer tastes or needs<br>Demographic change<br>Consolidation among buyers<br>New regulations | Economic downturn<br>Rise of low cost production abroad<br>Higher input prices<br>New substitute products<br>Competitive price pressure |

**The Value of Using SWOT analysis**
There is no point producing a SWOT analysis unless it is **actioned!** SWOT analysis should be more than a list - **it is an analytical technique to support strategic decisions**

Strategy should be devised around strengths and opportunities and the key words are **match and convert**:

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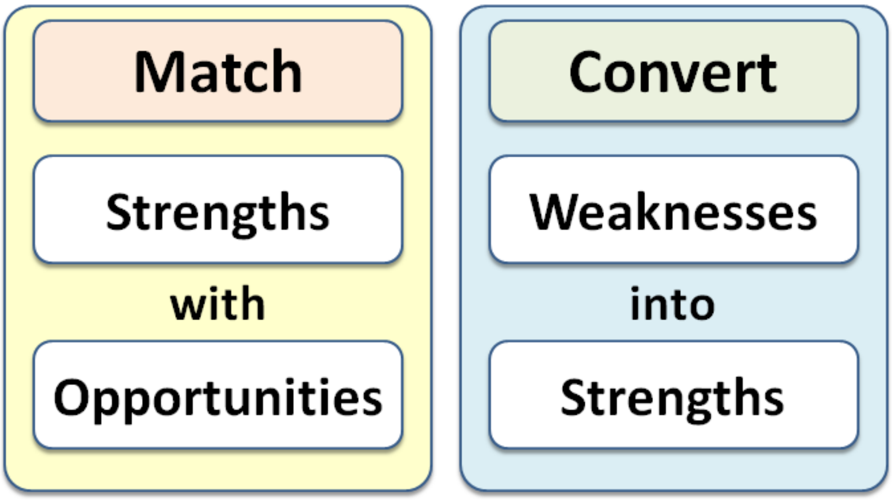



| **Weakness** | **Possible Response** |
|---|---|
| Outdated technology | Acquire competitor with leading technology |
| Skills gap | Invest in training & more effective recruitment |
| Overdependence on a single product | Diversify the product portfolio by entering new markets |
| Poor quality | Invest in quality assurance |
| High fixed costs | Examine potential for outsourcing or offshoring |

A key challenge for any business is to convert weaknesses into strengths. Don't forget also that for every perceived threat, the same change presents an opportunity for other businesses.

**Evaluating SWOT Analysis**
SWOT analysis is widely and effectively used in business management. The key advantages and disadvantages of using it can be summarised as follows.

| **Advantages of SWOT** | **Disadvantages of SWOT** |
|---|---|
| Easy to understand | Too often lacks focus or contains too many elements |
| Logical structure | Can quickly get out of date |
| Focuses on strategic issues | Is it an independent assessment? |
| Encourages analysis of external environment | |

**Key Terms**

| | |
|---|---|
| **Strengths** | Features within the control of a business that are a source of competitive advantage |
| **Weaknesses** | Features within the control of a business that are a source of competitive disadvantage |
| **Opportunities** | Features of the external environment that create opportunities for |

| | |
|---|---|
| | a business to leverage its strengths to benefit the business |
| **Threats** | Features of the external environment that threaten the performance and position of a business if not addressed |

## Topic: PESTLE Analysis

*3.1 Business Objectives and Strategy*

| **What You Need to Know** |
|---|
| PESTLE analysis of external environment<br>Aspects of change in the competitive environment |

### Introduction

- Businesses must take into account the external environment in which they operate in order to make effective decisions;
- Most businesses are unlikely to have much control (if any) over this environment;
- Businesses need to monitor their environment constantly, in order to react to any changes that occur;
- The most competitive businesses will anticipate change, rather than react to it.

### Overview of the External Environment using PESTLE Analysis

PESTLE Analysis provides a useful way to analyse the external environment. The acronym PESTLE stands for:

P **POLITICAL**
E **ECONOMIC**
S **SOCIAL**
T **TECHNOLOGICAL**
L **LEGAL**
E **ETHICAL / ENVIRONMENTAL**

Examples for each element of the PESTLE framework include:

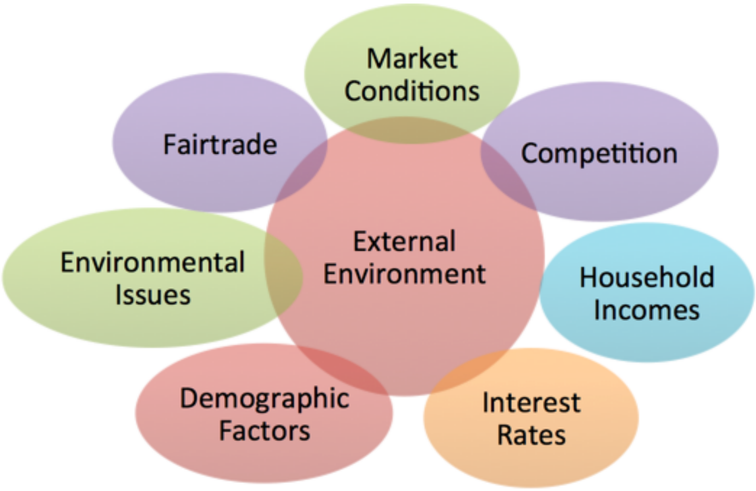
| **POLITICAL** | **ECONOMIC** | **SOCIAL** |
|---|---|---|
| Competition policy<br>Industry regulation<br>Govt. spending & tax policies<br>Business policy & incentives | Interest rates<br>Consumer spending & income<br>Exchange rates<br>Economic growth (GDP) | Demographic change<br>Impact of pressure groups<br>Consumer tastes & fashions<br>Changing lifestyles |
| **TECHNOLOGICAL** | **LEGAL** | **ETHICAL / ENVIRONMENT** |
| Disruptive technologies<br>Adoption of mobile tech<br>New production processes<br>Big data and dynamic pricing | Employment Law<br>Minimum / Living Wage<br>Health & Safety Laws<br>Environmental legislation | Sustainability<br>Tax practices<br>Ethical sourcing (supply chain)<br>Pollution & carbon emissions |

## Topic: PESTLE Analysis

*3.1 Business Objectives and Strategy*

**Exploring Specific Aspects of the External & Competitive Environment**

Let's explore a selection of particular features of the external environment that impact nearly all businesses (albeit to different degrees).




**Market Conditions**

Market conditions relate to the attractiveness (or otherwise) of the overall market in which a business operates. Market conditions tend to affect all businesses in an industry, although their ability to take advantage or, or respond to changes in market conditions will vary. Two key indicators of market conditions are:

| **Economic Growth (GDP)** | **Market Demand** |
|---|---|
| *Measure of the value of output (activity) in the economy*<br>*Value used to assess changes in economic growth* | *How much of a good or service a consumer wants – and is able to pay for*<br>*For a business, demand turns into revenues (sales)* |
| • The level of demand in most markets is influenced by the rate of economic growth<br>• Economies vary in terms of their "normal" long-term growth rate. A mature economy like the UK has a long-term growth rate of around 2-3%<br>• GDP growth will vary depending on the state of the economic cycle | • The size and growth rate of a market is a key indicator of market conditions<br>• A fast-growing market will encourage new entrants as well as benefit existing competitors<br>• A slow-growing or declining market makes market conditions much tougher, with competitors fighting for their share of weak demand |

**Competition**

- Competitors with significant market share or faster growth than the market
- Influence of disruptive technologies – increasing risk of new competitors
- Consolidation of a market that creates more powerful competitors (e.g. takeovers)
- Spare or surplus capacity in the market / industry which reduces industry profits and makes price wars more likely
- Investment in innovation & new product development by close competitors

## Real Incomes

Real incomes measure the amount of **disposable income** available to consumers (e.g. households & individuals). A range of factors impact on real incomes, including:

- Price Inflation
- Wage Growth
- Employment Levels
- Interest Rates
- Govt. Tax Policy

There are significant differences in household disposable incomes by region in the UK. For example, in 2013 London had the highest income per head, where the average person had £22,516 available to save or spend. Northern Ireland had the lowest, with the average person having £14,347.

Real incomes are closely linked to market demand (market conditions), since they are an important factor that affects demand. These factors include:

- **Real Disposable Income** (how much households have available to spend)
- **Employment and Job Security** (when the jobs market is improving, consumer confidence and incomes will improve)
- **Household Wealth** (e.g. house prices & share prices) – a rise in wealth can increase consumer demand)
- **Expectations and Sentiment** (economic uncertainty causes spending to fall, weakening demand)
- **Market Interest Rates** (interest rates affect both the incentive to save and the cost of borrowing)

## Interest Rates

An interest rate is the **reward for saving** and the **cost of borrowing** expressed as a percentage of the money saved or borrowed. At any one time there are a variety of different interest rates operating within the external environment; for example:

- Interest rates on savings in bank and other accounts
- Borrowing interest rates
- Mortgage interest rates (housing loans)
- Credit card interest rates and pay day loans
- Interest rates on government and corporate bonds

The Bank of England uses policy interest rates to help regulate the economy and meet economic policy objectives. The Bank of England Base Rate has been very low and stable for several years – at 0.5% since 2010. What might happen if interest rates start to rise? Possible effects might be:

- Cost of servicing loans / debt is reduced – boosting spending power
- Consumer confidence should increase leading to more spending
- Effective disposable income rises – lower mortgage costs
- Business investment should be boosted e.g. prospect of rising demand

- Housing market effects – more demand and higher property prices
- Exchange rate and exports – cheaper currency will increase exports

**Demographic Factors**
Demography is concerned with the size and composition of a population. Changes in population dynamics occur slowly but can be significant for businesses.

Two key demographic changes in the UK that impact on many businesses are:

| Demographic Change | Implication Examples |
|---|---|
| **Ageing population** | Greater demand for services to support older people (e.g. healthcare)<br>Increasing disposable incomes of older people reflected in higher demand for goods and services (e.g. holidays) |
| **Continued high net immigration** | Higher costs of (but greater demand for) public services (e.g. education, health, housing)<br>Increase in size of labour force – potentially keeping wage rates low |

**Environmental Issues**
Concern for the impact of business on the environment is now a significant issue that goes well beyond the potential reputational damage from issues such as pollution and noise. Key environmental issues that businesses need to address include:

- Use of raw materials, water and other resources (inputs)
- Energy use and its impact on climate change
- Waste and pollution produced by the business
- The impact the business has on employees and the local, wider and international community

Addressing environmental issues can also be a source of opportunity for many businesses. For example, it may result in:

- Lower raw material costs & waste disposal charges
- Longer life of assets that are recycled or repaired
- Trading opportunities with organisations that will only use environmentally-friendly suppliers
- Improved customer goodwill

**Key Terms**

| | |
|---|---|
| **External environment** | Features of the business environment that are outside of the control of a business |

**Topic: Porter’s Five Forces Model**
*3.1 Business Objectives and Strategy*

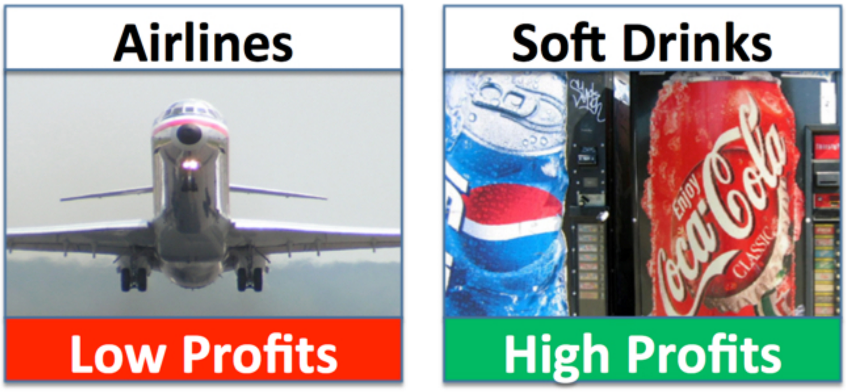
| **What You Need to Know** |
| --- |
| Porters Five Forces |

**Introduction to Porter’s Five Forces Model**
The Five Forces Model was devised by Professor Michael Porter. The model is a framework for analysing the nature of competition within an industry.

**Introduction & Background - the Nature of Industry Competition**
Every market or industry is different. Take any selection of industries and you should be able to find differences between them in terms of:

- Size (e.g. sales revenue, volumes, numbers of customers)
- Structure (e.g. the number of brands and competitors)
- Distribution channels (how the product gets from producer to final consumer)
- Customer needs and wants (the basis of marketing segmentation)
- Growth (the rate of growth and which businesses are growing faster or slower than the market)
- Product life cycle (the stage of the life cycle for the industry as a whole and for products and brands within it)
- Alternatives for the consumer (e.g. substitute products)

The result of the above differences is that industries vary in terms of how much profit they make. To take two classic examples:




Why do airlines make so little profit (and such big losses)? There are several factors, including:

- Very intensive competitor rivalry – mainly on price
- Low barriers to entry – lots of new airlines who want to set up
- Suppliers of aircraft & equipment are powerful – can charge high margins
- Customers have lots of substitute options – e.g. rail, car
- High fixed costs – airline losses rise significantly if revenues fall only slightly since it costs roughly the same to fly half-empty planes as full ones

By contrast, why are profits so high in the soft drinks market? The answer is mainly that:

- Customers and suppliers have little power – Pepsi has many millions of individual consumers, and thousands of retail distributors none of whom has much influence over the business
- There is high brand awareness & loyalty = less consumer desire for substitutes
- High barriers to entry – how do you enter a market dominated by Coca-Cola and Pepsi?

What we have illustrated above is some analysis that you would obtain by considering Porter's **Five Forces Model.**

**The Five Forces**


Porter identified five factors that act together to determine the nature of competition within an industry. These are the:

- Threat of new entrants to a market
- Bargaining power of suppliers
- Bargaining power of customers ("buyers")
- Threat of substitute products
- Degree of competitive rivalry

He identified that high or low industry profits (e.g. soft drinks v airlines) are associated with the following characteristics:

| **Low industry profits associated with:** | **High industry profits associated with:** |
|---|---|
| Strong suppliers<br>Strong customers (buyers)<br>Low entry barriers<br>Many opportunities for substitutes<br>Intense rivalry | Weak suppliers<br>Weak customers (buyers)<br>High entry barriers<br>Few opportunities for substitutes<br>Little rivalry |

## Topic: Porter's Five Forces Model

*3.1 Business Objectives and Strategy*

Let's look at each one of the five forces in a little more detail to explain how they work.

**Threat of New Entrants**

If new entrants move into an industry they will gain market share & rivalry will intensify.

The position of existing firms is stronger if there are **barriers** to entering the market.

If **barriers to entry** are low then the threat of new entrants will be high, and vice versa

Barriers to entry are, therefore, very important in determining the threat of new entrants.

An industry can have one or more barriers. The following are common examples of successful barriers:

| Barrier to Entry | Notes |
|---|---|
| **Investment cost** | High cost will deter entry<br>High capital requirements might mean that only large businesses can compete |
| **Economies of scale available to existing firms** | Lower unit costs make it difficult for smaller newcomers to break into the market and compete effectively |
| **Regulatory and legal restrictions** | Each restriction can act as a barrier to entry<br>E.g. patents provide the patent holder with protection, at least in the short run |
| **Product differentiation (including branding)** | Existing products with strong USPs and/or brand increase customer loyalty and make it difficult for newcomers to gain market share |
| **Access to suppliers and distribution channels** | A lack of access will make it difficult for newcomers to enter the market |
| **Retaliation by established products** | E.g. the threat of price war will act to discourage new entrants<br>But note that competition law outlaws actions like predatory pricing |

What makes an industry easy or difficult to enter? The following table helps summarise the issues you should consider:

| Easy to Enter | Difficult to Enter |
|---|---|
| Common technology | Patented or proprietary know-how |
| Access to distribution channels | Well-established brands |
| Low capital requirements | Restricted distribution channels |
| No need to have high capacity and output | High capital requirements |
| Absence of strong brands and customer loyalty | Need to achieve economies of scale for acceptable unit costs |

**Bargaining Power of Suppliers**

If a firm's suppliers have bargaining power they will:

- Exercise that power
- Sell their products at a higher price
- Squeeze industry profits

If the supplier forces up the price paid for inputs, profits will be reduced. It follows that the more powerful the customer (buyer), the lower the price that can be achieved by buying from them.

Suppliers find themselves in a powerful position when:

- There are only a few large suppliers
- The resource they supply is scarce
- The cost of switching to an alternative supplier is high
- The product is easy to distinguish and loyal customers are reluctant to switch
- The supplier can threaten to integrate vertically
- The customer is small and unimportant
- There are no or few substitute resources available

Just how much power the supplier has is determined by factors such as:

| Factor | Note |
|---|---|
| **Uniqueness of the input supplied** | If the resource is essential to the buying firm and no close substitutes are available, suppliers are in a powerful position |
| **Number and size of firms supplying the resources** | A few large suppliers can exert more power over market prices that many smaller suppliers each with a small market share |
| **Competition for the input from other industries** | If there is great competition, the supplier will be in a stronger position |
| **Cost of switching to alternative sources** | A business may be "locked in" to using inputs from particular suppliers – e.g. if certain components or raw materials are designed into their production processes. To change the supplier may mean changing a significant part of production |

**Bargaining Power of Customers**

**Powerful customers** are able to exert pressure to drive down prices, or increase the required quality for the same price, and therefore reduce profits in an industry.

A great example in the UK currently is the dominant grocery supermarkets which exert great power over supplier firms.

Several factors determine the bargaining power of customers, including:

| Factor | Note |
|---|---|
| **Number of customers** | The smaller the number of customers, the greater their power |
| **Their size of their orders** | The larger the volume, the greater the bargaining power of customers |
| **Number of firms supplying the product** | The smaller the number of alternative suppliers, the less opportunity customers have for shopping around |
| **The threat of integrating backwards** | If customers pose a threat of integrating backwards they will enjoy increased power |
| **The cost of switching** | Customers that are tied into using a supplier's products (e.g. key components) are less likely to switch because there would be costs involved |

Customers tend to enjoy strong bargaining power when:
- There are only a few of them
- The customer purchases a significant proportion of output of an industry
- They possess a credible backward integration threat – that is they threaten to buy the producing firm or its rivals
- They can choose from a wide range of supply firms
- They find it easy and inexpensive to switch to alternative suppliers

**Threat of Substitute Products**
A substitute product can be regarded as something that meets the same need.

Substitute products are produced in a different industry –but crucially satisfy the same customer need. If there are many credible substitutes to a firm's product, they will limit the price that can be charged and will reduce industry profits.

The extent of the threat depends upon
- The extent to which the price and performance of the substitute can match the industry's product
- The willingness of customers to switch
- Customer loyalty and switching costs

If there is a threat from a rival product the firm will have to improve the performance of their products by reducing costs and therefore prices and by differentiation.

**Overall Degree of Competitive Rivalry**
If there is intense rivalry in an industry, it will encourage businesses to engage in:

- Price wars (competitive price reductions),
- Investment in innovation & new products
- Intensive promotion (sales promotion and higher spending on advertising)

All these activities are likely to increase costs and lower profits.

Several factors determine the degree of competitive rivalry; the main ones are:

| Factor | Note |
|---|---|
| **Number of competitors in the market** | Competitive rivalry will be higher in an industry with many current and potential competitors |
| **Market size and growth prospects** | Competition is always most intense in stagnating markets |
| **Product differentiation and brand loyalty** | The greater the customer loyalty the less intense the competition<br>The lower the degree of product differentiation the greater the intensity of price competition |
| **The power of buyers and the availability of substitutes** | If buyers are strong and/or if close substitutes are available, there will be more intense competitive rivalry |
| **Capacity utilisation** | The existence of spare capacity will increase the intensity of competition |
| **The cost structure of the industry** | Where fixed costs are a high percentage of costs then profits will be very dependent on volume<br>As a result there will be intense competition over market shares |
| **Exit barriers** | If it is difficult or expensive to exit an industry, firms will remain thus adding to the intensity of competition |

**Topic: 3.2.1 Economies & Diseconomies of Scale**
*3.2 Business Growth*

| What You Need to Know |
|---|
| Objectives of growth: to achieve economies of scale<br>Problems arising from growth: diseconomies of scale |

**Why Do Businesses Want to Grow?**
Growth is at the heart of business and it is a common corporate objective. Here are the main reasons why businesses like and want to grow:

| GROWTH OBJECTIVE | REASON |
|---|---|
| **Increasing profits** | A key objective for many firms, particularly those whose shares are quoted on stock markets or who are owned by private equity. |
| **Achieve economies of scale** | By growing the scale of output, a business can achieve lower unit costs which can thereby improve a firm's competitiveness. |
| **Increase market power** | Larger firms may be able to exert greater bargaining power over suppliers and/or customers in order to gain a competitive advantage |
| **Increase market share and brand recognition** | Much research points to the link between growing market share and brand recognition with higher profits, so this reason is linked with increasing profits. |
| **Grow business and shareholder value** | Ultimately the main reason why so many firms adopt a growth strategy. Larger businesses are generally more valuable! |

**What are Economies of Scale?**
Economies of scale arise when **unit costs fall as output increases**

Remember that we can calculate unit costs (or cost per unit) using this important formula:

***Average cost per unit is calculated using:***

$$\frac{\text{Total production costs in period (£)}}{\text{Total output in period (units)}}$$

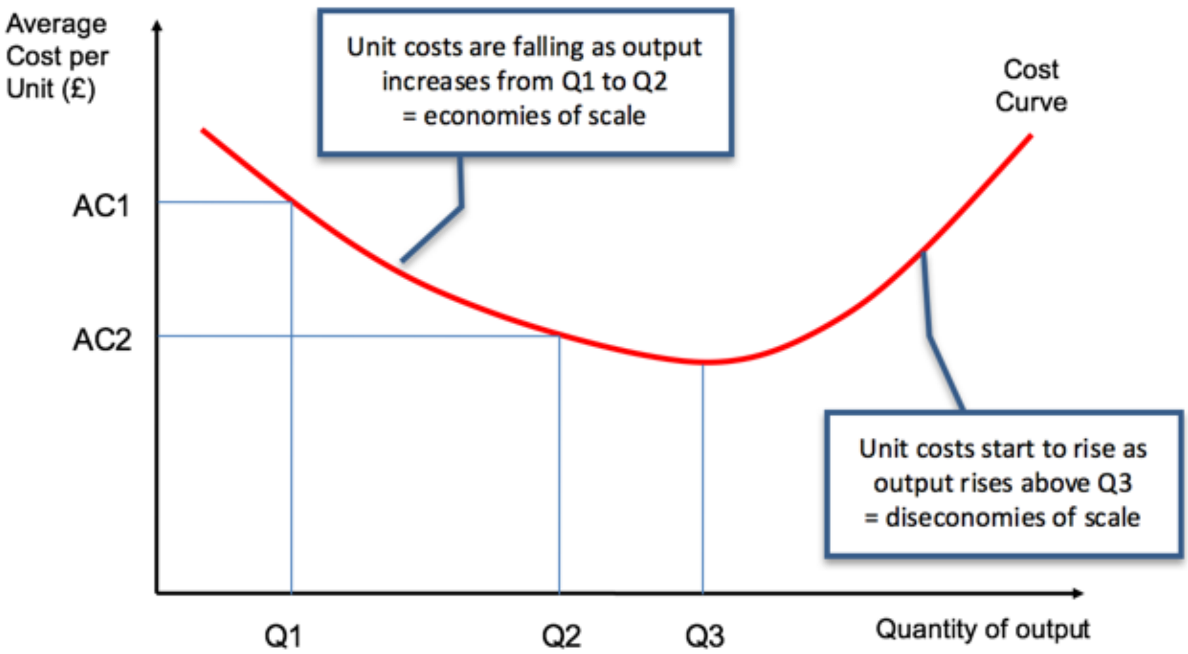
This calculation (and the effect of economies of scale on unit costs) can be illustrated by this simple example. Here, we assume that:

- Fixed costs are £10,000, and
- Variable costs are £100 per unit

| Output | Fixed Costs | Total Variable Costs | Total Costs | Cost per Unit |
|---|---|---|---|---|
| Units | £ | £ | £ | £ |
| 50 | 10,000 | 5,000 | 15,000 | **300** |
| 100 | 10,000 | 10,000 | 20,000 | **200** |
| 150 | 10,000 | 15,000 | 25,000 | **166** |
| 200 | 10,000 | 20,000 | 30,000 | **150** |
| 250 | 10,000 | 25,000 | 35,000 | **140** |

As output rises from 50 units to 250 units per period, the cost per unit falls from £300 per unit to £140 per unit. This is because the fixed costs of £10,000 per period are being spread over a larger number of units produced.

The effect of economies of scale on unit costs can also be illustrated diagrammatically as follows:




**How Economies of Scale Can Provide a Competitive Advantage**
In your studies of strategic positioning you look at the two key methods of strategic positioning for competitive advantage – low cost and differentiation.

Achieving economies of scale is a key aim for businesses that wish to position themselves as low-cost operators. One useful exercise is to compare the unit costs of different businesses in a market to see which is able to operate most efficiently.

A simple example of this kind of comparison is provided in the table below:

| Business | Output Units | Total Costs £ | Unit Costs £ |
|---|---|---|---|
| A | 10,000 | 50,000 | **5** |
| B | 20,000 | 80,000 | **4** |
| C | 5,000 | 30,000 | **6** |
| D | 25,000 | 75,000 | **3** |
| E | 15,000 | 75,000 | **5** |

**Categories of Economies of Scale**
Economies of scale can be distinguished between:

**Internal Economics of Scale**: arise from the increased output of the business itself
**External Economies of Scale**: occur within an industry: i.e. all competitors benefit

The main types of internal economies of scale are summarised in the following table:

| Economy | How It Works | Example |
|---|---|---|
| **Purchasing** | Buying in greater quantities usually results in a lower price (bulk-buying). | The major grocery supermarket chains are able to obtain much lower prices from key suppliers than smaller independent retailers – due to the volume of demand they provide to those suppliers. This gives the largest supermarkets a significant cost advantage |
| **Technical** | Use of specialist equipment or processes to boost productivity. | As firms grow, they are often able to invest heavily in automation in order to further improve their efficiency and productivity. Capital-intensive and automated production can provide firms with a significant unit cost advantage over smaller firms as well as creating a tough barrier to market entry. The car industry is, perhaps, the best example of this. |
| **Managerial** | Specialist managers can be employed to help reduce unit costs and boost efficiency | Smaller firms are often unable to afford managers with specialist expertise (e.g. in finance, HR, marketing). As a firm grows it is better able to bring in specialist managerial expertise which should enable it to be more efficiently run. |

**External Economies of Scale**
These arise from the way an industry operates as a whole – i.e. all competitors benefit
They are often associated with particular geographic areas – for example the concentration of creative & media businesses in London. Examples of why this works include:

- Having many specialist suppliers close by
- Access to research and development facilities
- Pool of skilled labour to choose from

**Diseconomies of Scale**
There is no guarantee that unit costs will fall as the scale of a business' operation rises. There may be reasons why inefficiencies arise as a business gets larger. For example:

- **Control** – problems in monitoring productivity and work quality, increasing wastage of resources
- **Co-operation** - workers in large firms may develop a sense of alienation and loss of morale
- Negative effects of internal politics, information over-load, unrealistic expectations among managers and cultural clashes between senior people with inflated ego

## Topic: Overtrading
*3.2 Business Growth*

| What You Need to Know |
|---|
| Problems arising from growth: overtrading |

### What is Overtrading?
Overtrading happens **when a business expands too quickly without having the financial resources to support such a quick expansion.**

If suitable sources of finance are not obtained, overtrading can lead to business failure.

Importantly, overtrading can occur even a business is profitable. It is an issue of working capital and cash flow.

Overtrading is, therefore, essentially a problem of growth. It is particularly associated with **retail businesses who attempt to grow too fast**

### When is Overtrading Most Likely to Happen?
Overtrading is most likely to occur if:

- Growth is achieved by making significant capital investment in production or operations capacity before revenues are generated
- Sales are made on credit and customers take too long to settle amounts owed
- Significant growth in inventories is required in order to trade from the expanding capacity
- A long-term contract requires a business to incur substantial costs before payments are made by customers under the contract

### Classic Symptoms that a Business Might Be Overtrading
Whilst the following symptoms do not guarantee that a business is overtrading, one or more of them might prove to be good indicators:

- High revenue growth but very low gross and operating profit margins (compared with key competitors
- Persistent use of a bank overdraft facility
- Significant increases in the payables days and receivables days ratios
- Significant increase in the current ratio
- Very low inventory turnover ratio
- Low levels of capacity utilisation (alongside high levels of investment in capacity)

### How Can Businesses Manage the Risk of Overtrading?
The most effective steps to avoid overtrading are essentially those that would be taken as part of a sensible cash flow and working capital management. For example:

- Reducing inventory levels
- Scaling back the pace of revenue growth until profit margins and cash reserves have improved
- Leasing rather than buying capital equipment

- Obtaining better payment terms from suppliers
- Enforcing better payment terms with customers (e.g. through prompt-payment discounts)

**Key Terms**

| | |
|---|---|
| **Overtrading** | When a business expands too quickly without having the financial resources to support such a quick expansion. |

## Topic: Reasons for Staying Small

*3.2 Business Growth*

| What You Need to Know |
|---|
| - Small business survival in competitive markets:<br>- Product differentiation and USPs<br>- Flexibility in responding to customer needs<br>- Customer service<br>- E-commerce |

### The Objectives of Smaller Businesses

Not every business (in fact, very few businesses) want to become multinationals. The key objectives of smaller businesses can include:

| Objective | Relevance to Smaller Firms |
|---|---|
| **Survival** | A key objective for startup firms and many smaller firms. Whilst small firms have lower costs, over-reliance on one or a few products can threaten survival. |
| **Revenue Maximisation** | Rarely a key objective for smaller firms, although they are often keen to grow sales albeit from a low base level. |
| **Profit Maximisation** | Smaller firms will normally earn lower absolute levels of profit (because their revenues are lower). However, they can still achieve high profit margins if operating in a suitable niche market. |
| **Cost Efficiency & Scale** | Smaller firms are unlikely to benefit from economies of scale although they may be good at keeping their cost base low. |
| **Customer Service** | Smaller firms are often associated with higher levels of customer service and satisfaction, often because the business owner is closely involved with the provision of customer service. |

### So Why Stay Small

Amongst the key reasons why businesses may prefer to stay small are:

- Product differentiation & USPs
- Flexibility in meeting customer needs
- Deliver high standard of customer service
- Exploit opportunities from e-commerce

### Product Differentiation & USPs

- Positioning a business as "small" can help differentiate against larger competitors
- Customer perception may be an expectation of a better product from a business that "cares"
- More scope for adding value through the provision of specialist expertise (e.g. advice)

### Flexibility in Meeting Customer Needs

- Many small businesses talk to their customers regularly; sometime every day
- Small firms often communicate in the customers' language which give the impression to the customer that they are more in tune with their needs

- Makes it easier to get customer feedback (larger firms often struggle with this)

**Delivery of High Standard of Customer Service**
- Most small businesses operate in the "service" sector, so this is a key source of competitive advantage
- Employees in smaller firms are likely to treat customer service as a priority (compared with larger firms) though there is no guarantee that smaller firms deliver better customer service!

**Exploit Opportunities from E-Commerce**
- E-commerce is an obvious (and increasingly common) way for small firms to reach a broader customer base
- It is now relatively easy for a small firm to target niche segments both domestically and overseas using e-commerce
- Smaller firms, provided they are confident with its use, can gain significant traction with customers using social media

## Topic: Methods of Growth
*3.2 Business Growth*

| What You Need to Know |
| --- |
| Reasons for mergers and takeovers<br>Distinction between mergers and takeovers<br>Horizontal and vertical integration<br>Financial risks and rewards<br>Problems of rapid growth |

### Methods of Business Growth
Most business want to grow and there are a variety of methods this can be achieved. Let's look at the key features of each approach.

### Organic (Internal) Growth
Organic growth involves expansion **from within a business**, for example by expanding the product range, or number of business units and locations.

### External Growth – Mergers and Takeovers
Mergers and takeover are the main methods of external growth.

A takeover (or acquisition) involves **one business acquiring control of another business.**

A merger is a **combination of two previously separate firms** which is achieved by **forming a completely new firm** into which the two original businesses are integrated.

So the key difference between the two can be summarised as follows:

| Merger | Takeover |
| --- | --- |
| Involves a **NEW FIRM** being created into which two existing businesses are "merged" | Involves an **EXISTING FIRM** acquiring more than 50% of another firm and thereby gaining control of it |

### Takeovers

Takeovers are the most common method of external growth and are undertaken for a wide variety of reasons: for example:

| Reasons for Growing through Takeovers | |
| --- | --- |
| Increase market share<br>Acquire new skills (e.g. research)<br>Access economies of scale<br>Secure better distribution<br>Acquire intangible assets (brands, patents, trade marks) | Overcome barriers to entry to target markets<br>Defend itself against a takeover threat<br>Enter new segments of an existing market<br>To eliminate competition<br>Spread risks by diversifying |

Takeovers might be the most appropriate method of growth for some businesses, for example when:

- Existing products are in the later stages of their life cycles
- Business lacks knowledge or resources to develop organically
- Speed of growth is a high priority
- Competitors enjoy significant advantages that are hard to overcome

However, takeovers are a high risk strategy and many end in failure. The many drawbacks of using takeovers include:

- High cost involved
- Problems of valuation
- Upset customers and suppliers
- Problems of integration (change management)
- Resistance from employees
- Non-existent cost savings
- Incompatibility of management styles, structures and culture
- Questionable motives

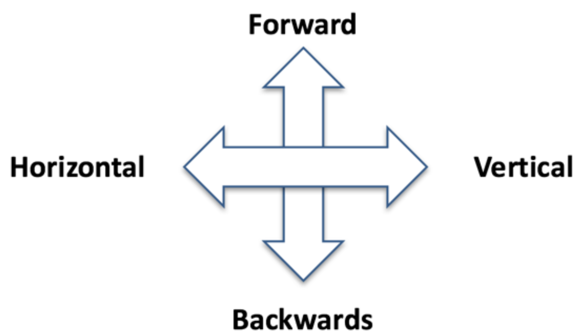
**Why Do Some Many Takeovers Fail?**

Takeovers are a very popular method of growth – but so many fail to achieve their objectives. Why is this? Here are the key reasons:

- Price paid for takeover was too high (over-estimate of synergies)
- Lack of decisive change management in the early stages
- The takeover was mishandled
- Cultural incompatibility between the two businesses
- Poor communication, particularly with management, employees and other stakeholders of the acquired business
- Loss of key personnel & customers post acquisition
- Competitors take the opportunity to gain market share whilst the takeover target is being integrated

**Types and Direction of Integration**

Growth strategies can also be categorised in terms of whether they involve a business moving forwards or backwards in the supply chain, or whether the strategy simply consolidates its position at the same stage of the supply chain.




Each of these directions of integration can be summarised as follows:

**Topic: Methods of Growth**
*3.2 Business Growth*

| Direction | Explanation |
|---|---|
| **Forward + vertical** | Acquiring a business further up in the supply chain – e.g. manufacturer buys a distributor |
| **Backward + vertical** | Acquiring a business operating earlier in the supply chain – e.g. a retailer buys a wholesaler |
| **Horizontal** | Acquiring a business at the same stage of the supply chain – e.g. a manufacturer buys a competitor |
| **Conglomerate** | Where the acquisition has no clear connection to the business buying it |

**Horizontal Integration**
The potential benefits of growing through horizontal integration include:

- More likely to achieve economies of scale
- Cost synergies (savings) from the rationalisation of the business
- Potential to secure revenue synergies
- Wider range of products - (i.e. diversification)
- Reduces competition by removing key rivals – this increases market share and long-run pricing power
- Buying a existing and well-known brand can be cheaper than organically growing a brand – this can then make the entry barriers higher for potential rivals

**Vertical Integration**
The potential benefits of growing through vertical integration include:

- Enables a business to capture a greater share of the profit on each sale
- Secures important sources of supply or distribution
- Create a barrier to entry to potential new competitors
- Gain greater insights into customer needs and wants at each stage of the supply chain

**More on Mergers**
A merger is a combination of two previously separate firms which is achieved by forming a completely firm into which the two original firms are integrated.

A merger can be seen as a decision made by two businesses that are broadly "equal" in terms of factors such as size, scale of operations, customers etc.

The enlarged, merged business, through the changes made by combining both together, can cut costs, grow revenues and increase profits - which should benefit shareholders of both the original two businesses.

## Topic: Methods of Growth
*3.2 Business Growth*

**Key Terms**

| | |
|---|---|
| **Takeover** | |
| **Merger** | |
| **Organic growth** | Growth that comes from within the business, e.g. through the launch of a new product or opening new locations |
| **External growth** | Growth that comes from outside the business, e.g. through a takeover or joint venture |
| **Horizontal integration** | Acquiring a business at the same stage of the supply chain |
| **Vertical integration** | Acquiring a business at either an earlier or later stage of the supply chain |
| **Joint venture** | A separate business entity created by two or more parties, involving shared ownership, returns and risks |

**Topic: Organic Growth**
*3.2 Business Growth*

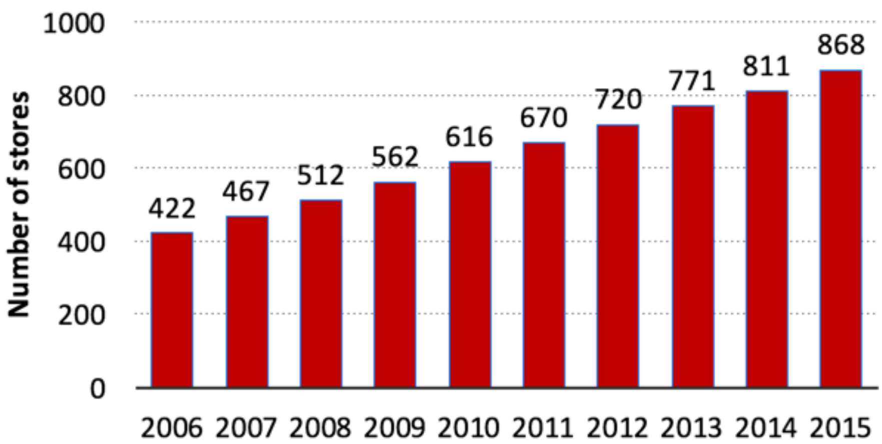
| **What You Need to Know** |
| --- |
| Distinction between inorganic and organic growth<br>Methods of growing organically<br>Advantages and disadvantages of organic growth |

**Methods of Business Growth**
Most business want to grow and there are a variety of methods this can be achieved. Let's look at the key features of each approach.

**Organic (Internal) Growth**
Organic growth involves expansion **from within a business**, for example by expanding the product range, or number of business units and locations.

Note: organic growth is also often called **"internal growth".**

A good example of organic growth is the increase in number of Dominos UK pizza outlets in the UK, as illustrated by the chart below:




The main benefits and drawbacks of organic growth can be summarised as follows:

| **Advantages** | **Disadvantages** |
| --- | --- |
| Less risk than external growth (e.g. takeovers) | Growth achieved may be dependent on the growth of the overall market |
| Can be financed through internal funds (e.g. retained profits) | Hard to build market share if business is already a leader |
| Builds on a business' strengths (e.g. brands, customers) | Slow growth – shareholders may prefer more rapid growth |
| Allows the business to grow at a more sensible rate | Franchises (if used) can be hard to manage effectively |

# Topic: Organic Growth
*3.2 Business Growth*

**Franchising**
Franchising is a common method of organic growth.

Franchising arises when a **franchisor grants a license (franchise) to another business (franchisee) to allow it trade using the brand / business format.**

Where appropriate, franchising is a classic growth strategy for a business (franchisor) that wants to allow others to license the right to trade using its **business format**:

- A classic growth strategy for a proven business format
- Enables much quicker geographical growth for a relatively low investment
- Still have the option to open locations that are operated by the Franchisor
- Capital investment by franchisees is an important source of growth finance

For a business that wants to operate a franchise (the franchisee) the key benefits and drawbacks are:

| Benefits for the Franchisee | Drawbacks for the Franchisee |
|---|---|
| Running your own business<br>Tried & tested brand<br>Advice, support, training<br>Easier to raise finance<br>Buying power of franchisor<br>Lower risk method of market entry + lower failure rate | Not cheap! Initial fees + royalties & commission<br>Restrictions on actions, including selling<br>Franchisor owns the brand<br>What happens if franchisor fails? |

**Key Terms**

| | |
|---|---|
| **Organic growth** | Growth that comes from within the business, e.g. through the launch of a new product or opening new locations |
| **External growth** | Growth that comes from outside the business, e.g. through a takeover or joint venture |

**Topic: 3.3.1 Quantitative Sales Forecasting**
*3.3 Decision-Making Techniques*

| **What You Need to Know** |
|---|
| Calculation of time-series analysis (moving averages)<br>Interpretation of scatter graphs & line of best fit – extrapolation of past data to future<br>Limitations of quantitative sales forecasting techniques |

**Why Does a Business Need or Want to Forecast Sales?**
Quantitative sales forecasting is a vital and common business planning activity: **a sales forecast forms the basis for most other common parts of business planning:**

- Human resource plan: how many people we need linked with expected output
- Production / capacity plans
- Cash flow forecasts
- Profit forecasts and budgets

**Moving Averages and Extrapolation**
Extrapolation involves the **use of trends established by historical data to make predictions about future values**.

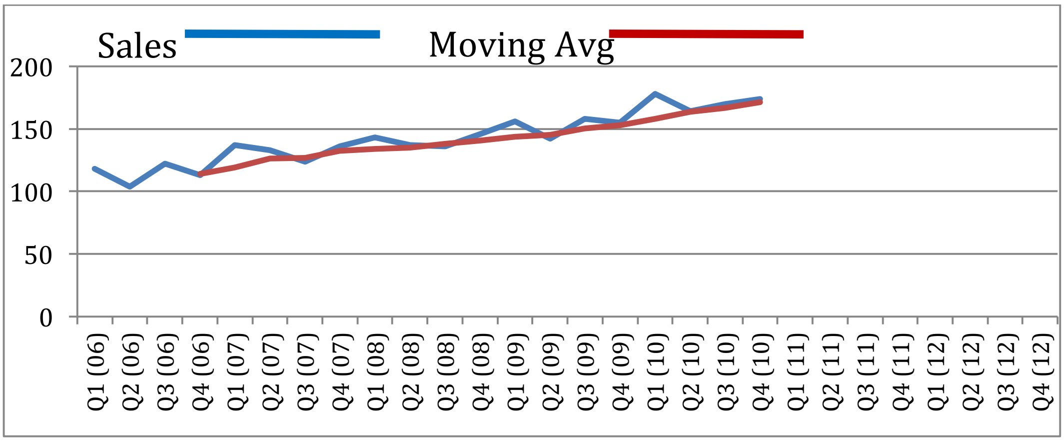
The basic assumption of extrapolation is that the trend / pattern will continue into the future unless evidence suggests otherwise.

The calculation and use of "moving averages" is often used as part of the process of extrapolation.

To understand these techniques further, look at the following chart that shows quarterly sales (£m) for a large business from Q1 Year'06 to Q4 (Year'10):

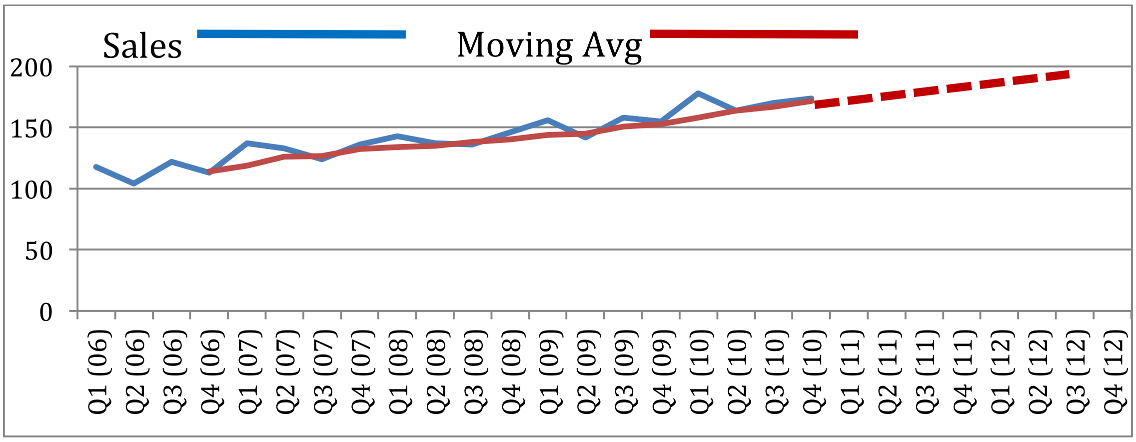
The blue line shows the actual quarterly sales figure. As you can see the sales total varies quarter by quarter, although you might guess from looking at the data that the overall trend is for a stead increase in sales.

The red line shows the **quarterly moving average.** This is calculated by adding the latest four quarters of sales (e.g. Q1 + Q2 + Q3 + Q4) and then dividing by four. This technique smoothes out the quarterly variations and gives a good indication of the overall trend in quarterly sales.




**The moving average helps point out the growth trend** (expressed as a percentage growth rate), and it is this which extrapolation would use first to predict the path of future sales.  This could be done mathematically using a spreadsheet.

Alternatively, an extrapolated trend can simply be drawn on the chart as a rough estimate, as shown below:




How useful is extrapolation?  The main benefits and drawbacks are summarised below:

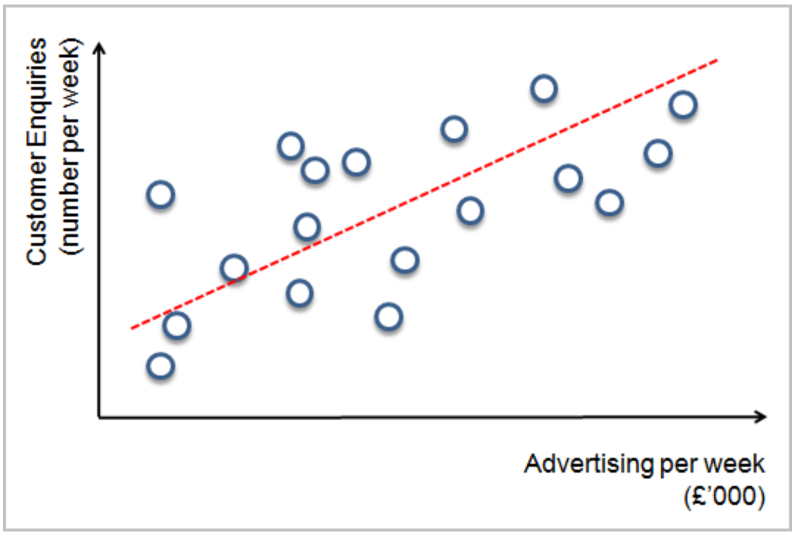
| **Benefits of Extrapolation** | **Drawbacks of Using Extrapolation** |
|---|---|
| A simple method of forecasting | Unreliable if there are significant fluctuations in historical data |
| Not much data required | Assumes past trend will continue into the future – unlikely in many competitive business environments |
| Quick and cheap | Ignores qualitative factors (e.g. changes in tastes & fashions) |

**Correlation**
Correlation is another method of **sales forecasting**. Correlation looks at the **strength of a relationship** between two variables.

## Topic: 3.3.1 Quantitative Sales Forecasting

*3.3 Decision-Making Techniques*

For marketing, it might be useful to know that there is a predictable relationship between sales and factors such as advertising, weather, consumer income etc. Correlation is usually measured by using a scatter diagram, on which data points are plotted. For example, a data point might measure the number of customer enquiries that are generated per week (x-axis) against the amount spent on advertising (y-axis). This is illustrated below:




It is normal convention to show the:

- **Independent variable** (the factor that causes the other variable to change) on the x-axis
- **Dependent variable** (the variable being influenced by the independent variable) on the y-axis

How might the marketing department make sense and use of all the data points once they have been plotted on the scatter diagram?

The answer is a **"line of best fit" (the regression line)** which attempts to plot the mathematical relationship between the variables based on the data points. This can be drawn by hand or using an Excel spreadsheet or specialist marketing software.

There are three kinds of possible correlation:

| | |
|---|---|
| **Positive correlation** | A positive relationship exists where as the independent variable increases in value, so does the dependent variable |
| **Negative correlation** | A negative relationship exists where as the independent variable increases in value, the dependent variable falls in value |
| **No correlation** | There is no discernible relationship between the independent and dependent variable |

The line of best fit indicates the strength of the correlation. Strong correlation means that there is little room between the data points and the line. Weak correlation means that the data points are spread quite wide and far away from the line of best fit.

If the data suggests strong correlation, then the relationship might be used to make marketing predictions.

The big danger with correlation is of believing there is really a **causal link** between two variables when, in fact, they are not related.

It is logical to believe that there is a causal link between the daily temperature and sales by ice-cream vans. However, is there a link between increasing childhood obesity and increasing disposal incomes for households? Both these variables have risen over the long-term, but they are probably not directly related.

**Limitations of Quantitative Sales Forecasting**
A variety of factors will impact the process of quantitative sales forecasting. The key ones are:

| | |
|---|---|
| **Consumer trends** | Demand in many markets changes as consumer tastes & fashions change<br>Affects both overall market demand & the market shares of existing competitors |
| **Economic variables** | Demand often sensitive to changes in variables such as exchange rates, interest rates, taxation etc.<br>Overall strength of the economy (GDP growth) also important |
| **Competitor actions** | These are often hard to predict, but often significant reason why sales forecasts prove over-optimistic |

The main reasons why sales forecasts often turn out to be pretty inaccurate when compared with actual sales achieved include:

- Business is new – a start-up (notoriously difficult to forecast sales)
- Market subject to significant disruption from technological change
- Demand is highly sensitive to changes in price and income (elasticity)
- Product is a fashion item
- Significant changes in market share (e.g. new market entrants)
- Management have demonstrated poor sales forecasting ability in the past!

**Key Terms**

| | |
|---|---|
| **Extrapolation** | The use of trends established by historical data to make predictions about future values. |
| **Correlation** | A method of forecasting that looks at the strength of a relationship between two variables |

**Topic: Investment Appraisal – Payback Period**
*3.3 Decision-Making Techniques*

| **What You Need to Know** |
|---|
| Investment appraisal: calculation and interpretation of simple payback |

## The Three Main Methods of Investment Appraisal

Payback period is one of three methods of investment appraisal that you need to be able to calculate and interpret:

| | |
|---|---|
| **Payback period** | The time it takes for a project to repay its initial investment |
| **Average rate of return** | Looks at the total accounting return for a project to see if it meets the target return |
| **Discounted cash flow (NPV)** | Net present value ("NPV") calculates the monetary value now of the project's future cash flows |

Payback period is unique in that it measures the return from investment in terms of a time period (years and days).

To calculate payback period:

- Identify the net cash flows for each period (e.g. year)
- Then keep a **running total** of the cash flows
- Initial investment = is nearly always an outflow
- Look to see when the running total move from negative (outflow) to positive (inflow)?
- When the total net cash flow becomes positive, that is the end of the payback period

An example of this approach is shown in the table below:

| **Year** | **Cash Flow Detail** | **Cash Flow £** | **Cumulative Cash Flow** | **Payback?** |
|---|---|---|---|---|
| **0** | Investment (cash outflow) | **(500,000)** | **(500,000)** | No |
| **1** | Net Cash Inflows | 100,000 | **(400,000** | No |
| **2** | Net Cash Inflows | 150,000 | **(250,000)** | No |
| **3** | Net Cash Inflows | 175,000 | **(75,000)** | No |
| **4** | Net Cash Inflows | 150,000 | **75,000** | Yes |

Payback in Year 4 can be calculated as follows:

*3 Years + the part of the $4^{th}$ Year when Payback was achieved*

$$3 + \left( \frac{£75{,}000}{£150{,}000} \right)$$

$$\boxed{3.5 \text{ years}}$$

**Benefits and Drawbacks of Using Payback Period**

These can be summarised as follows:

| **Benefits of Using Payback** | **Drawbacks of Using Payback** |
|---|---|
| Simple and easy to calculate + easy to understand the results<br>Focuses on cash flows<br>Emphasises speed of return; good for markets which change rapidly<br>Straightforward to compare competing projects | Ignores cash flows after payback has been reached<br>Takes no account of the “time value of money”<br>May encourage short-term thinking<br>Ignores qualitative aspects of a decision<br>Does not actually create a decision for the investment |

**Topic: Investment Appraisal – Average Rate of Return (ARR)**
*3.3 Decision-Making Techniques*

| **What You Need to Know** |
|---|
| Investment appraisal: calculation and interpretation of average rate of return |

**The Three Main Methods of Investment Appraisal**
Average rate of return ("ARR") is one of three methods of investment appraisal that you need to be able to calculate and interpret:

| | |
|---|---|
| **Payback period** | The time it takes for a project to repay its initial investment |
| **Average rate of return** | Looks at the total accounting return for a project to see if it meets the target return |
| **Discounted cash flow (NPV)** | Net present value ("NPV") calculates the monetary value now of the project's future cash flows |

**Calculating the ARR**
The key steps involved in calculating ARR are:

| | |
|---|---|
| **Step 1** | Calculate the average annual profit from the investment project |
| **Step 2** | Divide the average annual profit by the initial investment ("outlay") |
| **Step 3** | Compare with the target percentage return |

**A Worked Example**

| |
|---|
| A fashion retailer is planning to open 5 new stores next year. The initial investment will be £1,000,000.<br>The annual profits for these stores and the initial outlay (shop fitting etc.) is shown in the table below.<br>The target rate of return is 20%<br>What is the ARR for the 5 new stores? |

| Year | Annual Profit (£) |
|---|---|
| 1 | 100,000 |
| 2 | 250,000 |
| 3 | 400,000 |
| 4 | 500,000 |
| 5 | 500,000 |

*Working through the three steps, here's how to calculate ARR for this example:*

*Step 1: Average Annual Profit =*

*Total profits (150 + 250 + 400 +500 + 500)*
**Divided by**
*Number of Years (5)*

**£1,750,000 / 5**

**£350,000 Average Annual Profit**

*Step 2: Divide average annual profit by the initial outlay*

**£350,000 / £1,000,000**

**35%**

*Step 3: Compare the ARR with the target return*

**ARR: 35%**

**Target 20%**

**The ARR is significantly higher than the target return – suggesting the project should be accepted**

**Benefits and Drawbacks of Using ARR**

These can be summarised as follows:

| **Benefits of Using ARR** | **Drawbacks of Using ARR** |
|---|---|
| Simple to understand and easy to calculate<br>Focuses on the overall profitability of an investment project<br>Easy to compare ARR with other key target rates of return to help make a decision<br>Uses all the returns generated by a project | Ignores the timing of returns<br>Focuses on profits rather than cash flows<br>Does not adjust for the time-value of money |

**Topic: Investment Appraisal: Discounted Cash Flow (NPV)**
*3.3 Decision-Making Techniques*

| **What You Need to Know** |
|---|
| Investment appraisal: calculation and interpretation of net present value using discounted cash flows |

**The Three Main Methods of Investment Appraisal**
Discounted cash flow is one of three methods of investment appraisal that you need to be able to calculate and interpret:

| | |
|---|---|
| **Payback period** | The time it takes for a project to repay its initial investment |
| **Average rate of return** | Looks at the total accounting return for a project to see if it meets the target return |
| **Discounted cash flow (NPV)** | Net present value ("NPV") calculates the monetary value now of the project's future cash flows |

Discounted cash flow takes account of the "time value of money" to reduce (or "discount") the importance of cash flows arising further in the future.

So, discounting **is the method used to reduce the future value of cash flows to reflect the risk that they may not happen.**

**Why might it be important to take account of the time value of money?**

- It is surely better to receive cash now rather than in the future
- Future cash flows are worth less
- Using discount factors brings cash flows back to their "present value"
- The relevant discount factor is determined by the required rate of return

**How to Calculate Present Values?**
Each cash flow needs to be discounted before they can all be added up. This is done very simply by multiplying the cash flow by the relevant discount factor (which you will always be given):

**Cash Flow** X **Discount Factor**

= **Present Value**

For example:

**Cash Flow**
**£20,000**

**X**

**Discount Factor**
**0.9**

**=**

**Present Value**
**£20,000 x 0.9 = £18,000**

To get to the Net Present Value (NPV) of an investment project, we simply add all the present values together and consider whether the total is positive or negative.

**Accept the Project** — **Positive NPV**

**Reject the Project** — **Negative NPV**

An example of these calculations is provided in the table below:

| Year | Cash Flows | Net Flow | Discount Factor | Present Value |
|---|---|---|---|---|
| 0 | Investment | (100,000) | 1 | (100,000) |
| 1 | Project Profits | 40,000 | 0.91 | 36,400 |
| 2 | Project Profits | 50,000 | 0.83 | 41,500 |
| 3 | Project Profits | 60,000 | 0.76 | 45,600 |
| Total | | 50,000 | | 23,500 |

In the above example, the total of the present values (the NPV) is £23,500 – i.e. it is positive. This would normally suggest that the investment project should go ahead.

**Topic: Investment Appraisal: Discounted Cash Flow (NPV)**
*3.3 Decision-Making Techniques*

**Benefits and Drawbacks of Using Discounted Cash Flow (NPV)**
These can be summarised as follows:

| **Benefits of Using NPV** | **Drawbacks of Using NPV** |
|---|---|
| Considers all future cash flows<br>Reflects the risks that future cash flows will not be as expected<br>Different levels of risk can be accounted for by adjusting the discount rate<br>Creates a straightforward decision - positive NPV suggests project should go ahead | The most complicated method compared with Payback & ARR<br>Choosing the discount rate is hard, particularly for long projects<br>Result can be influenced / manipulated using the discount rate |

**Topic: Investment Appraisal – Interpretation & Limitations**
*3.3 Decision-Making Techniques*

| **What You Need to Know** |
|---|
| Interpreting investment appraisal & limitations of these techniques |

### Key Factors Influencing Investment Decisions
The key factors can be categorised into:

| **Financial Factors** | **Non-Financial Factors** |
|---|---|
| Investment criteria<br>Total returns (cash & profit) and sensitivity<br>Alternative investments (opportunity cost)<br>Financial position (e.g. liquidity, gearing) of the business | Corporate objectives<br>Organisational culture & attitude to risk<br>Management confidence in the investment appraisal data<br>Business image and reputation |

### Investment Criteria
Investment criteria are particularly important in determining whether or not to make an investment:

- Criteria = the measures by which an investment will be judged
- A target percentage rate of return is most common in business
- This target return can be compared with the ARR, or used as basis for the discount rate in NPV calculations
- Often larger businesses require investments to satisfy more than one criteria (e.g. positive NPV and above target ARR

### The Role of Corporate Objectives
As you have seen from your study of corporate objectives, these are the key strategic targets that the business wants to achieve. As such, they are bound to play a very influential role in investment decisions:

- Major investments need to be consistent with corporate aims and objectives
- For example, a objective of significant profit improvement through cost reduction would be consistent with approving investments in greater automation or efficiency

### Investment Decisions and Organisational Culture
Organisational (or corporate) culture is another important influence:

- All investment decisions involve an element of risk-taking
- The culture of a business is likely to significantly influence attitude to risk-taking
- The ways in which management are rewarded or accountable for investment decisions will also be important

### Uncertainty
- By their nature all business investment decisions involve some uncertainty
- Changes in the external environment can have a particularly significant impact on investment
- Contingency planning and sensitivity analysis can help businesses address the problems created by uncertainty

## Decision Trees
*3.3 Decision-Making Techniques*

| What You Need to Know |
|---|
| Construct & interpret simple decision tree diagrams<br>Calculations & interpretations of figures generated by those techniques<br>Limitations of using decision trees |

### Introduction

- A decision tree is a mathematical model used to help managers make decisions.
- A decision tree uses estimates and probabilities to calculate likely outcomes. Calculating these estimates helps to decide whether the net gain from a decision is worthwhile.

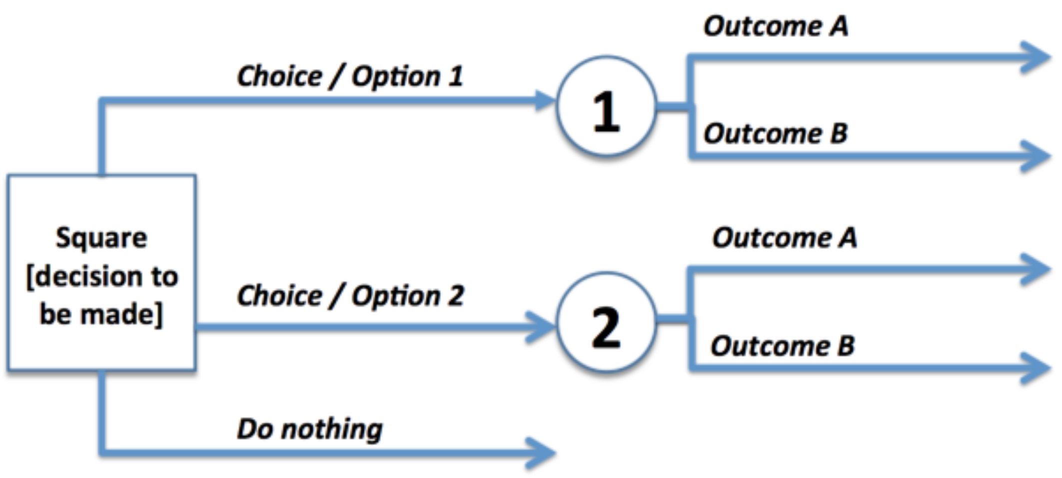
Let's look at an example of how a decision tree is constructed. We'll use the following data:

| **Decision Tree Example** | | |
|---|---|---|
| Clark Coffee operates a chain of five luxury coffee shops in Cheshire. It is looking at two options to increase revenues across the chain. The estimated impact of the two options on sales (and their probabilities) is shown below, as are the associated costs of each option. | | |
| | **Launch Loyalty Card** | **Cut Prices** |
| Cost of Option | £500,000 | £300,000 |
| Probability of High Sales | 0.6 | 0.8 |
| Probability of Low Sales | 0.4 | 0.2 |
| Result of High Sales | £1,000,000 | £800,000 |
| Result of Low Sales | £750,000 | £500,000 |

### Constructing the Decision Tree

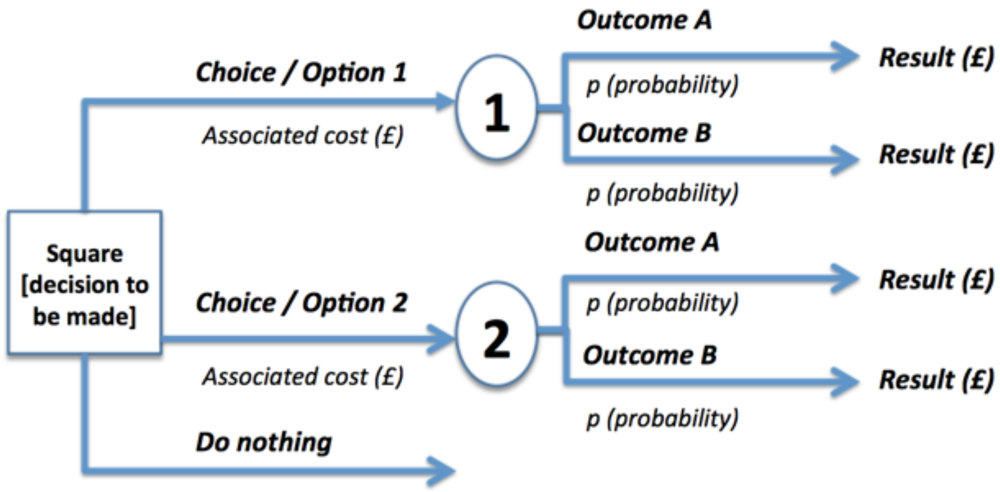
A decision tree starts with a decision to be made and the options that can be taken. Don't forget that there is always an option to decide to do nothing!

**The first task is to add possible outcomes to the tree (note: circles represent uncertain outcomes):**



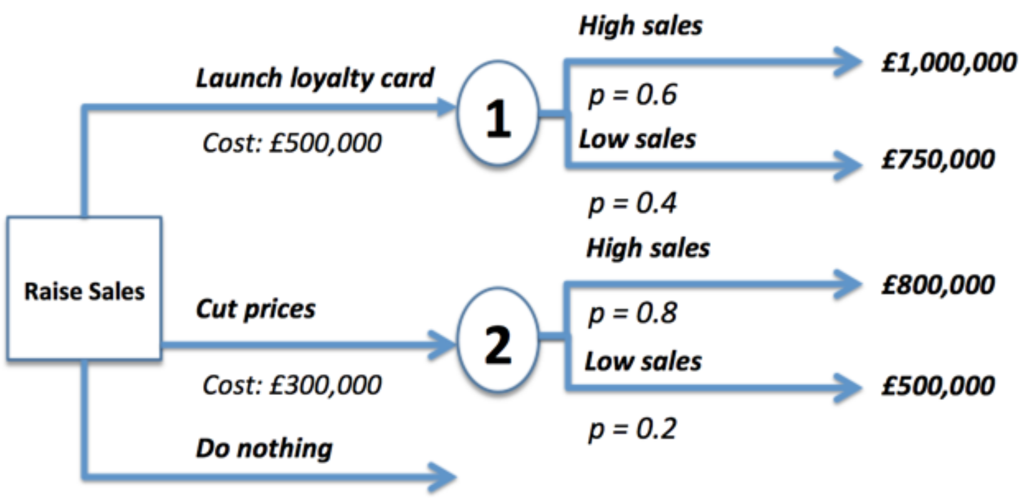
**Decision Trees**
*3.3 Decision-Making Techniques*

Next we add in the associated costs, outcome probabilities and financial results for each outcome.




These probabilities are particularly important to the outcome of a decision tree. Probability is

- The percentage chance or possibility that an event will occur
- Ranges between 1 (100%) and 0
- If all the outcomes of an event are considered, the total probability must add up to 1




Finally we complete the maths in the model by calculating:

- **Expected value:** this is the financial value of an outcome calculated by multiplying the estimated **financial effect by its probability**
- **Net gain:** this is the value to be gained from taking **a decision.** Net gain is calculated by adding together the expected value of each outcome and deducting the costs associated with the decision.

Let's look at the calculations. What do they suggest is the best option?

| Option: Launch Loyalty Card | Option: Cut Prices |
|---|---|
| High sales: (0.6 x £1,000,000) = £600,000<br>Low sales: (0.4 x £750,000) = £300,000<br>Total expected value = £900,000<br>**Net gain: £900,000 - £500,000 = £400,000** | High sales: (0.8 x £800,000) = £640,000<br>Low sales: (0.2 x £500,000) = £100,000<br>Total expected value = £740,000<br>**Net gain: £740,000 - £300,000 = £240,000** |

Both options indicate a positive net gain, suggesting that either would be better than doing nothing.

However, launching the loyalty card has a higher net gain & looks the best option of the two considered

**Benefits and Drawbacks of Using Decision Trees**
These can be summarised as follows:

| Benefits | Drawbacks |
|---|---|
| Choices are set out in a logical way<br>Potential options & choices are considered at the same time<br>Use of probabilities enables the "risk" of the options to be addressed<br>Likely costs are considered as well as potential benefits<br>Easy to understand & tangible results | Probabilities are just estimates – always prone to error<br>Uses quantitative data only – ignores qualitative aspects of decisions<br>Assignment of probabilities and expected values prone to bias<br>Decision-making technique doesn't necessarily reduce the amount of risk |

**Key Terms**

| | |
|---|---|
| **Expected value** | Financial value of an outcome calculated by multiplying the estimated financial effect by its probability |
| **Net gain** | The expected value of each outcome less the costs associated with the decision |

## Topic: Critical Path Analysis
*3.3 Decision-Making Techniques*

| What You Need to Know |
|---|
| • Nature and purpose of critical path analysis |
| • Complete & interpret simple networks to identify the critical path |
| • Calculate: earliest start time; latest finish time; total float |
| • Limitations of using critical path analysis |

### Introduction
Network, or as it is otherwise known - critical path analysis ("CPA") - is a widely-used **project management tool** that uses network analysis to **help project managers handle complex and time-sensitive operations.**

Many larger businesses get involved in projects that are complex and involve significant investment and risk. As the complexity and risk increases it becomes even more necessary to identify the relationships between the activities involved and to work out the most efficient way of completing the project.

### Building the CPA Model
The essential technique for using CPA is to construct a model of the project that includes the following:

- A list of all activities required to complete the project
- The time (duration) that each activity will take to completion
- The dependencies between the activities

Using this information, CPA calculates:
- The longest path of planned activities to the end of the project
- The earliest and latest that each activity can start and finish without making the project longer

This process determines which activities are **"critical" (i.e., on the longest path)** and which have **"total float"** (i.e. can be delayed without making the project longer).

In project management, a critical path is:
***The sequence of project activities which add up to the longest overall duration***

The critical path determines the shortest time possible to complete the project.

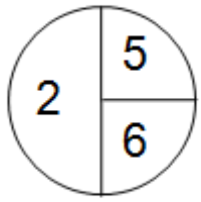
Any delay of an activity on the critical path directly impacts the planned project completion date (i.e. there is no float on the critical path).

### Illustrating CPA

Here is worked example to illustrate how the critical path for a project is determined.
Conventions in drawing the network

The main components of a network analysis are summarised below:

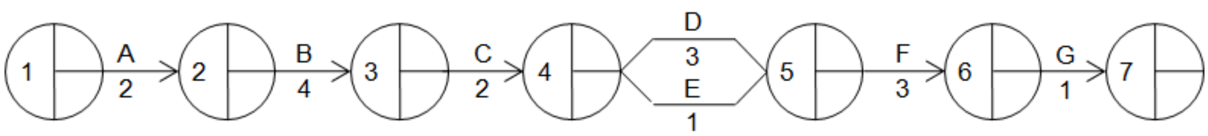
## Topic: Critical Path Analysis
*3.3 Decision-Making Techniques*

| **Component** | **Description** |
|---|---|
| **Node** | A circle that represents a point in time where an activity is started or finished. The node (circle) is split into three sections:<br><br><br>The left half of the circle is the unique node (activity) number – the network diagram draws these in order<br>The top right section shows the earliest start time (EST) that an activity can commence based on the completion of the previous activity<br>The bottom right section shows the latest finish time (LFT) by which the previous activity must be completed |
| **Activities** | An activity is something that takes time. An activity is shown on the network as a line, linking the nodes (circles). A description of the activity, or a letter representing the activity, is usually shown above the relevant line |
| **Duration** | The length of time it takes to complete an activity – shown as a number of the relevant units (e.g. hours, days) under the activity line |

**Example Network Diagram**
Consider the following series of activities in a business planning to launch a new product:

| Task | Activity | Order | Duration (months) |
|---|---|---|---|
| A | Conduct customer research | Starting activity | 2 |
| B | Design product concept | Begin when A complete | 4 |
| C | Design and test product prototype | Begin when B complete | 2 |
| D | Develop and test production tooling | Begin when C complete | 3 |
| E | Notify suppliers of requirements | Begin when C complete | 1 |
| F | Commence production | Begin when D complete | 3 |
| G | Conduct launch promotion | Begin when F complete | 1 |

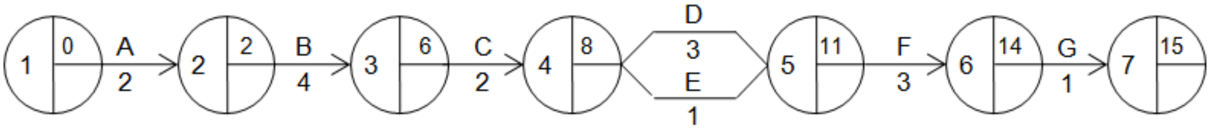
Laid out in the correct sequence of activities, the network diagram would look like this before we calculate the EST and LFT for each activity:



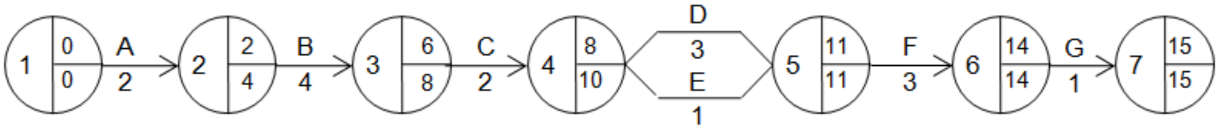

The next step is to calculate the EST for each activity.

For example:
The EST for task B is 2 months – the time taken to conduct market research (task A)
To calculate the EST for task C, we add the 2 months for task A to the 4 months for designing the product concept (task B) = 6 months
The remaining ESTs can then be added to the network diagram:

**Topic: Critical Path Analysis**
*3.3 Decision-Making Techniques*




The LFTs show the latest time an activity must be completed by to avoid a delay to the project. LFTs are calculated by looking right to left on the network diagram. So:




**Evaluating Network Analysis / CPA**
The main advantages and disadvantages of a business using CPA can be summarised as follows:

| **Advantages** | **Disadvantages** |
|---|---|
| Most importantly – helps reduce the risk and costs of complex projects | Reliability of CPA largely based on accurate estimates and assumptions made |
| Encourages careful assessment of the requirements of each activity in a project | CPA does not guarantee the success of a project – that still needs to be managed properly |
| Help spot which activities have some slack ("float") and could therefore transfer some resources = better allocation of resources | Resources may not actually be as flexible as management hope when they come to address the network float |
| A decision-making tool and a planning tool – all in one! | Too many activities may the network diagram too complicated. Activities might themselves have to be broken down into mini-projects |
| Provides managers with a useful overview of a complex project | |
| Links well with other aspects of business planning, including cash flow forecasting and budgeting | |

Key Terms

| | |
|---|---|
| **Critical path analysis** | A management planning tool to help manage complex and time-critical projects |

# Topic: Corporate Timescales
*3.4 Influences on Business Decisions*

| **What You Need to Know** |
|---|
| Short-termism versus long-termism |

**What is Short-termism?**
Short-termism is where a business **prioritises short-term rather than long-term performance.**

There are various reasons why the management of a business might be more concerned more with how the business performs in the short, rather than the long-term. These might include:

- Stock market (investor) focus on latest financial performance (e.g. shareholder pressure to see a rising share price)
- Bonuses and other financial incentives for management that are largely based on short-term performance
- Frequent changes in leadership & strategy (e.g. through takeover)

A short-termist approach is likely to involve management focusing on the following performance measures:

- Share price and market capitalisation
- Revenue growth
- Gross & operating profit
- Unit costs & productivity
- Return on capital employed

If you were looking for possible symptoms of short-termist management you might identify this from features such as:

- Low investment in R&D (particularly compared with competitors who make take a more long-term approach)
- High dividend payments rather than reinvesting profits
- Overuse of takeovers rather than internal growth

A common criticism of short-termism is that it does not focus a business on what it needs to do in order to build a sustainable competitive advantage. For example, some of the following performance measures might be considered to be more appropriate for a business taking a long-term rather than short-term perspective:

- Market share
- Quality (including reputation)
- Innovation
- Brand awareness and strength
- Employee skills & experience
- Social responsibility & sustainability

**Topic: Corporate Timescales**
*3.4 Influences on Business Decisions*

**Long-termism**
An increasing number of business leaders like Paul Polman (CEO of Unilever) argue that short-termism is highly damaging both to business and societal needs. They argue that it is much more important to take a long-term (or long-termist) approach business decision-making and objectives.

Since Polman took over as CEO in 2009 Unilever has stopped updating the stock market on its performance every quarter to encourage a long-term perspective, and it has launched a sustainable living plan.

The Mittelstand sector in Germany is often used as the best example of what can be achieved if businesses take a long-termist approach to their timescales.

Germany has more than 1,000 companies that have been in the same family for generations but can compete with the world's best. These companies and over 99 percent of all German companies are part of the 'Mittelstand', contributing nearly 52 percent of the country's economic output and employing more than 15 million people.

The key features of Mittelstand companies are:

- Family ownership or family-like corporate culture
- Generational continuity
- Long-term investment focus & focus on R&D
- Fiercely independent
- Investment into the workforce
- Flexibility
- Lean organisational hierarchies
- Focus on innovation and customer service
- Take corporate social responsibility seriously

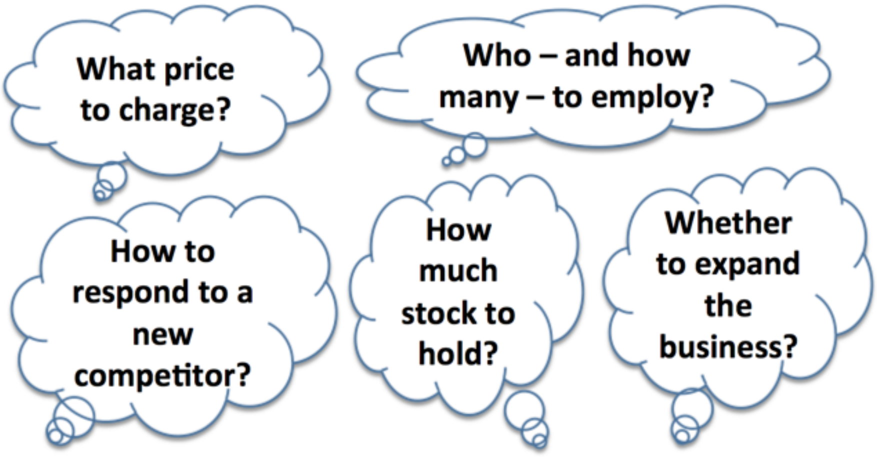
## Topic: Evidence-Based Versus Subjective Decision Making

*3.4 Influences on Business Decisions*

| What You Need to Know |
| --- |
| Evidence-based versus Subjective Decision Making |

**Introduction to Decision-Making**

The need to make decisions is at the heart of setting up, leading and managing a business. Decision-making takes place all the time at various levels within a business – all the way from the top corporate (board) level through the actions of employees at the "shop-floor". Examples of decisions include:




**Key Influences on Business Decision-Making**

The approach taken to making business decisions is influenced by a variety of factors, the key ones of which are outlined below:

- **Business Objectives / Budgets**
    - Set the scene for how decisions are made
    - A culture of strong budgetary control should encourage more data & evidence-driven decisions
- **Organisational Structure - Who Makes the Decisions?**
    - Who has authority to take decisions?
    - Are employees to empowered to take decisions to deliver more responsive customer service
    - Is decision-making centralised or decentralised?
- **Attitude to Risk**
    - Close link to business culture
    - Is risk-taking encouraged?
    - What are the penalties for poor decisions?
- **Availability & Reliability of Data**
    - Is the data available to support a scientific approach?
    - Are management comfortable with using scientific methods? Do they have the right skills and experience?
- **The External Environment**
    - How fast is the external environment changing?
    - Do the uncertainties in the external environment make scientific approaches less reliable?

**Topic: Evidence-Based Versus Subjective Decision Making**
*3.4 Influences on Business Decisions*

**Evidence-Based V Subjective: Two Broad Approaches to Decision-Making**
There are two main ways in which business decisions are made:

| Subjective | Evidence-Based |
|---|---|
| Based on **intuition, gut feel and experience**<br>Key benefit – quick!<br>But hard to justify for business decisions involving significant risk | Based on **data and analysis**<br>Downside: time-consuming & costly; no guarantee of the right decision<br>Increasingly common and automated, supported by Big Data and data analytics |

**Reasons Why Evidence-Based Decision-Making is Becoming More Popular**
- More widespread availability of data (in particular big data)
- Greater sophistication of data analytics & skills / experience of data analysts
- Management expectation that data will be used wherever possible, particularly where a decision is significant to the business

## Topic: Corporate Culture

*3.4 Influences on Business Decisions*

| What You Need to Know |
|---|
| How corporate culture is formed<br>Strong and weak cultures<br>Classification of company cultures (Handy):<br>Power \| Role \| Task \| Person<br>Difficulties in changing corporate culture |

### What is Organisational Culture?

Although most of us understand in our own minds what is meant by organisational culture, it is hard to define precisely. We know (and can often sense) a "culture" exists when we visit a business as a customer or work there, but how can this be explained?

Charles Handy described organisational (or corporate) culture as:

**"The way we do things around here"**

Culture consists of factors such as:

- The shared values of a business
- The beliefs and norms that affect every aspect of work life
- The behaviours typical of day-to-day behaviour
- The strength of a culture determines how difficult or easy it is to know how to behave in the business

The culture of a business is reflected in many ways – including:

- How employees are recruited – the cultural factors that make one applicant more suitable than another
- The way that visitors and guests are looked after
- How the working space is organised
- The degree of delegation & individual responsibility
- How long new employees stay in a business
- How contracts are negotiated and agreed
- The personality and style of the sales force
- The responsiveness of communication
- The methods used for communication
- How staff call each other (e.g. first name)
- The nature and style of marketing materials
- The speed with which decisions are taken
- The number of layers in the management hierarchy

### Strong v Weak Culture

When you visit a range of businesses you soon get a sense of the strength of the business culture. If a culture can be measured as then how might this show itself?

**Signs of a strong organisational culture include:**

- Staff understand and respond to culture
- Little need for policies and procedures
- Consistent behaviour
- Culture is embedded

**Evidence that points to a weak organisational culture include:**

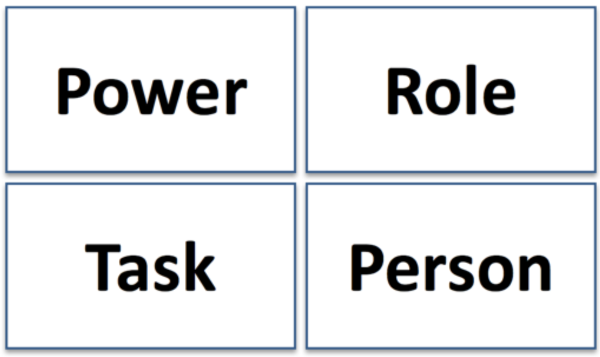
- Little alignment with business values
- Inconsistent behaviour
- A need for extensive bureaucracy & procedures

**Note: strong culture is particularly hard to change!**

**Handy's Model of Organisational Culture**

Charles Handy, a leading authority on organisational culture, defined four different kinds of culture:

- **Power culture**
- **Role culture**
- **Task culture**
- **Person culture**




Let's summarise what each of those kinds of organisational culture mean, according to Handy:

**Power Culture**

In an organisation with a power culture, power is held by just a few individuals whose influence spreads throughout the organisation.

There are few rules and regulations in a power culture. What those with power decide is what happens. Employees are generally judged by what they achieve rather than how they do things or how they act. A consequence of this can be quick decision-making, even if those decisions aren't in the best long-term interests of the organisation.

A power culture is usually a strong culture, though it can swiftly turn toxic. The collapse of Enron, Lehman Brothers and RBS is often attributed to a strong power culture.

**Role Culture**

Organisations with a role culture are based on **rules**. They are highly controlled, with everyone in the organisation knowing what their roles and responsibilities are. Power in a role culture is determined by a person's position (role) in the organisational structure.

Role cultures are built on detailed organisational structures which are typically tall (not flat) with a long chain of command. A consequence is that decision-making in role cultures can often be painfully-slow and the organisation is less likely to take risks. In short, organisations with role cultures tend to be very bureaucratic.

**Task Culture**
Task culture forms when teams in an organisation are formed to address specific problems or progress projects. The task is the important thing, so power within the team will often shift depending on the mix of the team members and the status of the problem or project.

Whether the task culture proves effective will largely be determined by the team dynamic. With the right mix of skills, personalities and leadership, working in teams can be incredibly productive and creative.

**Person Culture**
In organisations with person cultures, individuals very much see themselves as unique and superior to the organisation.

The organisation simply exists in order for people to work. An organisation with a person culture is really just a collection of individuals who happen to be working for the same organisation. Perhaps some Premier League football teams have a person culture!

**Key Influences on Organisational Culture**
Organisational culture is complex and is built on a variety of influences, some of which will be much more important than others in certain organisations. Key influences include:

- Influence of the founder **("shadow of the leader")**
- Size & development stage of the business (e.g. start-up, multisite, multinational)
- Leadership & management style
- Organisational structure, policies & practices
- Employee & management reward structures (e.g. pay, bonuses, individual v team rewards)
- Market /industries in which it operates
- Working environment & nature of tasks (e.g. physical, office, remote working, flexible working)
- External environment (e.g. legal, economic)
- Attitude of organisation to risk-taking & innovation

**What Are the Signs that Organisational Culture Might Need Changing?**
Attempts to change organisational culture are often associated with other transformational ("step") change projects in organisations.

Accordingly, the signs that culture may need to change are often the same symptoms of the need for broader organisational change, including:

- Declining profits and sales
- Inadequate returns on investment
- Low quality or standards of customer service
- Loss of market share
- Failure to innovate

The above list are largely strategic business issues. Other culture-related symptoms might point to a more deep-seated problem with culture that needs to be addressed, such as:

- Internal fighting; management criticism ("us & them mentality")
- High levels of voluntary staff turnover & hard to retain top talent
- Greater absenteeism
- Processes become more bureaucratic
- Innovation is no longer valued
- Evidence of declining customer service
- Leadership show double standards or decision-making becomes inconsistent
- Communication becomes more closed and restricted

**Changing Organisational Culture is Hard**
Almost by definition, if an existing organisational culture is strong (i.e. deeply embedded) then it is going to be hard to change, particularly in the short-term.

Professor Ed Schein, an expert on organisational culture, argues that senior management should never start with the intention of changing a culture. Instead they should start with the issues that the organisation faces and assess whether the existing culture gets in the way of resolving those issues.

Schein argues that management should always think first of the organisational culture as a source of strength even if some elements are dis-functional. If major changes are needed, try to build on existing cultural strengths.

## Topic: Shareholders versus Stakeholders

*3.4 Influences on Business Decisions*

| **What You Need to Know** |
|---|
| Internal & external stakeholders<br>Stakeholder objectives<br>Stakeholder & shareholder influences<br>Potential for conflict between shareholders and stakeholders |

**What is a Stakeholder?**

A stakeholder is any individual or organisation who has a **vested interest** in the **activities and decision making** of a business.

Shareholders (the owners of a business) are one example of stakeholders, but the two terms are easily confused. There is a difference:

| **Shareholders** | **Other Stakeholders** |
|---|---|
| Own the business | Have an interest in the activities of the business – but do not own it |
| May also work in the business | May work for (employees) or otherwise transact with the business |
| Benefit directly from increases in the value of the business | Can benefit from the success of the business, but don't directly share the value of the business |

Of course it is possible to be both a shareholder and stakeholder. For example, employees are often shareholders in a business (particularly larger firms with a public stick market quotation).

**Main Stakeholders in a Business**

The key stakeholders in a business can be grouped as follows:

| **INTERNAL** | **CONNECTED** | **EXTERNAL** |
|---|---|---|
| *Internal to the business* | *Connected by a relationship based on a contract* | *Relationship not based on a legal contract* |
| Managers & employees | Customers | Government |
| Shareholders /owners | Suppliers | Competitors |
| | Creditors | Society |

## Topic: Shareholders versus Stakeholders

*3.4 Influences on Business Decisions*

### Key Interests of Main Stakeholder Groups

Stakeholders have different interests in the activities of a business. For example:

| STAKEHOLDER | MAIN INTERESTS |
|---|---|
| **Shareholders / owners** | Return on investment + profits and dividends<br>Success and growth of the business<br>Proper running of the business |
| **Managers & employees** | Rewards, including basic pay and other financial incentives<br>Job security & working conditions<br>Promotion opportunities + job satisfaction & status – motivation, roles and responsibilities |
| **Customers** | Value for money<br>Product quality & customer service |
| **Suppliers** | Continued, profitable trade with the business<br>Financial stability – can the business pay its bills? |
| **Banks & other finance** | Can the business repay amounts loaned or invested?<br>Profitability and cash flows of the business<br>Growth in profits and value of the business |
| **Government** | The correct collection and payment of taxes (e.g. VAT)<br>Helping the business to grow – creating jobs<br>Compliance with business legislation |
| **Society** | Success of the business – particularly creating and retaining jobs<br>Compliance with local laws and regulations (e.g. noise, pollution) |

### Managing Conflicts Between Stakeholders

Given their different interests in the business, it is inevitable that **conflicts** arise between stakeholders. For example:

| Business Decision | Likely to be Supported By | Possibly Opposed By? |
|---|---|---|
| Cut jobs to reduce costs | Shareholders<br>Banks | Employees<br>Local community |
| Add extra shifts to increase factory capacity | Management<br>Customers & suppliers | Local community |
| Introduce new machinery to replace manual work | Customers<br>Shareholders | Employees |
| Increase selling prices significantly to improve profit margins | Shareholders<br>Management | Customers |

To manage its stakeholders well, a business effectively to make choices. It is very difficult to meet the needs of every stakeholder group and most decisions will end up being "win-lose": i.e. supporting one stakeholder means another misses out. How should a business respond to variations in stakeholder power and influence? The matrix below provides some guidance on the approach often taken:

## Topic: Shareholders versus Stakeholders

*3.4 Influences on Business Decisions*

| | **High Level of Stakeholder Interest** | **Low Level of Stakeholder Interest** |
|---|---|---|
| **High Level of Stakeholder Power** | Key players<br>Take notice of them<br>Engage directly with them | Keep them satisfied |
| **Low Level of Stakeholder Power** | Communicate regularly with them | Communicate only when necessary |

### Key Terms

| | |
|---|---|
| **Shareholder** | An owner of a business |
| **Stakeholder** | Someone who has an interest in the activities of a business |

## Topic: Business Ethics

*3.4 Influences on Business Decisions*

| **What You Need to Know** |
|---|
| Ethics of strategic decisions: trade-off between profit and ethics \| pay & rewards |

**What are Ethics?**

Ethics are **moral guidelines** which govern **acceptable behaviour.**

Ethical behaviour (in life generally as well as in business) is about **doing what is morally right**.

In business, ethical standards play a crucial role in decision-making:

- Used by individuals to make choices about how to behave
- They define acceptable conduct in business
- Should underpin decision making
- An ethical decision is one that is both legal and meets the shared ethical standards of the relevant business community
- Note: different countries and cultures have different attitudes to what constitutes acceptable ethical behaviour!

**Business Benefits and Drawbacks of Ethical Behaviour**

Whilst we might instinctively feel that acting ethically is the right thing to do in business, it is worth remembering that there are benefits and potential drawbacks of so doing:

| **Potential Benefits** | **Potential Drawbacks** |
|---|---|
| Higher revenues – demand from positive consumer support<br>Improved brand and business awareness and recognition<br>Better employee motivation and recruitment<br>New sources of finance – e.g. ethical investors | Higher costs – e.g. sourcing from Fairtrade suppliers rather than lowest price<br>Higher overheads – e.g. training & communication of ethical policy<br>A danger of building up false expectations |

**Ethics and Business Decisions**

Business ethics are tested every day in business decision-making and activities. Ethical issues arise most commonly in business areas such as:

- Pay & rewards
- Advertising and other promotion
- Personal selling
- Supplier contracts
- Treatment of employees
- Pricing

**Topic: Business Ethics**
*3.4 Influences on Business Decisions*

**Pay and Rewards**
The ways that employees and management are rewarded can create significant ethical issues.

The strong "bonus culture" in financial services is a good example of this. Driven by the incentive of large bonuses, do management cut corners or break the rules?

What about the way that senior management are often paid many more times the remuneration of others in a business – the so-called "fat cats". Is it ethical that CEOs should be paid hundreds of more times better than the average for employees in their businesses?

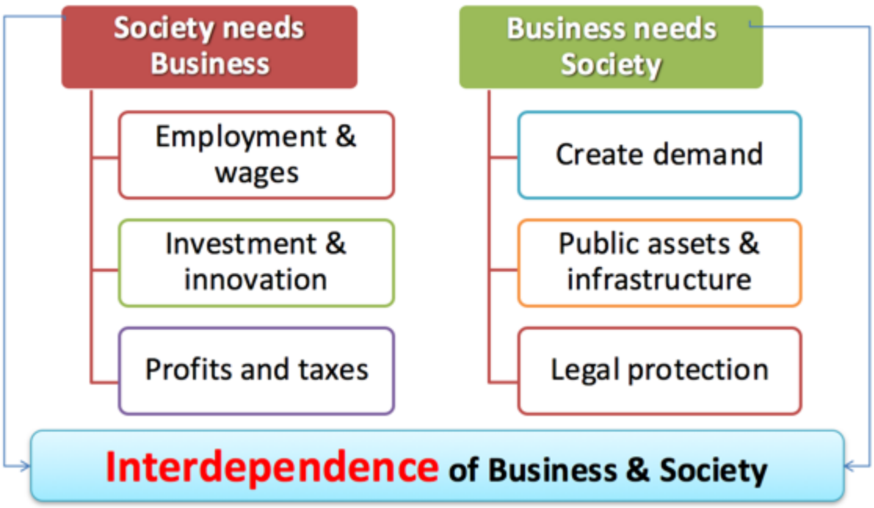
**Topic: Corporate Social Responsibility**
*3.4 Influences on Business Decisions*

| What You Need to Know |
|---|
| Corporate Social Responsibility (CSR) |

**What is Corporate Social Responsibility (CSR)?**
CSR is concerned with:

- The extent to which a business addresses the concerns and obligations to its wider stakeholders
- The actions a business takes over and above the minimum required by law in addressing societal needs and wants

CSR is Based on the Idea that the Needs of Business & Society are Interdependent




**The Debate on the Importance of CSR**

Not all business organisations behave in a socially responsible manner. Some argue that it is not the job of businesses to be concerned about social issues and problems.

In framing the debate, you need to know that there are two main schools of thought:

- **Corporate social responsibility view:** business should be concerned with social issues. This is also known as the **Stakeholder Concept.**
- **Free market view:** the job of business is to create wealth for shareholders. This is also known as the **Shareholder Concept**.

**The Stakeholder Concept**
The key arguments underpinning the stakeholder concept are:

- Businesses do not have an unquestioned right to operate in society
- Those managing business should recognise that they depend on society
- Business relies on inputs from society and on socially created institutions
- There is a social contract between business and society involving mutual obligations that society and business recognise that they have to each other

## Topic: Corporate Social Responsibility
*3.4 Influences on Business Decisions*

The key arguments for businesses embracing CSR are:

- It is the ethical thing to do
- Improves a business' image and reputation
- Necessary in order to avoid excessive regulation
- Socially responsible actions can be profitable
- Improved social environment benefits business
- Helps attract investors
- Can increase employee motivation
- Helps to corrects the social problems caused by business

**The Shareholder Concept**
The shareholder concept is closely associated with the writings of US economist Milton Friedman who argued that:

**"…the only one responsibility of business towards the society is the maximisation of profits to the shareholders, within the legal framework and the ethical custom of the country"**

The key arguments for businesses focusing on meeting the needs of shareholders rather than wider societal needs include:

- The only social responsibility of business is to create shareholder wealth
- The efficient use of resources will be reduced if businesses are restricted in how they act
- Businesses cannot decide what is in society's interest
- Extra costs will be incurred which must be passed on to consumers
- CSR stifles innovation

## Topic: Statement of Comprehensive Income

*3.5 Assessing Competitiveness*

| What You Need to Know |
|---|
| Statement of comprehensive income (profit and loss account): key information \| stakeholder interest |

**What is the Statement of Comprehensive Income ("Income Statement)?**

The Income Statement is one of the three main financial accounts of a business:

| | |
|---|---|
| **Income statement (profit and loss)** | This measures the business' **performance** (income & costs) over a given period of time, usually one year |
| **Statement of Financial Position (balance sheet)** | A **snapshot** of the business' assets (what it owns or is owed) and its liabilities (what it owes) on a particular day |
| **Cash flow statement** | Shows how the business has generated and disposed of cash and liquid funds during a specific period |

An example Income Statement is shown below.

| All figures in £'000 | This Year | Last Year |
|---|---|---|
| **Revenue** | **3,500** | **2,750** |
| Cost of Sales | (1,700) | (1,300) |
| **Gross Profit** | **1,800** | **1,450** |
| Administrative Expenses | (650) | (550) |
| **Operating Profit** | **1,150** | **900** |
| Net Finance Costs | (75) | (80) |
| Taxation | (250) | (150) |
| **Profit for the Year** | **825** | **670** |

A brief explanation of each key line in the income statement is provided in the table below:

| Category | Explanation |
|---|---|
| **Revenue** | Revenues (sales) during the period. |
| **Cost of sales** | Direct costs of generating revenues go into "cost of sales". Includes the cost of raw materials, components, goods bought for resale and the direct labour costs of production |
| **Gross profit** | The difference between revenue and cost of sales. A simple but very useful measure of how much profit is generated from every £1 of revenue before overheads and other expenses are taken into account. Is used to calculate the gross profit margin (%) |

## Topic: Statement of Comprehensive Income

*3.5 Assessing Competitiveness*

| | |
|---|---|
| **Administration expenses** | Operating costs and expenses that are not directly related to producing the goods or services are recorded here. Includes distribution costs (e.g. marketing, transport) and the wide range of administrative expenses or overheads that a business incurs |
| **Operating profit** | A key measure of profit. Operating profit records how much profit has been made in total from the trading activities of the business before account is taken of how the business is financed. |
| **Finance expenses** | Interest paid on bank and other borrowings, less interest income received on cash balances. A useful figure for shareholders to assess how much profit is being used up by the funding structure of the business. |
| **Taxation** | An estimate of the amount of corporation tax that is likely to be payable on the profits for the period. |
| **Profit for the year** | The amount of profit that is left after the tax has been accounted for. Shareholders then decide how much of this is paid out to them in dividends and how much is left in the business ("retained profits"). |

**Stakeholder Interest in the Income Statement**

As the most important financial statement concerned with the performance of a business, the Income Statement is widely used by many business stakeholders. For example:

| **Who** | **Stakeholder Interest** |
|---|---|
| **Shareholders** | How much profit is our business making?<br>How much profit can be distributed to us in dividends? |
| **Competitors** | What is the profit (amount) and profitability (% margin)?<br>Is the business more efficient or does it add more value? |
| **Government** | How much tax should this business pay on its profits? |
| **Employees** | How secure is the business in terms of profit or loss?<br>If bonuses are based on profit, has it been achieved? |

**Topic: Statement of Financial Position**
*3.5 Assessing Competitiveness*

| What You Need to Know |
|---|
| Statement of financial position (balance sheet): key information \| stakeholder interest |

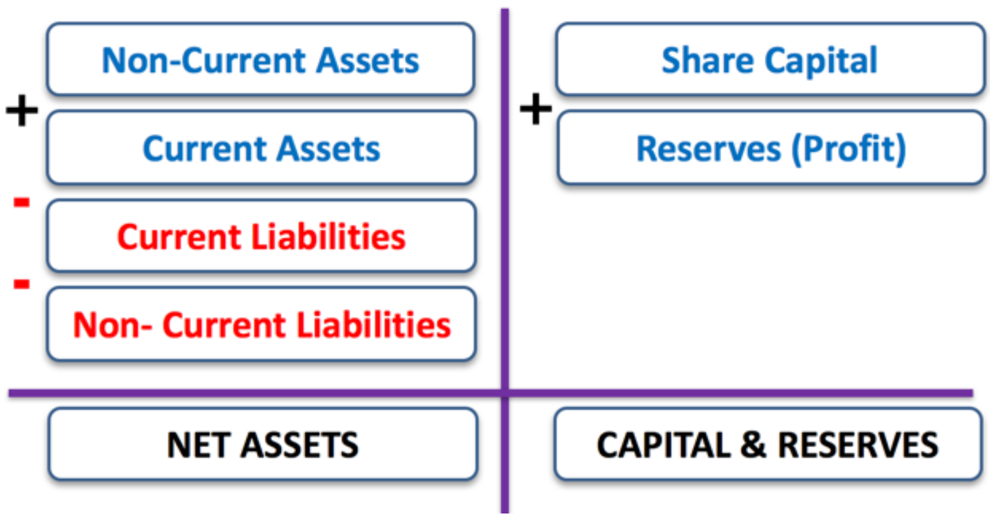
### What is the Statement of Financial Position (Balance Sheet)?

The Statement of Financial Position is one of the three main financial accounts of a business:

| | |
|---|---|
| **Income statement (profit and loss)** | This measures the business' **performance** (income & costs) over a given period of time, usually one year |
| **Statement of Financial Position (balance sheet)** | A **snapshot** of the business' assets (what it owns or is owed) and its liabilities (what it owes) on a particular day |
| **Cash flow statement** | Shows how the business has generated and disposed of cash and liquid funds during a specific period |

### Structure of the Balance Sheet

There are two sides to a balance sheet, which are summarised below:




### Stakeholder Interest in the Statement of Financial Position

The Statement of Financial position is a snapshot of the assets, liabilities and capital structure of a firm at a moment in time. Accordingly, key stakeholder interests include:

| | |
|---|---|
| **Creditors** | What is the liquidity position of the business?<br>Is the business able to pay its debts as they fall due? |
| **Banks & other lenders** | How much debt does the business have (gearing)?<br>Is it able to finance its debt<br>What cash and other liquid balances does it have? |
| **Employees** | Is the business solvent?<br>Does the business have a suitably strong liquidity position? |

**Topic: Gearing**
*3.5 Assessing Competitiveness*

| What You Need to Know |
|---|
| Financial ratio analysis – gearing ratio |

### What is "Gearing"

"Gearing" measures the proportion of a business' capital (finance) provided by **debt**

### What is the Capital Structure of a Business?

The capital of a business represents the finance provided to it to enable it to operate over the long-term. There are two parts to the capital structure: equity and debt

| Equity Finance | Debt Finance |
|---|---|
| Amounts invested by the owners of the business | Finance provided to the business by external parties: |
| Examples:<br>Share capital<br>Retained profits | Examples:<br>Bank loans<br>Other long-term loans |

### What Factors Influence the Mix of Equity and Debt in a Financial Structure?

These factors can be summarised as follows:

| Reasons for Higher Equity | Reasons for Higher Debt |
|---|---|
| Where there is greater business risk (e.g. a startup)<br>Where more flexibility required (e.g. don't have to pay dividends) | Where interest rates are very low = debt is cheap to finance<br>Where profits and cash flows are strong; so debt can be repaid easily |

### Measuring the Level of Debt in a Business Using the Gearing Ratio

The proportion of a business' finance that is debt is measured by what is known as the **gearing ratio.**

The key benefits to calculating the gearing ratio include:

- A useful measure of the financial health of a business
- Focuses on the level of debt in the financial structure of a business
- A high gearing ratio can mean higher risk of business failure (but not always)

### Worked Example of How to Calculate & Analyses the Gearing Ratio

Let's look at how to calculate & analyse the gearing ratio by considering the following information about two businesses: Company A & Company B:

| £million | Business A | Business B |
|---|---|---|
| Non-Current Liabilities (A) | 200 | 500 |
| Total Equity (B) | 600 | 300 |
| Equity + Non-Current Liabilities (A + B) | 800 | 800 |

**Topic: Gearing**
*3.5 Assessing Competitiveness*

The formula for calculating the gearing ratio is as follows

$$\textbf{Gearing \%} = \frac{\textit{Non-current liabilities}}{\textit{Total equity + non-current liabilities}} \times 100$$

Applying this formula to the financial data for Business A & B, the gearing ratio can be calculated as follows:

| **£million** | **Business A** | **Business B** |
|---|---|---|
| Non-Current Liabilities (A) | 200 | 500 |
| Total Equity (B) | 600 | 300 |
| Equity + Non-Current Liabilities (A + B) | 800 | 800 |
| Gearing (A) / (A + B) | 200 / 800 | 500 / 800 |
| **Gearing %** | **25%** | **62.5%** |

As you can see, Business B has much higher gearing (62.5%) than Business A (25%). Is this a bad thing? As always, it depends!

- A gearing ratio of 50%+ is normally said to be high
- A gearing ratio of less than 20% is normally said to be low
- However, the level of acceptable gearing depends on the business & industry

The relative merits of high or low gearing can be summarised as follows:

| **Benefits of High Gearing** | **Benefits of Low Gearing** |
|---|---|
| Less capital required to be invested by the shareholders<br>Debt can be a relatively cheap source of finance compared with dividends<br>Easy to pay interest if profits and cash flows are strong | Less risk of defaulting on debts<br>Shareholders rather than debt providers "call the shots"<br>Business has the capacity to add debt if required |

**Key Terms**

| | |
|---|---|
| **Gearing** | The proportion of a business' capital structure that is in the form of debt |
| **Equity** | The proportion and amount of the capital structure that is provided by shareholders or left as retained profits |

## Topic: Return on Capital Employed (ROCE)

*3.5 Assessing Competitiveness*

| What You Need to Know |
|---|
| Financial ratio analysis to include: Return on capital employed (ROCE) |

**What is Return on Capital Employed?**
ROCE is a measure of relative profitability.

ROCE tells us what returns (profits) the business has made on the resources available to it. ROCE is particularly useful as a ratio as it helps:

- Evaluate the overall performance of the business
- Provide a target return for individual projects
- Benchmark performance with competitors

**Calculating ROCE**
To calculate ROCE, you need information about the amount of profit earned in a particular period (usually a year), which you get from the Income Statement. To calculate Capital Employed, you need information from the Statement of Financial Position (Balance Sheet). ROCE is then calculated using the following formula:

$$\text{ROCE (\%)} = \frac{\text{Operating Profit (or Net Profit)}}{\text{Total Equity + Non-Current Liabilities}} \times 100$$

A worked example of this formula is provided in the table below:

| £'000 | COMPANY X | COMPANY Y |
|---|---|---|
| Non-Current Liabilities | 500 | 700 |
| Share Capital | 1,000 | 1,000 |
| Reserves | 250 | 1,500 |
| Total Equity | 1,250 | 2,500 |
| Operating Profit | 400 | 600 |
| ROCE Calculation: | 400 / (1,250 + 500) | 600 / (2,500 +700) |
| ROCE % | 22.8% | 18.7% |

**Evaluating ROCE**
Key points to remember are:

- ROCE will vary between industries; ROCE is a particularly important measure in capital-intensive industries with significant amounts of capital employed!
- ROCE is based on a snapshot of a business' balance sheet
- Comparisons over time and with key competitors are most useful

**Topic: Role, Value and Limitations of Financial Ratios**
*3.5 Assessing Competitiveness*

| What You Need to Know |
|---|
| Interpreting ratios to make business decisions<br>Limitations of ratio analysis |

**What is Ratio Analysis?**
Ratio analysis involves the **comparison** of **financial data** to gain insights into **business performance**

**Ratio Analysis Helps Answer Questions Such As**
Why is one business more profitable than another?
What returns are being earned in investment in a business?
Is a business able stay solvent?
How effectively is a business using its assets?

**The Importance of Comparison and Trends**
It is important to remember that calculating just one ratio is rarely enough if you are to gain useful insights into the financial performance of a business. Effective ratio analysis means you:

- Need to compare with competitors
- Need to analyse over time (trends)

**Where Information for Ratio Analysis Comes From?**
The financial accounts of a business are the source of the information you need for ratio analysis:

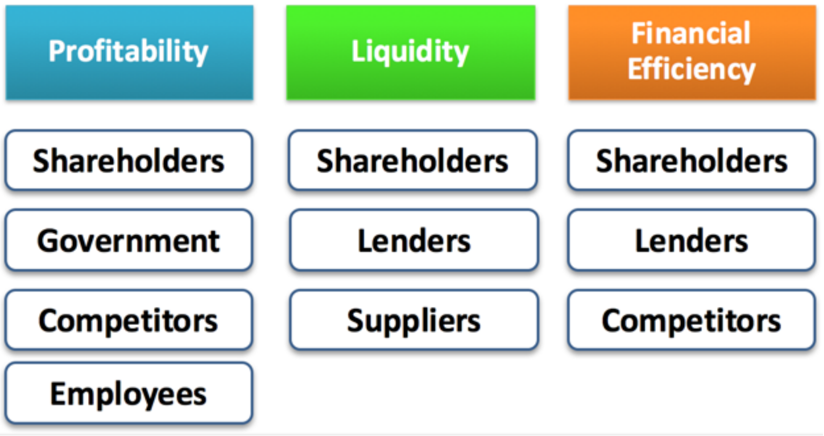
| **Income Statement (Profit & Loss Account)** | **Statement of Financial Position (Balance Sheet)** |
|---|---|
| Revenues<br>Cost of Sales<br>Gross Profit<br>Operating Profit<br>Net Profit (Profit for the Year) | Current assets<br>Current liabilities<br>Inventories<br>Trade receivables & payables<br>Long-term liabilities<br>Capital & reserves |

Ratios perform different purposes and can be grouped into three main types:

| Profitability | Liquidity | Financial Efficiency |
|---|---|---|
| • Gross profit margin<br>• Operating profit margin<br>• Return on Capital Employed | • Current ratio<br>• Acid-test ratio | • Payables Days<br>• Receivables Days<br>• Inventory turnover<br>• Gearing |

**Topic: Role, Value and Limitations of Financial Ratios**
*3.5 Assessing Competitiveness*

The key users of these ratio types include:




**Limitations of Ratios**
Whilst ratio analysis is widely used, it is important to understand some of the key limitations of ratios and also what financial ratios don't measure!

Key limitations include:

- One data set is not enough – ratio data over a period of time is much better
- How reliable is the financial data? (see below)
- Ratios are based on the past – they are not a predictor of the future
- Comparability – be careful with comparing ratios, for example, between different industries

Which might the financial data used in ratios not be wholly reliable?

- Financial information involves making subjective judgements
- Different businesses have different accounting policies
- Potential for manipulation of accounting information (e.g. window-dressing)

Remember that financial ratios are concerned with financial data. So they don't tell you directly about how well a business is performing in areas such as:

- Competitive advantages: e.g. brand strength
- Quality
- Ethical & CSR reputation
- Human resource management

**Topic: Human Resources**
*3.5 Assessing Competitiveness*

| **What You Need to Know** |
|---|
| • a) Calculate and interpret the following to help make business decisions:<br>• labour productivity<br>• labour turnover and retention<br>• absenteeism<br>• b) Strategies to improve the above |

**Measuring the Effectiveness of Human Resources**
In this topic we look at three important measures of HR performance:

| **Measure** | **Calculation** |
|---|---|
| Labour Turnover & Staff Retention | Percentage of staff who leave during a period |
| Labour Productivity | Output per employee |
| Absenteeism | Percentage of staff who are absent from work |

**Employee Retention**
**Every business experiences the departure of employees**. This can be due to:

- Retirement / Maternity / Death / Long-term Illness
- Unsuitability
- Changes in strategy (e.g. closure of locations)

However, the loss of employee (labour turnover) still needs to be managed carefully if a business is to succeed. Employee retention looks at the ability of a business to convince its employees to remain with business.

**Labour Turnover**
Labour turnover measures **the percentage of the workforce (employees) that leave a business within a given period** (usually a year). It is commonly calculated using this formula:

$$\frac{\textbf{Number of employees leaving during period}}{\textbf{Average number employed during period}} \times 100$$

Let's look at an example of the calculation:

| |
|---|
| Early Risers Ltd is a manufacturer of breakfast cereals. In 2015 it employed an average of 80 staff. During 2015 the business recruited 12 staff to replace 15 who left. What was the staff turnover in 2015? |

$$\textbf{Labour turnover} = \frac{\text{Number of employees leaving (15)}}{\text{Average number employed (80)}} \times 100$$

$$= 18.75\%$$

A wide variety of factors can influence labour turnover:

- Type of business
  - Some businesses have seasonal labour turnover (e.g. holiday parks)
  - Some businesses employ many temporary staff (e.g. hotels)
- Pay and other rewards
- Working conditions
- Opportunities for promotion
- Competitor actions
- Standard of recruitment
- Quality of communication in business
- Economic conditions
  - Downturn often leads to lower staff turnover
  - Buoyant economy – staff more likely to leave
- Labour mobility
  - How transferable are staff skills
  - What other jobs are available?
- Employee loyalty

A sustained, high level of labour turnover has the potential to add significantly to business costs:

- Higher recruitment & training
- Cost of temporary or cover staff
- Increased pressure on remaining staff
- Disruption to production / productivity
- Harder to maintain required standards of quality and customer service

What can be done to improve or minimise labour turnover? Here are some popular approaches:

- Effective recruitment and training
  - Recruit the right staff
  - Do all you can to keep the best staff (role for training & other motivation tools)
- Provide (more) competitive pay and other incentives
  - Competitive pay levels & non-financial benefits
- Job enrichment and empowerment
- Reward staff loyalty
  - Service awards, extra holiday etc.

**Labour Productivity**
As we explore when looking at operational efficiency (unit costs), labour productivity matters, particularly for labour-intensive businesses.

- Labour costs are usually a significant part of total costs
- Business efficiency and profitability are closely linked to productive use of labour
- In order to remain **competitive**, a business needs to keep its unit costs down

An example of how unit labour costs can be calculated is provided below:

| Employees | Labour Costs (£) | Output (Units) | Output per Employee | Labour Cost per Unit |
|---|---|---|---|---|
| 10 | 100,000 | 2,000 | 200 | £50 |
| 20 | 200,000 | 5,000 | 250 | £40 |
| 30 | 300,000 | 10,000 | 333 | £30 |
| 40 | 400,000 | 20,000 | 500 | £20 |
| 50 | 500,000 | 30,000 | 600 | £17 |

Key factors that influence the level of labour productivity include:

- Extent and quality of fixed assets (e.g. equipment, IT systems)
- Skills, ability and motivation of the workforce
- Methods of production organisation
- Extent to which the workforce is trained and supported (e.g. working environment)
- External factors (e.g. reliability of suppliers)

Labour productivity is calculated using the following formula:

$$\frac{\textbf{Output per period (units)}}{\textbf{Number of employees at work}}$$

The result is expressed in terms of units of output per employee.

An example of the calculation is:

**Precision Plastics makes 10,000 units each week. Total weekly labour hours are 400. What is labour productivity (hours per unit)?**

Labour productivity is therefore:

$$\frac{\textbf{Labour hours per week (400)}}{\textbf{Units produced per week (10,000)}}$$

$$\mathbf{= 0.04hrs\ /\ unit}$$

Potential approaches to improving labour productivity include:

- Measure performance and set targets
- Streamline production processes
- Invest in capital equipment (automation + computerisation)
- Invest in employee training
- Improve working conditions

However, there are some potential pitfalls or issues when trying to raise labour productivity:

- Potential "trade-off" with quality – higher output must still be of the right quality
- Potential for employee resistance – depending on the methods used (e.g. introduction of new technology)
- Employees may demand higher pay for their improved productivity (negates impact on labour costs per unit)

**Absenteeism**
Absenteeism is an **employee's intentional or habitual absence from work.**

Absenteeism can be a significant operational issue in business, particularly in labour-intensive operations:

- **A significant business cost**
  - Sickness absence costs UK businesses around £600 for each worker per year
- **Key to understand reasons (genuine / not)**
  - Genuine sickness, bereavement, bullying, stress
  - Some employees simply "playing the system"
- **Often predictable**
  - Monday / Friday or End of Shift Pattern
  - Main holidays

Absenteeism can be calculated using this formula:

$$\frac{\textbf{Number of staff absent during period}}{\textbf{Number employed during period}} \times 100$$

An alternative formula that focuses on the number of working days lost is:

$$\frac{\textbf{Number days taken off for unauthorised absence (during period)}}{\textbf{Total days worked by workforce over the period}} \times 100$$

The key to tackling absenteeism is for management to:

- Understand the causes
- Set targets and monitor trends
- Have a clear sickness & absence policy
- Provide rewards for good attendance
- Consider the wider issues of employee motivation

**Employee Costs as a Percentage of Turnover**
Finally let's look briefly at a potentially useful management ratio that can provide insights into how efficiently a business is using its labour resources.

- Calculating revenue per employee is one way of assessing how effectively a business is using its labour resources
- The calculation is particularly useful in labour intensive industries where labour is a key part of adding value through production
- Two popular calculations
  - Revenue per employee
  - Employee costs / Revenues

Some examples of the calculations for two companies are shown below:

| | COMPANY A | COMPANY B |
|---|---|---|
| Revenues (£'000) | 8,000 | 6,000 |
| Employees (Number) | 50 | 30 |
| Employee Costs (£'000) | 1,750 | 900 |
| | | |
| Revenue per Employee (£) | 35,000 | 30,000 |
| Employee Costs / Revenue (%) | 21.9% | 15% |

Here is some summary guidance on interpreting the two ratios:

| Revenues per Employee (£) | Employee Costs / Revenues % |
|---|---|
| Important to compare with key competitors | Important indicator of efficiency and labour productivity |
| Should be high for where labour resources add lots of value (e.g. services) | Again – important to compare with closest competitors and look at trend over several years |
| Should rise if labour intensive processes are automated | Relatively high figure might indicate poor labour productivity and/or employees paid too much |
| Relatively low figure compared with competition might suggest poor added value or selling prices too low | Increased automation should lower the percentage |

**Empowerment**
Empowerment involves giving people greater control over their working lives.

Organising the labour force into empowered teams with a high degree of autonomy can achieve this. This means that employees plan their own work, take their own decisions and solve their own problems. Teams are set targets to achieve and may receive rewards for doing so. Empowered teams motivate through allowing people the opportunity to meet some of the higher needs as identified by Maslow or Herzberg's motivators.

This is a common topic for examination questions as empowered teams are a popular method of organising labour forces. It is important to appreciate the advantages and disadvantages of this approach. The advantages centre upon the positive motivational effects. This can result in higher productivity, leading to improved competitiveness and higher profits or market share. Disadvantages (which may only exist in the short term) centre upon the cost and disruption of training, and opposition from employees.

**Key Terms**

| | |
|---|---|
| **Labour turnover** | The proportion of a firm's workforce that leaves during the course of a year |
| **Absenteeism** | The incidence of unauthorised absence from work |

## Topic: Causes and Effects of Change

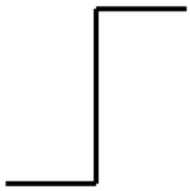
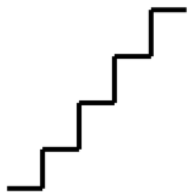
*3.6 Managing Change*

| **What You Need to Know** |
|---|
| Causes of change: changes in organisational size \| poor business performance \| new ownership \| transformational leadership \| market & other external factors (PESTLE)<br>Possible effects of change: competitiveness \| productivity \| financial performance \| stakeholders |

**What is Change Management?**
Change management involves the **process** that ensures a business responds to the **environment** in which it operates

**Key Types of Change: Incremental, Step and Disruptive**
Classifying change into different categories based on the degree and nature of change is a good way of understanding the context for change management.

A classic way to distinguish change is to compare Step change with Incremental Change. These two are summarised below.

| **Step Change**<br>Significant & occurs rapidly | **Incremental Change**<br>Many small and frequent changes |
|---|---|
|  |  |
| ***Key features:*** | ***Key features:*** |
| Dramatic or radical change in one fell swoop<br>Often required when a business has suffered from strategic drift<br>Often involves significant alteration in the business<br>Gets it over with quickly / decisively<br>May require some coercion to overcome resistance | Many small changes which take place as a business develops and responds to subtle changes in the external environment<br>Usually involves little resistance<br>Arises as strategy develops<br>Often not noticed<br>A culture of accepting and embracing incremental change may develop |

**Disruptive Change**
This is a form of step change that arises from changes in the external environment which impact the market as a whole.

Disruptive change impacts the market as a whole, challenging the established "business model" (i.e. how products and services are sold).

Rapid improvements in technology are the main driver of disruptive change since technological innovation provides new ways of delivering goods and services as well as reducing barriers to market entry.

## Topic: Causes and Effects of Change

*3.6 Managing Change*

### Internal and External Causes of Change

A distinction can be made in terms of the causes of change between those that are **"internal" (i.e. within the control of the business)** and those that are **"external" (i.e. outside of the control of the business** but which still need to be addressed).

| **Internal Causes of Change** | **External Causes of Change** |
|---|---|
| *Arise from factors **within the control** of the business – i.e. the decisions taken by business management* | *Arise from factors **outside the control** of the business – i.e. as a result of changes in the external environment* |
| ***Examples:***<br>New leadership<br>Change in strategic direction & corporate objectives<br>Significant investment decisions<br>Changes to scope of business activities (e.g. business unit closures)<br>Adjusting the organisational structure (e.g. delayering) | ***Examples:***<br>Significant competitor actions (e.g. new products, takeovers)<br>Political & legal changes (e.g. deregulation or new taxes)<br>Significant changes in economic environment (e.g. post Brexit for UK firms)<br>Longer-term changes in society (e.g. lifestyles, demographics)<br>Technological change (e.g. rapid growth or mobile device usage and related market disruption) |

### Possible Effect of Effective Change

Whilst change is often viewed with concern by those affected, it is an essential part of business life.

The external environment, in particular, is constantly changing, which makes change a constant too!

If a business is able to implement change effectively, then several potential business benefits may arise:

- It may help sustain a competitive advantage (and respond to competitor changes)
- Aligns business strategy with evolving nature of customer needs & wants
- Business may be better able to take advantage of developing technologies
- Stakeholders (employees, shareholders etc.) should gain from improved productivity and work environment
- Change in organisational structure may enable a business to improve the effectiveness of its communication and decision-making
- Being perceived as a business that leads change rather than follows it may bring market benefits (e.g. developing a reputation for innovation)

### Key Terms

| | |
|---|---|
| **Change management** | The process that ensures a business responds to the environment in which it operates |

**Topic: Causes and Effects of Change**
*3.6 Managing Change*

| | |
|---|---|
| **Step change** | Significant and often transformational change that is significant to the business |
| **Incremental change** | Small, frequent and relatively insignificant changes to the business |
| **Disruptive change** | Change that arises from changes in the external environment which impact the market as a whole. |

## Topic: Key Factors in Change

*3.6 Managing Change*

| What You Need to Know |
|---|
| Organisational culture |
| Size of organisation |
| Time / speed of change |
| Managing resistance to change |

**Organisational Culture**

Organisational culture is usually at the heart of any major change programme. There are two key reasons why it usually needs to change:

| | |
|---|---|
| **To help improve business performance** | Declining profits and sales<br>Inadequate returns on investment<br>Low quality or standards of customer service |
| **To make the business more responsive to external change** | Market changes (growth, competitors)<br>Political & legal environment<br>Change in societal views<br>Change of ownership (e.g. takeover)<br>Change of management or leadership (e.g. a new CEO)<br>Economic conditions (e.g. downturn) |

Classic symptoms or evidence that an organisational culture needs to change include:

- Internal fighting; management criticism ("us & them mentality")
- High levels of voluntary staff turnover & hard to retain top talent
- Absenteeism is rising
- Business processes have become more bureaucratic
- Innovation is no longer valued or celebrated
- Evidence of declining customer service
- Leadership show double standards or decision-making becomes inconsistent
- Communication becomes more closed and restricted

**Managing Resistance to Change**

Kotter and Schlesinger developed theories to explain two key areas of change:

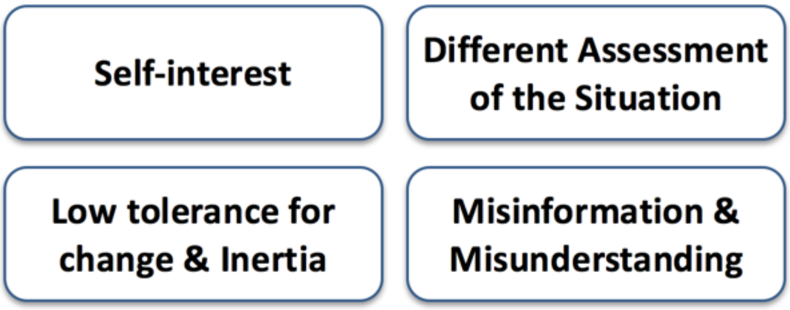
(1) Why is change resisted?
(2) What can be done to overcome resistance to change?

Let's look at each area.

**Kotter and Schlesinger's Four Reasons for Resistance to Change**

Kotter & Schlesinger suggest that there are four main reasons why change is resisted:

**Topic: Key Factors in Change**
*3.6 Managing Change*




The key points to remember for each of the four reasons above are:

**Self-interest**

- Self-interest is a powerful motivator
- Arises from a perceived threat to job security, status and financial position
- Understandable - why would you want to lose something you believe to be valuable?
- Individuals often place their own interests ahead of those of their organisation, particularly if they don't feel a strong loyalty to it

**Misinformation & Misunderstanding**

- People don't understand why change is needed, perhaps because they are misinformed about the real strategic position of the business
- Perception may be widespread that there is no compelling reason for change
- Perhaps even an element of people fooling themselves that things are better than they really are

**Different Assessment of the Situation**

- Here there is disagreement about the need for change or what that change needs to be
- Some people may simply disagree with the change proposed, or they may feel they have a better solution
- This is different from "self-interest" – the resistance here is based on disagreement about what is best for the business

**Low Tolerance and Inertia**

- Many people suffer from inertia or reluctance to change, preferring things to stay "the way they are"
- Many people need security, predictability & stability in their work
- If there is low tolerance of change (perhaps arising from past experience) then resistance to change may grow

**Kotter and Schlesinger's Six Ways of Overcoming Resistance to Change**
How can senior management overcome the inevitable resistance to change when change is required? In their work, six approaches suggested by Kotter & Schlesinger.

**Topic: Key Factors in Change**
*3.6 Managing Change*


Here are the key points for each of the six approaches:

**Education & Communication**

- The starting point for successful change is to communicate effectively the reasons why change is needed!
- Honest communication about the issues and the proposed action helps people see the logic of change
- Effective education helps address misconceptions about the change, including misinformation or inaccuracies
- Education and communication are unlikely to achieve very short-term effects. They need to be delivered consistently and over a long-period for maximum impact

**Participation & Involvement**

- Involvement in a change programme can be an effective way of bringing "on-board" people who would otherwise resist
- Participation often leads to commitment, not just compliance
- A common issue in any change programme is just how much involvement should be permitted. Delays and obstacles need to be avoided.

**Facilitation & Support**

- Kotter & Schlesinger identified what they called "adjustment problems" during change programmes
- Most people (though not all) will need support to help them cope with change
- Key elements of facilitation and support might include additional training, counselling and mentoring as well as simply listening to the concerns of people affected
- If fear and anxiety is at the heart of resistance to change, then facilitation and support become particularly important

**Co-option & Manipulation**

- Co-option involves bringing specific individuals into roles that are part of change management (perhaps managers who are likely to be otherwise resistant to change)
- Manipulation involves the selective use of information to encourage people to behave in a particular way
- Whilst the use of manipulation might be seen as unethical, it might be the only option if other methods of overcoming resistance to change prove ineffective

**Negotiation & Bargaining**

- The idea here is to give people who resist an incentive to change – or leave
- The negotiation and bargaining might involve offering better financial rewards for those who accept the requirements of the change programme
- Alternatively, enhanced rewards for leaving might also be offered
- This approach is commonly used when a business needs to restructure the organisation (e.g. by delayering)

**Explicit & Implicit Coercion**

- This approach is very much the "last resort" if other methods of overcoming resistance to change fail
- Explicit coercion involves people been told exactly what the implications of resisting change will be
- Implicit coercion involves suggesting the likely negative consequences for the business of failing to change, without making explicit threats
- The big issue with using coercion is that it almost inevitably damages trust between people in a business and can lead to damaged morale (in the short-term)

## Topic: Scenario Planning
*3.6 Managing Change*

| What You Need to Know |
|---|
| Identifying key risks through risk assessment<br>Planning for risk mitigation |

**Introduction to Scenario Planning**

Scenario planning involves:

- Preparing for predictable and quantifiable problems
- Preparing for unexpected and unwelcome events

The aim of scenario planning is to **minimise the impact** of a **significant foreseeable event** and to plan for how the business will resume normal operations after the event.

**Scenario Planning and Risk Management**

Scenario planning is one of the three approaches a business can take to manage risk. These are:

| | |
|---|---|
| **Risk management** | Identifying and dealing with the risks threatening a business |
| **Scenario planning** | Planning for unforeseen events |
| **Crisis management** | Handling potentially dangerous events for a business |

What do we mean by "risk" in business? Risk can be:

- The possibility of loss or business damage
- A threat that may prevent or hinder the ability to achieve business objectives
- The chance that a hoped-for outcome will not occur (e.g. customers do not respond well to a new product launch)

Risk is ever-present in business and there are a variety of possible responses to it:

- Ignore it (wait and see)
- Share/deflect the risk (e.g. take-out insurance)
- Make **scenario plans** - prepare for it
- Embrace risk as an opportunity- particularly if it also affects other competitors

Some examples of how action can be taken to reduce risk include:

| **Area** | **Risk Management Action** |
|---|---|
| **Marketing** | Avoid over-reliance on customers or products<br>Develop multiple distribution channels<br>Test marketing for new products |
| **Operations** | Hold spare capacity<br>Rigorous quality assurance & control procedures & culture<br>IT systems failure: back-up data and recovery plans |
| **Finance** | Insurance against bad debts<br>Investment appraisal techniques |

| | |
|---|---|
| **People** | Key man insurance – protect against loss of key staff<br>Rigorous recruitment & selection procedures<br>Succession planning; making sure the business has a robust plan in place where it knows it will need to replace key management (e.g. through retirement) |

**What is Involved in Scenario Planning**

The **process** of scenario planning involves:

- Identifying what and how things can and might go wrong
- Understanding the potential effects if things go wrong
- Devising plans to cope with the threats
- Putting in place strategies to deal with the risks before they happen

Almost by definition, scenario planning should focus on the most important risks; those that have the potential for significant business disruption or damage. Risks vary in terms of their significance to the business.

Scenario planning is not required for every eventuality. However, risks of strategic significance cannot be ignored

**Key Terms**

| | |
|---|---|
| **Scenario planning** | The process of preparing for predictable and quantifiable problems and preparing for unexpected and unwelcome events |
| **Succession planning** | Planning for the orderly replacement of key management and employees |

## Topic: Growing Economies
*4.1 Globalisation*

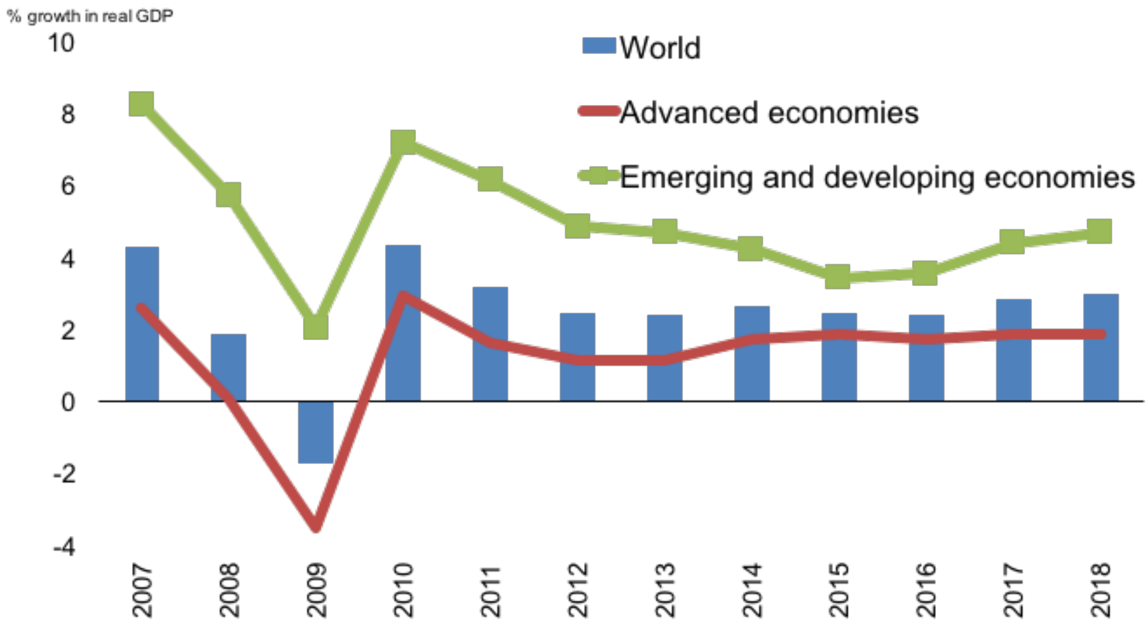
| What You Need to Know |
|---|
| a) Growth rate of the UK economy compared to emerging economies<br>b) Growing economic power of countries within Asia, Africa and other parts of the world<br>c) Implications of economic growth for individuals and businesses: trade opportunities for businesses; employment patterns<br>d) Indicators of growth:<br>Gross Domestic Product (GDP) per capita; literacy; health; Human Development Index (HDI) |

**What is an Emerging Economy?**
An "emerging economy" is used to describe an economy in the process of rapid growth and industrialisation.

The key features of emerging economies are:

- Economies making a transition
- Going through a process of rapid industrialisation (i.e. development of secondary & tertiary sectors)
- Have potential to become developed economies
- Enjoy faster long-term economic growth than most developed economies
- Many inhabitants still in poverty, though economic growth is taking many out of poverty
- Domestic businesses still struggle to access global markets (e.g. trade barriers)

Emerging economies have achieved significantly higher economic growth rates in recent years, as illustrated by this chart:




**The Original Emerging Economies – BRICs**
When emerging economies first came to prominence, four countries were singled out: the so-called BRIC economies:

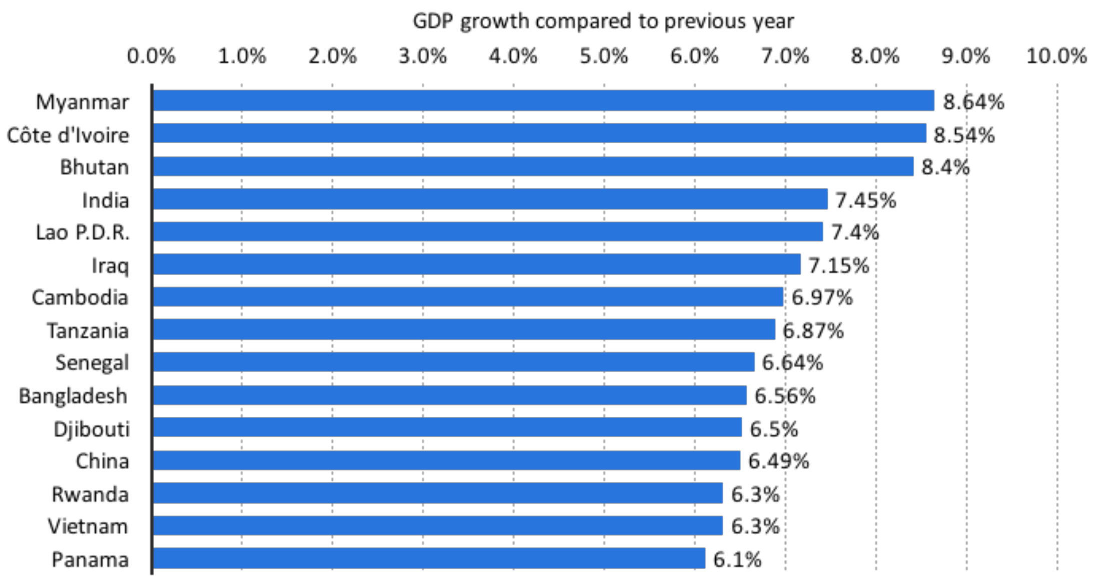
**Topic: Growing Economies**
*4.1 Globalisation*

- BRICs = Brazil, Russia, India & China
- Research by Jim O'Neill (Goldman Sachs) 15 years ago highlighted the prominent rise of these four emerging markets
- Each was particularly significant for developed economies – because of their scale and growth rate
- Brazil has since entered a prolonged recession (as did Russia)
- China has now become the world's largest economy and in many respects is now a developed economy

**Comparing the Economic Growth Rates of the UK and Emerging Economies**
Some recent data on the comparative rates of economic growth is provided in the table below:

| **Country / Groups** | **2013** | **2014** | **2015** | **2016f** |
|---|---|---|---|---|
| BRICS | 5.7 | 5.1 | 3.9 | 4.6 |
| Developing economies | 5.3 | 4.9 | 4.3 | 4.8 |
| High-income economies (e.g. UK) | 1.2 | 1.7 | 1.6 | 2.1 |
| Low-income economies | 6.4 | 6.1 | 5.1 | 6.2 |
| **World economy** | **2.4** | **2.6** | **2.4** | **2.9** |
| **Regions / Developing Countries** | | | | |
| Developing East Asia and Pacific | 7.1 | 6.8 | 6.4 | 6.3 |
| Developing Europe and Central Asia | 3.9 | 2.3 | 2.1 | 3.0 |
| Developing Latin America and the Caribbean | 3.0 | 1.5 | -0.7 | 0.1 |
| Developing Middle East and N. Africa | 0.6 | 2.5 | 2.5 | 5.1 |
| Developing South Asia | 6.2 | 6.8 | 7.0 | 7.3 |
| Developing Sub-Saharan Africa | 4.9 | 4.6 | 3.4 | 4.2 |

The fastest-growing individual economies (based on forecast data as at September 2016) are:



## Topic: Growing Economies
*4.1 Globalisation*

It is reasonable to expect that emerging economies will continue to enjoy faster economic growth (on average) compared with developed economies, in particular because:

- Urbanisation process continues
- Industrialisation – especially in East Asia and SS Africa
- Population growth
- Per capita income growth, rise of middle classes and consumer society
- Workforce will continue to improve skills and be more productive
- Technological innovation in many emerging markets (especially in Korea, China, India)

**Business Opportunities and Threats from Emerging Economies**
For some businesses, emerging economies present an exciting opportunity; for others, they pose a major threat.

***From the point of view of businesses in the UK***, emerging markets might be considered as:

| Opportunities | Threats |
|---|---|
| Growing numbers of educated middle class consumers - = growing consumer spending<br>Cultural shifts – e.g. higher demand for personal products, private education & healthcare<br>Demand for infrastructure and other products & services from developed economies<br>Source of high-skilled but low-cost labour (outsourcing / offshoring)<br>Great potential for joint ventures and acquisitions | Increasingly large pool of skilled, but low-cost labour<br>Undervalued currencies make their exports cheaper<br>Inadequate protection of brand and other intellectual property<br>State subsidy of industries to make them more competitive globally |

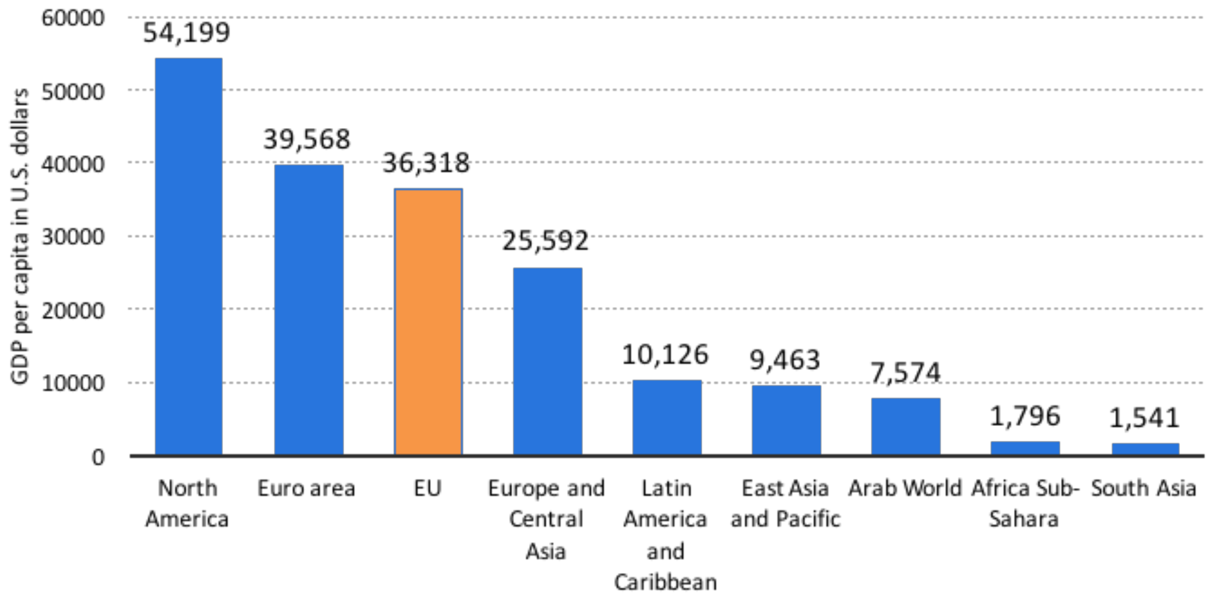
In several respects, expansion into emerging markets poses greater risks for businesses located in developed economies such as the UK. Key risks include:

- Political instability
- Cultural differences / sensitivities
- Variable approaches to financial & legal dealings (e.g. contractual law)
- Corruption and bureaucracy still an issue
- Emerging markets becoming major exporters
- Low-cost production makes developed economies uncompetitive in some markets

**Indicators of Economic Growth**
Whilst GDP is the most commonly-used method of measuring economic growth, it is just one of several indicators of economic growth and development.

For example, GDP per capita measures the value of GDP per person in a country.

The chart below shows gross domestic product per capita in selected global regions measured at current prices in 2014 (in U.S. dollars):




Here is a selection of recent data for GDP per capita for different types of economy:

| | GDP Per Capita ($) | GDP Per Capita PPP Adjusted |
|---|---|---|
| Central African Republic | 320 | 600 |
| Malawi | 350 | 1,140 |
| Ethiopia | 590 | 1,620 |
| Kenya | 1,340 | 3,060 |
| Bangladesh | 1,190 | 3,550 |
| Sub-Saharan Africa | 1,628 | 3,562 |
| Zambia | 1,500 | 3,660 |
| South Asia | 1,533 | 5,653 |
| Vietnam | 1,980 | 5,690 |
| India | 1,590 | 6,020 |
| South Africa | 6,050 | 12,830 |
| China | 7,820 | 14,160 |
| Brazil | 9,850 | 15,020 |
| World Average | 10,437 | 15,415 |

**More Complex Measures of Economic Growth & Development: The Human Development Index (HDI)**

Since 1990, the United Nations has published an alternative measure of economic development - **the Human Development Index** (shortened to HDI).

- HDI focuses on **three key measures of human development:** longevity (how long people live), basic education and minimal income

- The HDI **tracks progress** made by countries in improving these three basic development outcomes
- The inclusion of education and health indicators is a sign of successful policies in providing access to health care, sanitation and education

The three measures used to compile the index are:

- **Knowledge:** First an educational component made up of two statistics – mean years of schooling and expected years of schooling
- **Long and healthy life:** Second a life expectancy component is calculated using a minimum value for life expectancy of 25 years and maximum value of 85 years
- **A decent standard of living:** The final element is gross national product (GDP per capita adjusted to purchasing power parity standard (PPP)

The countries with the highest HDI rankings in 2015 were:

| | Human Development Index (HDI) | Life expectancy at birth | Expected years of schooling | Mean years of schooling | Gross national income (GNI) per capita |
|---|---|---|---|---|---|
| Country | Value | (years) | (years) | (years) | (2011 PPP $) |
| Norway | 0.944 | 81.6 | 17.5 | 12.6 | 64,992 |
| Australia | 0.935 | 82.4 | 20.2 | 13.0 | 42,261 |
| Switzerland | 0.930 | 83.0 | 15.8 | 12.8 | 56,431 |
| Denmark | 0.923 | 80.2 | 18.7 | 12.7 | 44,025 |
| Netherlands | 0.922 | 81.6 | 17.9 | 11.9 | 45,435 |
| Germany | 0.916 | 80.9 | 16.5 | 13.1 | 43,919 |
| Ireland | 0.916 | 80.9 | 18.6 | 12.2 | 39,568 |
| United States | 0.915 | 79.1 | 16.5 | 12.9 | 52,947 |
| Canada | 0.913 | 82.0 | 15.9 | 13.0 | 42,155 |
| New Zealand | 0.913 | 81.8 | 19.2 | 12.5 | 32,689 |
| Singapore | 0.912 | 83.0 | 15.4 | 10.6 | 76,628 |
| Hong Kong | 0.910 | 84.0 | 15.6 | 11.2 | 53,959 |
| Liechtenstein | 0.908 | 80.0 | 15.0 | 11.8 | 79,851 |
| Sweden | 0.907 | 82.2 | 15.8 | 12.1 | 45,636 |
| **UK** | **0.907** | **80.7** | **16.2** | **13.1** | **39,267** |
| Iceland | 0.899 | 82.6 | 19.0 | 10.6 | 35,182 |
| South Korea | 0.898 | 81.9 | 16.9 | 11.9 | 33,890 |

The countries with the lowest HDI ranking in 2015 were:

| | Human Development Index (HDI) | Life expectancy at birth | Expected years of schooling | Mean years of schooling | Gross national income (GNI) per capita |
|---|---|---|---|---|---|
| Country | Value | (years) | (years) | (years) | (PPP $) |
| Côte d'Ivoire | 0.462 | 51.5 | 8.9 | 4.3 | 3,171 |
| Malawi | 0.445 | 62.8 | 10.8 | 4.3 | 747 |
| Ethiopia | 0.442 | 64.1 | 8.5 | 2.4 | 1,428 |
| Gambia | 0.441 | 60.2 | 8.8 | 2.8 | 1,507 |
| DRC | 0.433 | 58.7 | 9.8 | 6.0 | 680 |
| Liberia | 0.430 | 60.9 | 9.5 | 4.1 | 805 |
| Guinea-Bissau | 0.420 | 55.2 | 9.0 | 2.8 | 1,362 |
| Mali | 0.419 | 58.0 | 8.4 | 2.0 | 1,583 |
| Mozambique | 0.416 | 55.1 | 9.3 | 3.2 | 1,123 |
| Sierra Leone | 0.413 | 50.9 | 8.6 | 3.1 | 1,780 |
| Guinea | 0.411 | 58.8 | 8.7 | 2.4 | 1,096 |
| Burkina Faso | 0.402 | 58.7 | 7.8 | 1.4 | 1,591 |
| Burundi | 0.400 | 56.7 | 10.1 | 2.7 | 758 |
| Chad | 0.392 | 51.6 | 7.4 | 1.9 | 2,085 |
| Eritrea | 0.391 | 63.7 | 4.1 | 3.9 | 1,130 |
| Central African Rep | 0.350 | 50.7 | 7.2 | 4.2 | 581 |
| Niger | 0.348 | 61.4 | 5.4 | 1.5 | 908 |

**Limitations of the HDI**
Whilst the HDI is increasingly used as a reliable measure of economic development, it still has some important limitations:

- The standard HDI measure does not take into account **qualitative factors**, such as cultural identity and political freedoms (human security, gender opportunities and human rights for example)
- The GDP per capita figure – and consequently the HDI figure – takes no account of **income distribution**.
- If income is unevenly distributed, GDP per capita will be an inaccurate measure of people's monetary well-being
- Purchasing power parity (PPP) values used to adjust GDP data change quickly and can be inaccurate or misleading

**Key Terms**

| | |
|---|---|
| **Human Development Index** | A composite index that attempts a broader measure of economic development |
| **GDP per capita** | Measures the value of GDP per person in a country |

## Topic: International Trade & Business Growth
*4.1 Globalisation*

| What You Need to Know |
|---|
| Exports and imports<br>Link between business specialisation and competitive advantage<br>Foreign direct investment (FDI) and link to business growth |

**What is International Trade?**
- **International trade is the exchange of products (goods and services)**
- Trade doesn't take place between countries, it takes place between the economic agents of that country, such as businesses, governments or consumers
- When conditions are right, international trade brings benefits to all countries involved and it can be a powerful driver for sustained GDP growth, employment and rising living standards

The key benefits of international trade for both businesses and economies include:

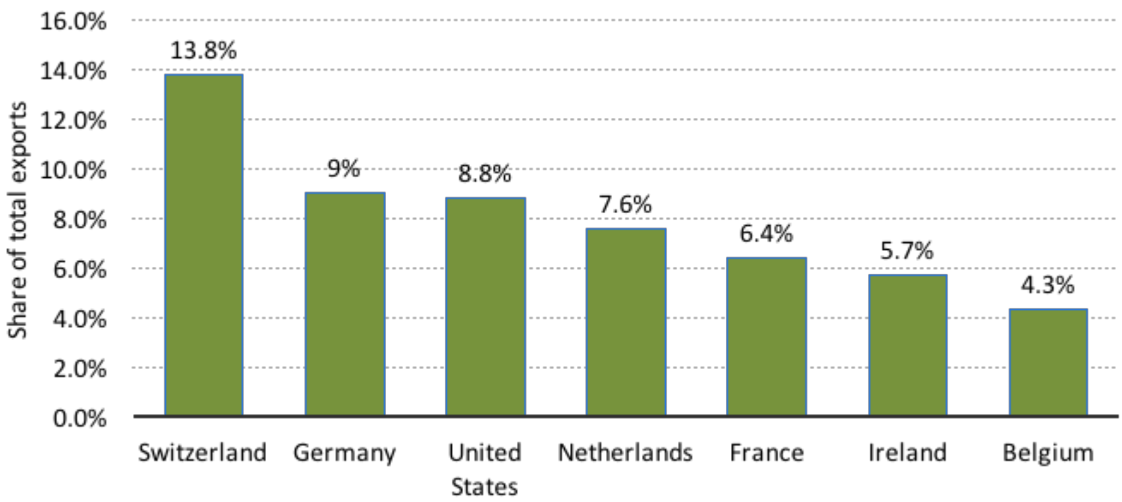
- Export revenues and jobs help to reduce poverty
- Low prices for consumer as markets are more competitive
- Technology is spread, raising productivity
- Knowledge and skills cross borders
- Economies of scale – causing lower unit costs and prices
- Better use of scarce resources

However, international trade is not without drawbacks. These include:

- Transport costs e.g. emissions from food miles
- Negative externalities from production and consumption
- Structural unemployment as patterns of trade change
- Rising inequality – uneven gains from trade
- Pressure on wages and working conditions
- Risks from global (external) shocks

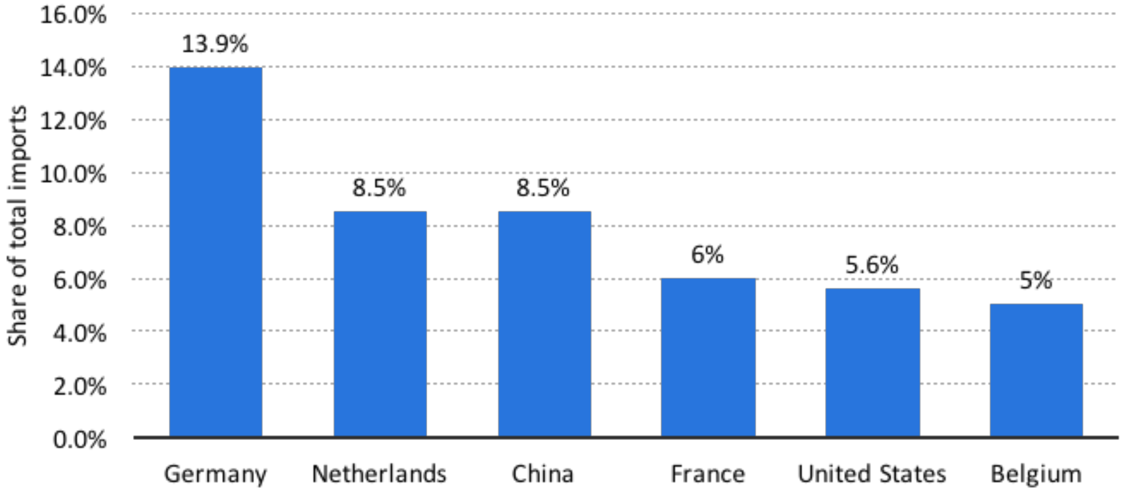
**What are Exports?**
Exports arise as a function of international trade whereby **goods and services produced by one country are sold to another country.**

More than half of the UK's exports go to the other nations inside the European Union. Switzerland is our biggest export market but is outside of the EU.




**What are Imports?**
Imports are the opposite of exports. **Imports are goods or service brought into one country from another.**

More than half of the UK's exports go to the other nations inside the European Union. Switzerland is our biggest export market but is outside of the EU.




**The Importance of Specialisation for International Trade**
Why are some countries better at producing certain goods or services than others? There are two key reasons:

1. The relative opportunity cost of production for a good or service is lower than in another country
2. A country is relatively more productively efficient than another

The basic rule for a country is to specialise in the goods and services that a country is relatively best at. This opens up important potential gains from specialisation and trade

**Why Does Specialisation Make Sense?**

## Topic: International Trade & Business Growth

*4.1 Globalisation*

- If each country specialises, total economic output can be increased across the global economy
- Providing that a good price can be found from buyers, then specialisation should focus on those goods and services that provide the best value
- In many countries, competitive advantage is shifting towards specialising in and exporting high-technology manufactured goods and high-knowledge services which get a higher price
- As a country develops more capabilities, then it can produce a wider range of closely-linked goods and services
- Countries such as South Korea, Japan, Germany, the USA and UK all have a highly diversified pattern of exports
- Nations at a lower stage of development tend to have fewer capabilities and thus export a narrower range of products

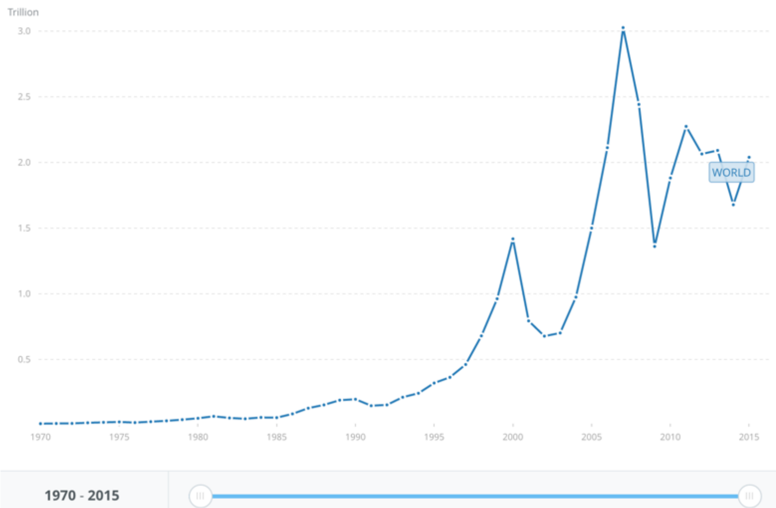
**Some examples of countries specialising include:**

- Zambia and Chile - copper mining
- Bangladesh - textiles
- Vietnam - light manufacturing (assembly)
- Angola – crude oil
- Ivory Coast - cocoa

**What is Foreign Direct Investment (FDI)?**

FDI is investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses.

The extent and value of FDI globally has grown exponentially in recent decades, peaking at $3 trillion just before the global financial crash, as illustrated in the chart below:

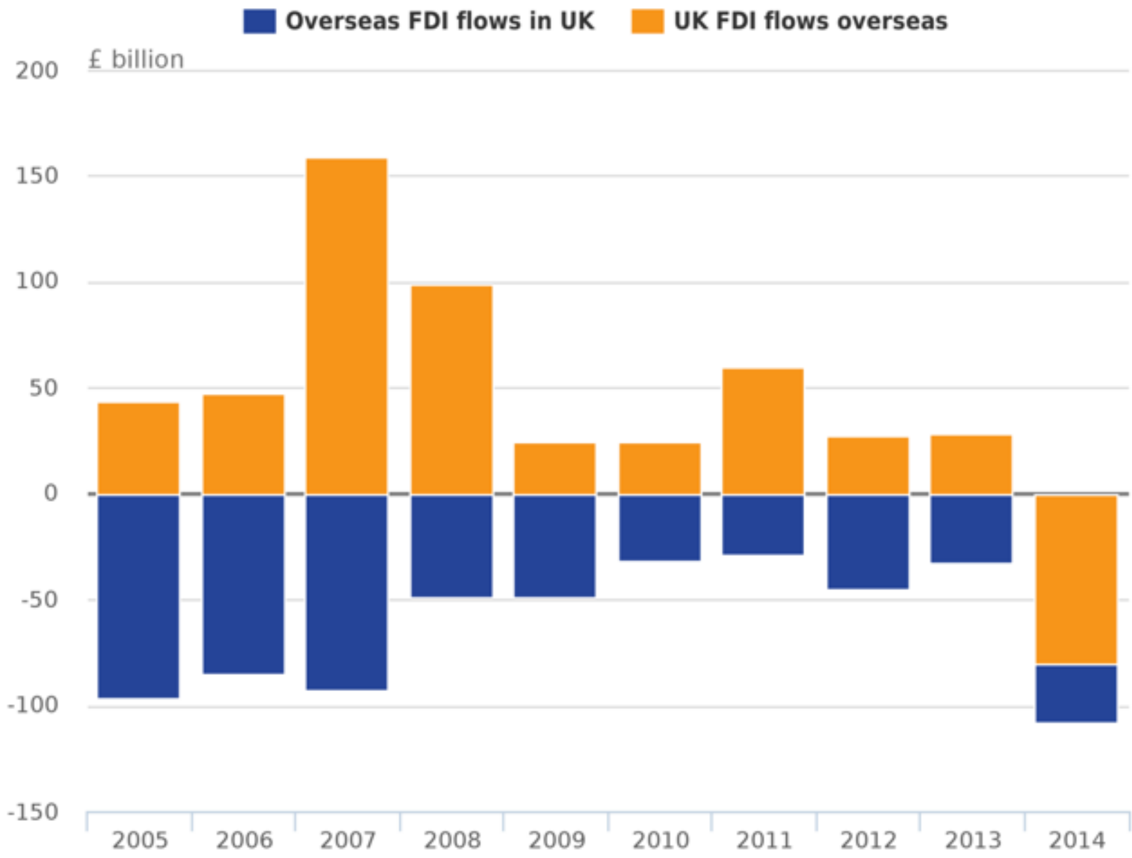


**Topic: International Trade & Business Growth**
*4.1 Globalisation*

**There are two types of FDI:**

| **Inward FDI** | **Outward FDI** |
|---|---|
| E.g. an overseas business decides to build a manufacturing factory in the UK<br>A foreign retail firm invests to open new stores in the UK | E.g. an UK business expands into an overseas market by opening a new production facility<br>A UK business completes a takeover of a business based in another country |

For the UK economy, there has been both substantial inward and outward FDI in recent years:




**Key Terms**

| | |
|---|---|
| **Foreign Direct Investment (FDI)** | Investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses. |

**Topic: Factors Contributing to Increased Globalisation**
*4.1 Globalisation*

| What You Need to Know |
|---|
| Factors impacting globalisation:<br>Reduction of trade barriers & greater trade liberalisation<br>Political change<br>Reduced cost of transport & communication<br>Increased significance of global businesses<br>Increased investment flows (FDI)<br>Migration & growth of global labour force<br>Structural change |

**What is Globalisation?**
**The OECD defines globalisation as**

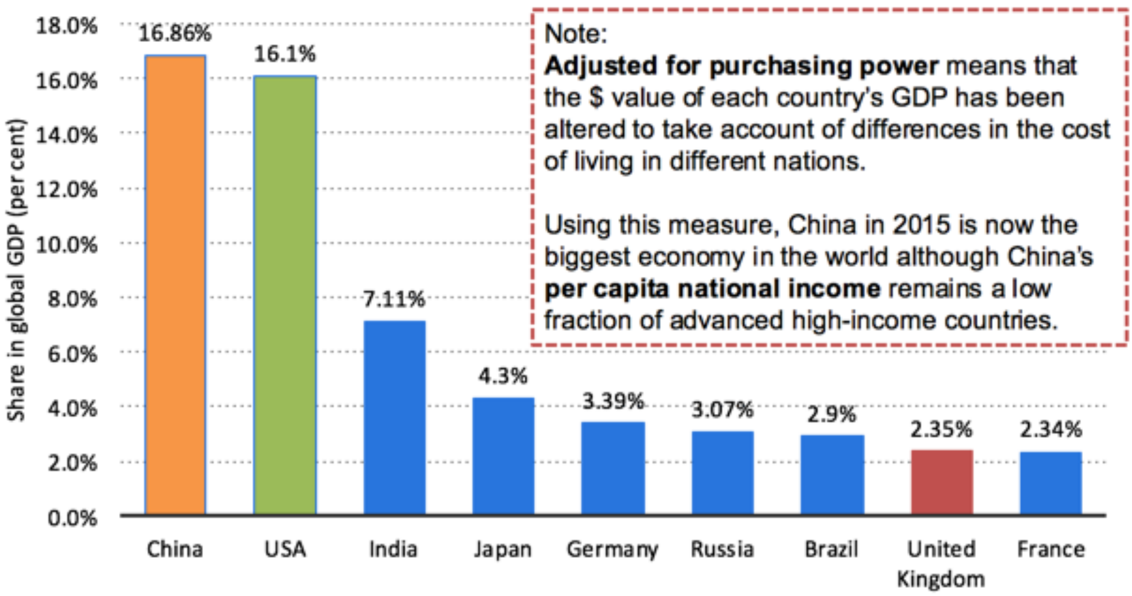
"The geographic dispersion of industrial and service activities, for example research and development, sourcing of inputs, production and distribution, and the cross-border networking of companies, for example through joint ventures and the sharing of assets."

Key points to remember about the overall process of globalisation:

- Globalisation is a **process** in which economies have become increasingly integrated and inter-dependent
- Globalisation is **dynamic** rather than an end state
- Globalisation is **not inevitable** – it can reverse, indeed the growth of world trade in goods and services slowed in recent years following the global financial crisis

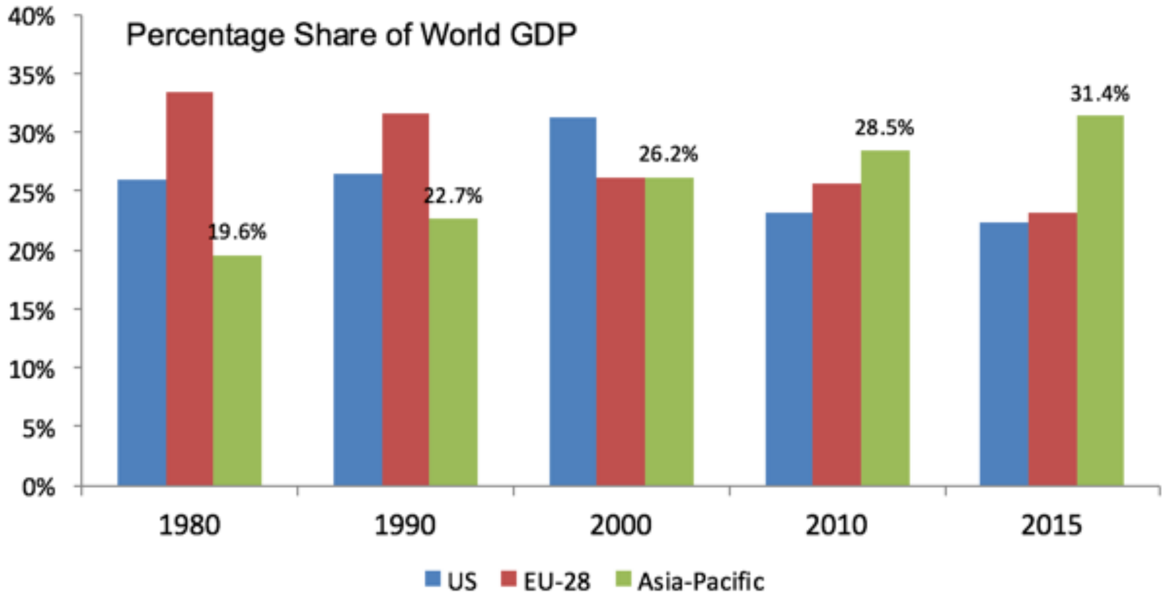
**Key Features of the Changing Global Economy**

The world's largest economies, as measured by their share of global GDP, are illustrated in the chart below:



## Topic: Factors Contributing to Increased Globalisation
*4.1 Globalisation*

It is important to understand that the world economy has changed significantly in recent decades and continues to change as emerging economies develop further. Since 1980 the share of global economic output has shifted towards Asian-Pacific countries who now dominate, as illustrated in the chart below:




### The Key Features of Globalisation
The process of globalisation has had a dramatic effect on both the structure of the global economy and also how business is done in international markets. The key features of globalisation include:

- Trade to GDP ratios are increasing for most countries
- Expansion of Financial Capital Flows between countries
- Foreign Direct Investment and Cross Border M&A
- Rising number of global brands – including from emerging countries
- Deeper specialization of labour – components come from many nations
- Global supply chains & new trade and investment routes e.g. South-South trade
- Increasing levels of international labour migration and migration within countries
- Increasing connectivity of people and businesses through mobile and Wi-Fi networks

### What Factors Have Contributed to Globalisation?
Whilst there are many factors that contributed to the process of globalisation, certain factors are widely considered to have played a major role over the long-term. These are summarised below:

| | |
|---|---|
| **Containerization** | The costs of ocean shipping have come down, due to containerization, bulk shipping, and other efficiencies. The lower unit cost of shipping products around the global economy helps to bring prices in the country of manufacture closer to those in export markets, and it makes markets more contestable globally |
| **Technological** | Rapid and sustained technological change has reduced the cost of |

| | |
|---|---|
| **change** | transmitting and communicating information – sometimes known as **"the death of distance"** – a key factor behind trade in knowledge products using web technology. |
| **Economies of scale** | Many economists believe that there has been an increase in the minimum efficient scale (MES) associated with some industries. If the MES is rising, a domestic market may be regarded as too small to satisfy the selling needs of these industries. Many emerging countries have their own transnational corporations |
| **Differences in tax systems** | The desire of businesses to benefit from lower unit labour costs and other favourable production factors abroad has encouraged countries to adjust their tax systems to attract **foreign direct investment (FDI).** Many countries have become engaged in tax competition between each other in a bid to win lucrative foreign investment projects. |
| **Shift from protectionism towards open trade** | Old forms of non-tariff protection such as import licensing and foreign exchange controls have gradually been dismantled. Borders have opened and average import tariff levels have fallen. However, in the last few years, there has been a rise in non-tariff barriers such as import quotas as countries have struggled to achieve real economic growth and as a response to persistent trade and current account deficits |
| **Growth of MNCs** | In their pursuit of revenue and profit growth, increasingly global businesses and brands have invested significantly in expanding internationally. This is particularly the case for businesses owning brands that have proved they have the potential to be successfully globally, particularly in faster-growing economies fueled by growing numbers of middle class consumers. |

**Who Benefits from Globalisation?**
The key potential benefits for businesses and the economies in which they operate include:

- Encourages producers and consumers to benefit from deeper division of labour and economies of scale
- Competitive markets reduce monopoly profits and incentivise businesses to seek cost-reducing innovations
- Enhanced growth has led to higher per capita incomes – and helped many of poorest countries to achieve faster economic growth and reduce extreme poverty measured as incomes
- Advantages from the freer movement of labour between countries
- Gains from the sharing of ideas / skills / technologies across national borders
- Competitive pressures of globalisation may prompt improved governance and better labour protection

**Drawbacks and Risks of Globalisation**
Key points include:

- **Inequality**: Globalisation has been linked to rising inequalities in income and wealth. Evidence for this is the growing rural–urban divide in countries such as

China, India and Brazil. This leads to political and social tensions and financial instability that will constrain growth. Many of the world's poorest people do not have access to basic technologies and public goods. They are excluded from the benefits.

- **Inflation:** Strong demand for food and energy has caused a steep rise in commodity prices. Food price inflation has placed millions of the world's poorest people at great risk.
- **Vulnerability to external economic shocks** – national economies are more connected and interdependent; this increases the risk of contagion i.e. an external event somewhere else in the world coming back to affect you has risen / making a country more vulnerable to macro-economic problems elsewhere
- **Threats to the environment:** Irreversible damage to ecosystems, land degradation, deforestation, loss of bio-diversity and the fears of a permanent shortage of water afflict millions of the world's most vulnerable
- **Race to the bottom** – nations desperate to attract inward investment may be tempted to lower corporate taxes, allow lax health and safety laws and limit basic welfare safety nets with damaging social consequences
- **Trade imbalances:** Global trade has grown but so too have trade imbalances. Some countries are running big trade surpluses and these imbalances are creating tensions and pressures to introduce protectionist policies such as new forms of import control. Many developing countries fall victim to export dumping by producers in advanced nations (dumping is selling excess output at a price below the unit cost of supply.)

**Topic: Protectionism**
*4.1 Globalisation*

| What You Need to Know |
|---|
| Tariffs<br>Import quotas<br>Other trade barriers |

**What is Open Trade?**
Free (open) trade is an **economic policy** of not discriminating against imports from and exports to other countries.

Buyers and sellers from separate economies may trade without the domestic government applying tariffs, quotas, subsidies or prohibitions on their goods and services.

The key benefits of open trade include:

- Countries can benefit from comparative advantage
- Businesses can better achieve economies of scale
- Encourages competition and economic efficiency
- Enables businesses to grow beyond their domestic borders

The World Trade Organization (WTO) is the only international organisation dealing with the global rules of trade between nations. **Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.**

**What is Protectionism?**
Protectionism involves any attempt by a country to to impose restrictions on trade in goods and services.

The main aim of protectionism is to cushion domestic businesses and industries from overseas competition and prevent the outcome resulting solely from the interplay of free market forces of supply and demand. The three main types of protectionism are summarised below:

| | |
|---|---|
| **Import Quotas** | A tariff a tax or duty that **raises the price of imported products** and causes a reduction in domestic demand and an expansion in domestic supply. For example, until recently, Mexico imposed a 150% tariff on Brazilian chicken. The United States has an 11% import tariff on imports of bicycles from the UK! |
| **Tariffs** | Quotas are **volume limits on the level of imports allowed or a limit to the value of imports permitted** into a country in a given time period. For example, until 2014, South Korea maintained strict quotas on imported rice. It has now replaced a quota with import tariffs designed to protect South Korean rice farmers. Quotas do not normally bring in any immediate tax revenue for the government although if they cause domestic production and incomes to expand, there will be a beneficial impact on taxes paid. |
| **Domestic & Export Subsidies** | A subsidy is a **payment to encourage domestic production** by lowering their costs. Well known subsidies include Common Agricultural Policy in the EU, or cotton subsidies for US farmers and farm subsidies introduced by countries such as Russia. In 2012, the US government imposed tariffs on Chinese |

| | |
|---|---|
| | manufacturers of solar panel cells, judging that they benefited from unfair export subsidies after a review that split the US solar industry. |

Whilst protectionism might seem not to be in the best interests of business and society, there are several reasons why protectionism is favoured and encouraged by some economies (to a greater or lesser extent):

| | |
|---|---|
| **Infant Industry Protection** | Help infant or fledgling industries establish themselves, including achieving economies of scale |
| **Protection of Strategic Industries** | Protect jobs, skills and capabilities in key (strategic) industries to a country |
| **Protection Against Import Dumping** | Dumping is a form of predatory pricing which can seriously damage domestic industries |

The key arguments against protectionism (which are in effect also arguments in support of open or free trade) include:

| | |
|---|---|
| **Higher prices for consumers** | Particularly arising from import tariffs or import quotas that restrict market supply |
| **Retaliation from other countries** | Protectionist measures often result in retaliation - such as price wars |
| **Extra costs for exporters** | Protectionism that becomes widespread in global industries increases the costs facing domestic firms trying to export |

**Key Terms**

| | |
|---|---|
| **Protectionism** | An economy policy that involves any attempt by a country to to impose restrictions on trade in goods and services or to favour domestic firms against international competition |
| **Open trade** | An **economic policy** of not discriminating against imports from and exports to other countries |

## Topic: Trading Blocs
*4.1 Globalisation*

| What You Need to Know |
|---|
| a) Expansion of trading blocs:<br>EU and the single market \| ASEAN \| NAFTA<br>b) Impact on businesses of trading blocs |

### What is a Trading Bloc?
Trade blocs are usually **groups of countries in specific regions that manage and promote trade activities**.

Trade blocs lead to **trade liberalisation** (the freeing of trade from protectionist measures) and trade creation between members, since they are treated favourably in comparison to non-members.

### The Main Trading Blocs and Regional Trading Agreements (RTAs)
The World Trade Organisation (WTO) permits the existence of trade blocs, provided that they result in lower protection against outside countries than existed before the creation of the trade bloc. The most significant trading blocs and RTAs are currently:

- European Union (EU) – a customs union, a single market and now with a single currency
- European Free Trade Area (EFTA)
- North American Free Trade Agreement (NAFTA) between the USA, Canada and Mexico
- Mercosur - a customs union between Brazil, Argentina, Uruguay, Paraguay and Venezuela
- Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA)
- Common Market of Eastern and Southern Africa (COMESA)
- South Asian Free Trade Area (SAFTA) created in 2006 with countries such as India and Pakistan
- Pacific Alliance – 2013 – a regional trade agreement between Chile, Colombia, Mexico and Peru

### Key Benefits of Trading Blocs
These can be summarised as follows:

| | |
|---|---|
| **Foreign Direct Investment** | An increase in foreign direct investment results from trade blocs and benefits the economies of participating nations |
| **Economies of Scale** | Larger markets created via trading blocs permit economies of scale |
| **Competition** | Trading blocs bring businesses in numerous countries closer together, resulting in greater competition |
| **Greater trade** | Trading blocs seek to reduce protectionist measures such as tariffs and quota tariffs, which should stimulate greater demand within the trading bloc |
| **Market efficiency** | The combination of greater competition, FDI, economies of scale and greater trade should result in a more efficient market |

## Topic: Trading Blocs

*4.1 Globalisation*

**European Union (EU) and the Single Market**

As of July 2016, there are 28 member nations of the EU – collectively known as EU28. The EU28 comprises:

Belgium (BE), Bulgaria (BG), Croatia, Czech Republic (CZ), Denmark (DK), Germany (DE), Estonia (EE), Ireland (IE), Greece (EL), Spain (ES), France (FR), Italy (IT), Cyprus (CY), Latvia (LV), Lithuania (LT), Luxembourg (LU), Hungary (HU), Malta (MT), the Netherlands (NL), Austria (AT), Poland (PL), Portugal (PT), Romania (RO), Slovenia (SI), Slovakia (SK), Finland (FI), Sweden (SE) and the United Kingdom (UK).

***Note: In June 2016, the UK voted in a binary referendum to leave the European Union. This process is known as Brexit and the UK is expected to leave between 2019-2020.***

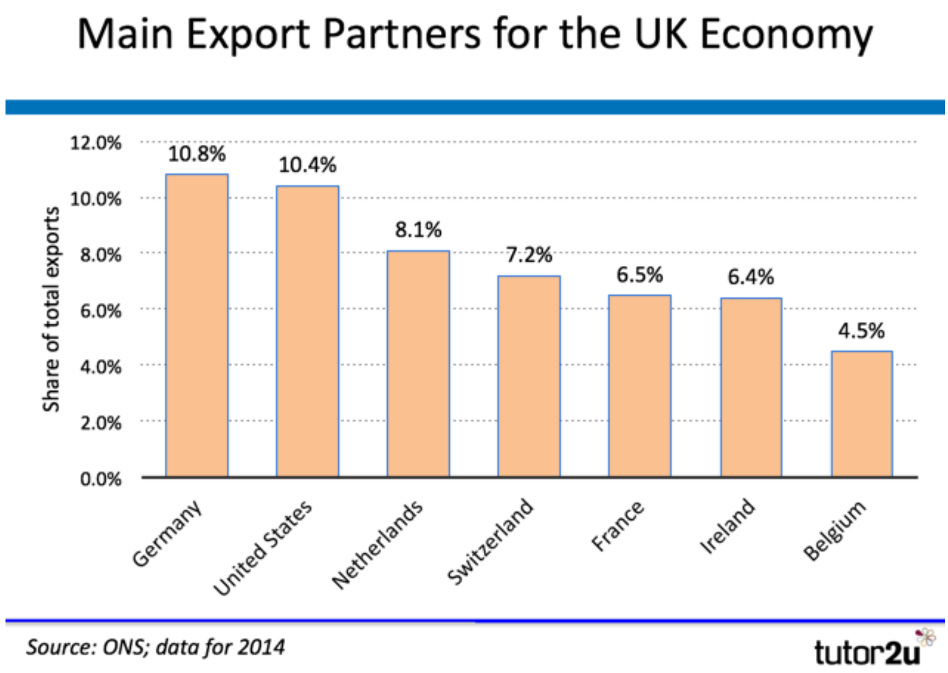
**Key statistics on the EU: (note: pre-Brexit)**

- EU accounts for around 30% of the total value of global GDP
- Total population 506m; live births each year 5.23m
- Largest population - Germany 81 million, Smallest – Malta 0.4 million
- The EU, with 503 million inhabitants, accounts for 7% of the world population
- Gross domestic product of the EU €13.08tn
- Per capita GDP in the EU €25,500
- Average unemployment rate in the Euro area 12%
- Youth unemployment rate in the Euro area 23.9%

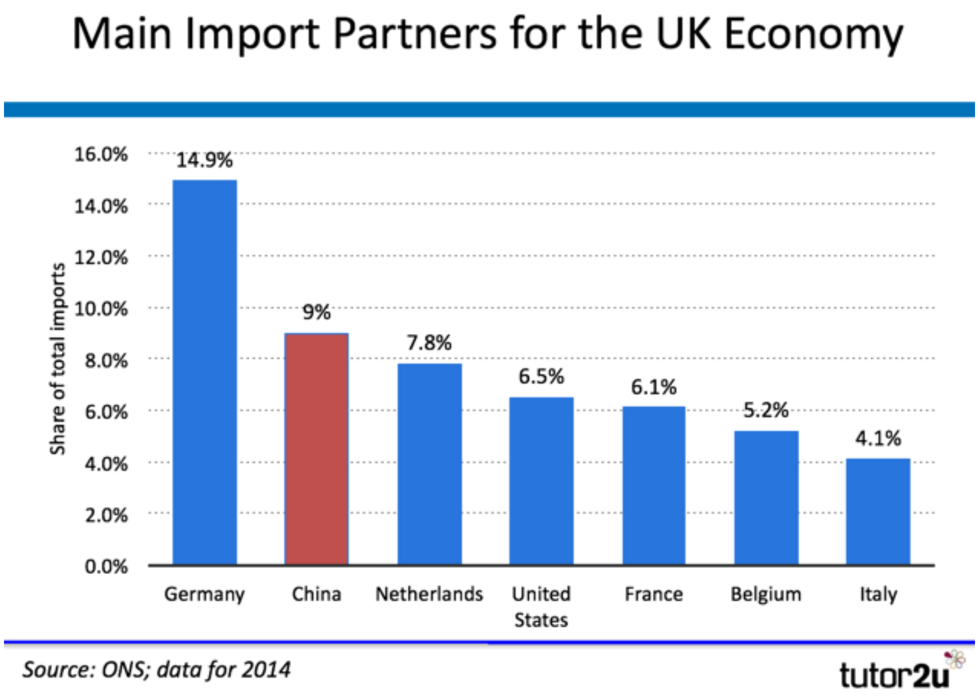
**The EU single market** is built upon four key freedoms:

| | |
|---|---|
| **Free Trade in Goods** | Businesses can sell their products anywhere in the EU's member states and consumers can buy where they want with no penalty |
| **Mobility of Labour** | Citizens of EU member states can live study and work in any other country. The aim is to improve the mobility of labour. |
| **Free Movement of Capital** | Currencies and capital can flow freely between member states and EU citizens can use financial services in any member state. |
| **Free Trade in Services** | Professional services such as pensions, architecture, telecoms and advertising can be offered in any member state |

Countries in the EU are amongst the most significant trading partners of the UK, as illustrated by the chart below:




Similarly, the EU is a significant source of imports into the UK:




**The Business Impact of Brexit**
On 23 June 2016 the UK voted in a referendum to leave the European Union.
Prime Minister David Cameron resigned the morning after the vote and a few weeks later, Theresa May was elected leader of the Conservative Party and new Prime Minister. The process of Brexit has begun although, at the time of writing (September 2016) the timing of the decision to invoke Article 50 of the EU treaty remains uncertain. Once Article 50 is invoked, there is a maximum period of two years before the UK finally leaves the EU
The terms of the UK's new economic relationship with the EU also remain uncertain.

## Topic: Trading Blocs
*4.1 Globalisation*

The potential impact of Brexit include:

| Impact | Comment |
|---|---|
| **Weaker exchange rate (depreciation)** | Sterling fell sharply against US dollar and Euro following vote<br>Higher prices for imports<br>Over 50% of UK imports come from EU |
| **Lower economic growth?** | Expected to take possibly two years to negotiate EU exit terms<br>Initial fall in business and consumer confidence<br>Weak demand in supply chains suggest businesses are being cautious |
| **Housing market** | Fall in confidence may dent mortgage demand<br>Possibility of decline in overseas demand although weaker pound increases real purchasing power of US dollars in UK property market |
| **Unemployment** | Unemployment tends to be a lagging indicator of the economic cycle – a month after Brexit, the UK unemployment rate fell below 5% |

**Trans-Pacific Partnership (TPP)**
The TPP is the latest, and one of the most controversial trading blocs.

It involves 12 countries: the US, Japan, Malaysia, Vietnam, Singapore, Brunei, Australia, New Zealand, Canada, Mexico, Chile and Peru.

The TPP aims to deepen economic ties between these nations, slashing tariffs and fostering trade to boost growth. Member countries are also hoping to develop a closer relationship on economic policies and regulation. The agreement could create a new single market something like that of the EU.

**NAFTA**
The North American Free Trade Agreement (NAFTA) is a trade agreement that sets the rules of trade and investment between Canada, the United States, and Mexico. Since it was formed in 1994 NAFTA has effectively eliminated most tariff and non-tariff barriers to free trade and investment between the three NAFTA countries.

**ASEAN**
ASEAN is a trade bloc of 10 nations with an aggregate economic size of $2.3 trillion. The aim is to establish an economic community (AEC). The trading bloc's diversity – ranging from advanced economies like Singapore to developing countries like Myanmar is an interesting feature. ASEAN's member countries (in 2015) are Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam

**Key Terms**

| | |
|---|---|
| **Trading bloc** | A group of countries in specific regions that manage and promote trade activities. |

## Topic: Conditions that Prompt Trade
*4.2 Global Markets and Business Expansion*

| **What You Need to Know** |
|---|
| Push factors<br>Pull factors |

**What Factors Are Driving and Prompting Trade**
There is no doubt that business is becoming increasingly international in nature. Key evidence of this includes

- Trade to GDP ratios are increasing for most countries
- Expansion of Financial Capital Flows between countries
- Foreign Direct Investment and Cross Border M&A
- Rising number of global brands – including from emerging countries
- Deeper specialisation of labour – components come from many nations
- Global supply chains & new trade and investment routes
- Increasing levels of international labour migration and migration within countries
- Increasing connectivity of people and businesses through mobile and Wi-Fi networks

Whilst many businesses are content to target their domestic customers, the opportunity to trade internationally is increasingly seen as attractive by businesses.

The key reasons why international markets are targeted include:

- Reducing dependence on domestic market
- Accessing faster-growing markets & demand
- Achieving economies of scale
- Better serving customers located overseas
- Building brand value, particularly global brands

**Push and Pull Factors Prompting Trade**
These can be summarised as follows:

| **Push Factors** | **Pull Factors** |
|---|---|
| Where businesses feel they **have to** expand internationally because of domestic / home market issues | Where businesses are **attracted by** compelling opportunities to grow by expanding internationally |

**Topic: Conditions that Prompt Trade**
*4.2 Global Markets and Business Expansion*

Two key push factors prompting trade are:

| | |
|---|---|
| **Saturated Markets** | A feature of markets where sale growth has stalled or is falling<br>Difficult for firms to grow revenues other than by taking market share from competitors<br>Market often characterised by a lack of product innovation<br>Strategic response is often to look for growth opportunities for the same product in overseas markets |
| **Increased Competition** | Domestic firms may be faced with new market entrants who take market share<br>Result is lower revenues in the domestic market – creating the incentive to pursue revenues elsewhere |

Two key pull factors prompting trade are:

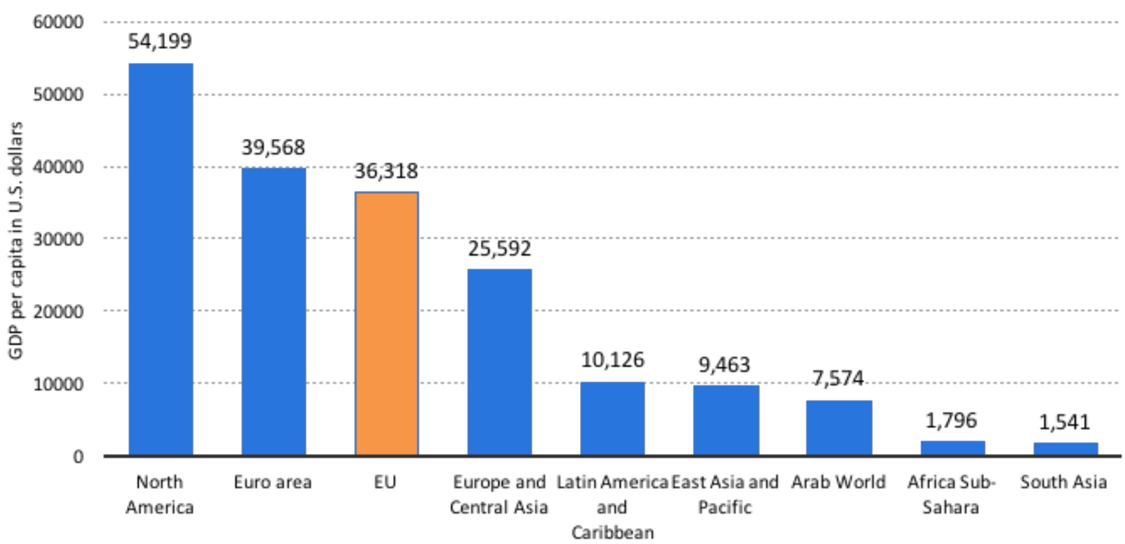
| | |
|---|---|
| **Economies of scale** | Extending a business' operations overseas provides an opportunity to increase output and access economies of scale, thereby reducing unit costs<br>This might involve **offshoring** production to lower-cost economies |
| **Risk spreading** | **Ansoff Matrix** suggests that moving into new markets (overseas) involves greater risk (market development)<br>However, trading internationally can spread the activities and revenues of a business over a wider range of markets, making the business less dependent on domestic demand |

| What You Need to Know |
|---|
| • Assessment of a Country as a Market: factors to consider:<br>– levels and growth of disposable income<br>– ease of doing business<br>– infrastructure<br>– political stability<br>– exchange rate |

**Disposable Income**
Disposal income is a key factor that directly influences the level of consumer demand in a market.

- Disposal income – is the income that consumers have left to spend after tax
- Gross domestic income per capital is a good proxy for the relative levels of disposable income in different international markets
- Businesses looking to expand internationally may identify countries with fast-growing income per capita as a key factor
- Rising disposable incomes are often associated with the growth of a "middle class" with money to spend on products and services

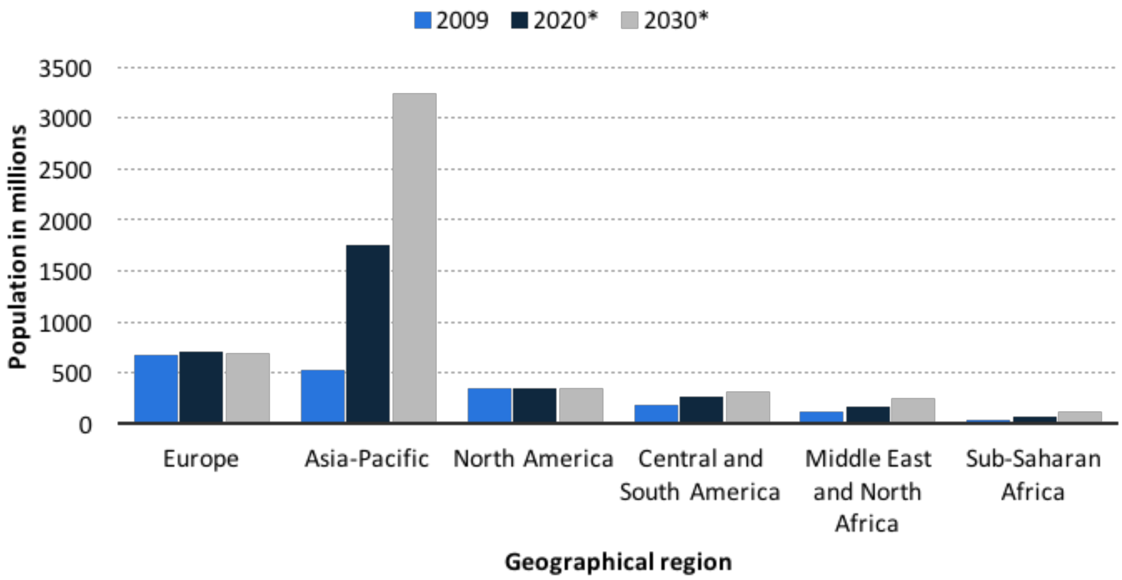
There is wide variation in per capita disposable incomes around the world, as illustrated by the chart below:




As economies grow, disposable incomes also tend to grow, although not everyone benefits. Income inequality is a major issue in both developed and emerging economies.

One feature of emerging economies is the rapid growth of the "middle class" – the social-economic grouping who tend to benefit most from rising disposable incomes. The chart below shows the Brookings Institute forecast of the global middle class population from 2009 to 2030, by region (in millions):

**Topic: Assessment of a Country as a Market**
*4.2 Global Markets and Business Expansion*



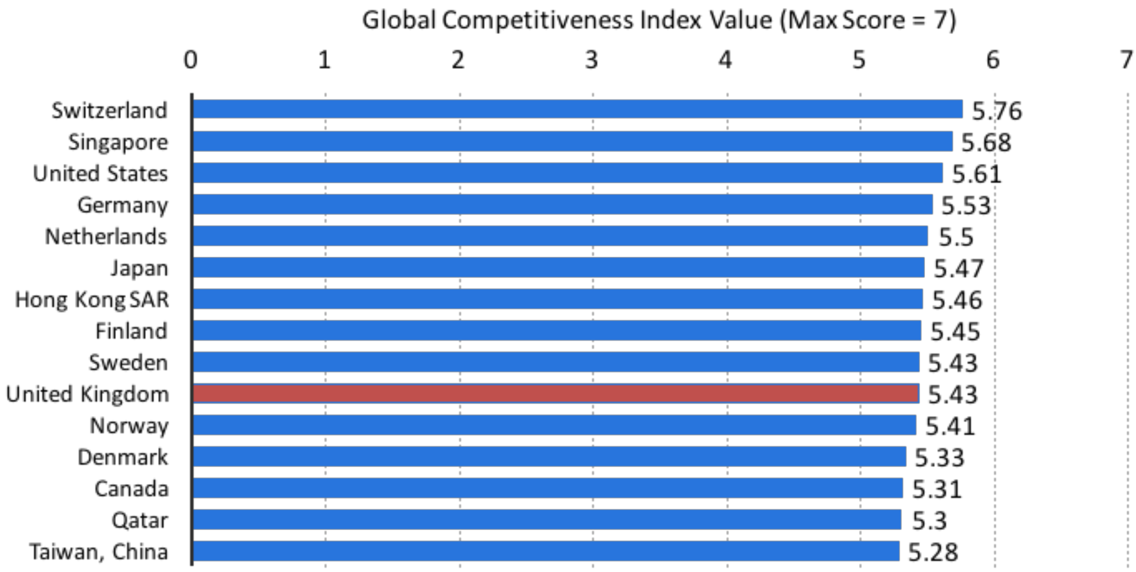

**Ease of Doing Business & More**
Another way of assessing a country as a market is to consider how easy (or difficult) it is to "do business" there. This is an area where qualitative judgements need to be made across a variety of potential indicators.

The World Economic Forum undertakes a major exercise each year to rank countries in terms of competitiveness as a market; they evaluate measures such as:

| **Indicator** | **Measured by…** |
|---|---|
| Effectiveness of institutions | Protection of property rights, rule of law, corruption |
| Quality of infrastructure | Quality of transport, communications, energy etc. |
| Macroeconomic performance | Inflation, fiscal balance, government debt, growth |
| Health and primary education | Malaria incidence, prevalence of HIV, mortality rates |
| Higher education and training | Quality of teaching and attainment e.g. in Maths |
| Efficiency of goods & labour markets | Intensity of competition, tariffs, other barriers |
| Technological readiness | Internet use, availability of latest technologies |
| Sophistication of business | Supplier quality, business clusters, |
| Innovation | Patent applications, research & development spend |

Here are the best countries to do business in based on a recent WEF report:

**Topic: Assessment of a Country as a Market**
*4.2 Global Markets and Business Expansion*



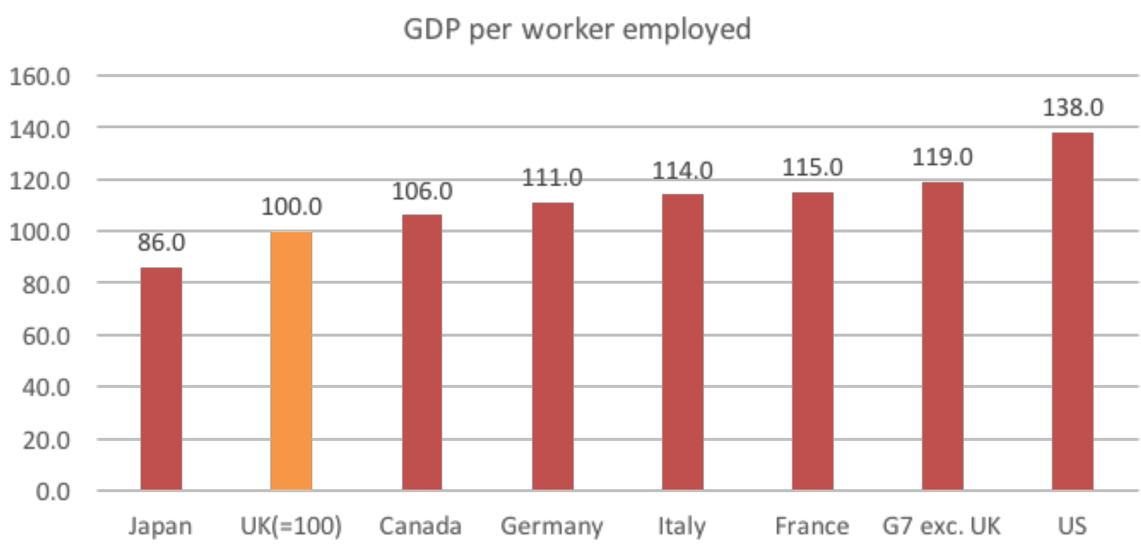
**Topic: Assessment of a Country as a Production Location**

*4.2 Global Markets and Business Expansion*

| What You Need to Know |
| --- |
| • Assessment of a Country as a Production Location<br>– costs of production<br>– skills and availability of labour force<br>– infrastructure<br>– location in trade bloc<br>– government incentives<br>– ease of doing business<br>– political stability<br>– natural resources<br>– likely return on investment |

**Choosing a Production Location – the Importance of Labour Productivity**

For many businesses, particularly those with labour-intensive operations, unit labour costs are one of the most important location factors. Labour productivity can be measured by GDP per hour worked and per worker, and growth in GDP per hour worked. This chart shows GDP per worker for G7 countries.




The UK is often criticised for its relatively poor record on labour productivity, which may in turn affect its attractiveness as a production location (particularly for MNCs). Key reasons often cited for low labour productivity in the UK include:

- Low rate of new capital investment in the UK
- Banking crisis affecting lending to businesses
- Possible slowing rates of process innovation
- Persistent and deep skills shortages in key industries
- Relatively low levels of market competition
- Low aggregate demand & high spare capacity – under-utilizing resources

**Skills and Supply of a Country's Labour Force is a Key Competitiveness Issue**

Investment returns from research and development and subsequent innovation depend critically on a country's labour force, which determines their capacity to recognize, assimilate, and apply new technologies.

How might a country try to improve the competitiveness of it workforce?

- Skills
  - Workplace training to increase people's occupational mobility and increase the flexibility of the labour market
- Enterprise
  - Programs for start-ups e.g. Start-Up Chile, Young Innovative Companies in France, Entrepreneurship First (UK)
- Mobility
  - Housing market reforms to improve affordability and geographical mobility
- STEM
  - Investment in improved access to and quality of teaching in STEM subjects (Science, Technology, Engineering and Maths)

**Exchange Rates and Competitiveness**
We have looked at the detail on exchange rates elsewhere in this theme. In terms of competitiveness, usually a **depreciation** of the exchange rate helps to improve the price competitiveness of domestic producers facing competition from imports and also exporters trying to sell in world markets.

**Other Factors – Ease of Doing Business**
There are many qualitative factors that combine to determine the overall ease with which business can be done in terms of production. Here are the rankings from a recent survey, starting with the countries where doing business is easiest!

| Economy | Ease of Doing Business Rank ▲ | Starting a Business | Dealing with Construction Permits | Getting Electricity | Registering Property | Getting Credit | Protecting Minority Investors | Paying Taxes | Trading Across Borders | Enforcing Contracts | Resolving Insolvency |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Singapore | 1 | 10 | 1 | 6 | 17 | 19 | 1 | 5 | 41 | 1 | 27 |
| New Zealand | 2 | 1 | 3 | 31 | 1 | 1 | 1 | 22 | 55 | 15 | 31 |
| Denmark | 3 | 29 | 5 | 12 | 9 | 28 | 20 | 12 | 1 | 37 | 9 |
| Korea, Rep. | 4 | 23 | 28 | 1 | 40 | 42 | 8 | 29 | 31 | 2 | 4 |
| Hong Kong SAR, China | 5 | 4 | 7 | 9 | 59 | 19 | 1 | 4 | 47 | 22 | 26 |
| United Kingdom | 6 | 17 | 23 | 15 | 45 | 19 | 4 | 15 | 38 | 33 | 13 |
| United States * | 7 | 49 | 33 | 44 | 34 | 2 | 35 | 53 | 34 | 21 | 5 |
| Sweden | 8 | 16 | 19 | 7 | 11 | 70 | 14 | 37 | 17 | 24 | 19 |
| Norway | 9 | 24 | 26 | 18 | 13 | 70 | 14 | 14 | 45 | 8 | 6 |
| Finland | 10 | 33 | 27 | 16 | 20 | 42 | 66 | 17 | 32 | 30 | 1 |

And here are the worst!

# Topic: Assessment of a Country as a Production Location

*4.2 Global Markets and Business Expansion*

| Economy | Ease of Doing Business Rank ▼ | Starting a Business | Dealing with Construction Permits | Getting Electricity | Registering Property | Getting Credit | Protecting Minority Investors | Paying Taxes | Trading Across Borders | Enforcing Contracts | Resolving Insolvency |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Eritrea | 189 | 184 | 189 | 142 | 177 | 185 | 122 | 174 | 189 | 121 | 189 |
| Libya | 188 | 158 | 189 | 126 | 189 | 185 | 188 | 160 | 107 | 131 | 189 |
| South Sudan | 187 | 181 | 177 | 187 | 180 | 174 | 181 | 104 | 179 | 76 | 189 |
| Venezuela, RB | 186 | 186 | 125 | 171 | 129 | 109 | 178 | 188 | 186 | 141 | 165 |
| Central African Republic | 185 | 189 | 155 | 186 | 167 | 133 | 150 | 185 | 144 | 177 | 149 |
| Congo, Dem. Rep. | 184 | 89 | 131 | 174 | 135 | 133 | 174 | 173 | 187 | 165 | 189 |
| Chad | 183 | 185 | 133 | 181 | 155 | 133 | 155 | 186 | 168 | 156 | 149 |
| Haiti | 182 | 188 | 167 | 136 | 179 | 174 | 187 | 143 | 76 | 123 | 189 |
| Angola | 181 | 141 | 108 | 166 | 169 | 181 | 66 | 141 | 181 | 185 | 189 |
| Equatorial Guinea | 180 | 187 | 157 | 135 | 156 | 109 | 144 | 175 | 175 | 108 | 189 |
| Liberia | 179 | 37 | 174 | 180 | 178 | 109 | 182 | 118 | 183 | 176 | 168 |
| Guinea-Bissau | 178 | 179 | 163 | 184 | 150 | 133 | 155 | 152 | 148 | 162 | 189 |
| Afghanistan | 177 | 34 | 185 | 156 | 184 | 97 | 189 | 89 | 174 | 172 | 160 |

## Topic: Reasons for Global Mergers or Joint Ventures

*4.2 Global Markets and Business Expansion*

| **What You Need to Know** |
|---|
| • a) Spreading risk over different countries/regions |
| • b) Entering new markets/trade blocs |
| • c) Acquiring national/international brand names/patents |
| • d) Securing resources/supplies |
| • e) Maintaining/increasing global competitiveness |

**What is a Joint Venture?**
A joint venture (JV) is a **separate business entity created by two or more parties, involving shared ownership, returns and risks.**

Joint ventures are different from takeovers and mergers in that the risks and returns of the business formed as the joint venture are shared by the parties involved. Usually this is a 50:50 share, although that doesn't have to be the case.

The parties involved in a joint venture are usually looking to benefit from complementary strengths and resources brought to the venture, as well as sharing the risks and rewards involved.

Joint ventures are often used as a method of one business entering international markets. Indeed, in some cases, this is a requirement of firms entering certain industries in some countries

The potential benefits and drawbacks of using joint ventures as a method of growth include:

| **Benefits of a Joint Venture** | **Drawbacks of a Joint Venture** |
|---|---|
| JV partners benefit from each other's expertise and resources (e.g. market knowledge, customer base, distribution channels, R&D expertise)<br><br>Each JV partner might have the option to acquire in the future the JV business based on agreed terms if it proves successful<br><br>Reduces the risk of a growth strategy - particularly if it involves entering a new market or diversification | Risk of a clash of organisational cultures - particularly in terms of management style<br><br>The objectives of each JV partner may change, leading to a conflict of objectives with the other<br><br>In practice, there turns out to be an imbalance in levels of expertise, investment or assets brought into the venture by the different partners<br><br>What happens if the JV business fails? Can the JV be closed or sold amicably? |

## Topic: Reasons for Global Mergers or Joint Ventures

*4.2 Global Markets and Business Expansion*

**Examples of Global Joint Ventures**

| | |
|---|---|
| Google & GSK<br>Joint venture to develop bioelectronics medicines | Pool resources and expertise to enable innovation and leadership in an emerging global market opportunity. Also helps spread risk |
| Jaguar Land Rover & Chery Automobile<br>Joint venture to build a car factory in China | Enables Jaguar Land Rover to make cars in China for the first time (overcoming protectionism) |
| Novartis & GSK<br>Two pharmaceutical MNCs combine separate divisions into a new business | Combining two business units into one in order to give the combined JV business greater scale and global competitiveness |

**Mergers**

A merger is a **combination of two previously separate firms** which is achieved by **forming a completely new firm** into which the two original businesses are integrated.

So the key difference between the two can be summarised as follows:

| **Merger** | **Takeover** |
|---|---|
| Involves a **NEW FIRM** being created into which two existing businesses are "merged" | Involves an **EXISTING FIRM** acquiring more than 50% of another firm and thereby gaining control of it |

**Examples of Global Mergers**

- 2010: British Airways and Iberia merge to form IAG
- 2000: Glaxo Wellcome plc and SmithKline Beecham plc merge to form GSK plc
- 2014: Dixons plc and Carphone Warehouse merge to form Dixons Carphone
- 2015: Paddy Power and Betfair merge to form Paddy Power Betfair
- 2015: H.J. Heinz Company & Kraft Foods Group merge to form The Kraft Heinz Company

**Key Terms**

| | |
|---|---|
| **Joint venture** | A separate business entity created by two or more parties, involving shared ownership, returns and risks. |
| **Merger** | A combination of two previously separate firms which is achieved by forming a completely new firm into which the two original businesses are integrated. |

**Topic: Marketing**
*4.3 Global Marketing*

| What You Need to Know |
|---|
| • a) Global marketing strategy and global localisation (glocalisation)<br>• b) Different marketing approaches:<br>– domestic/ethnocentric<br>– mixed/geocentric<br>– international/polycentric<br>• c) Application and adaptation of the marketing mix (4Ps) and Ansoff's Matrix to global markets |

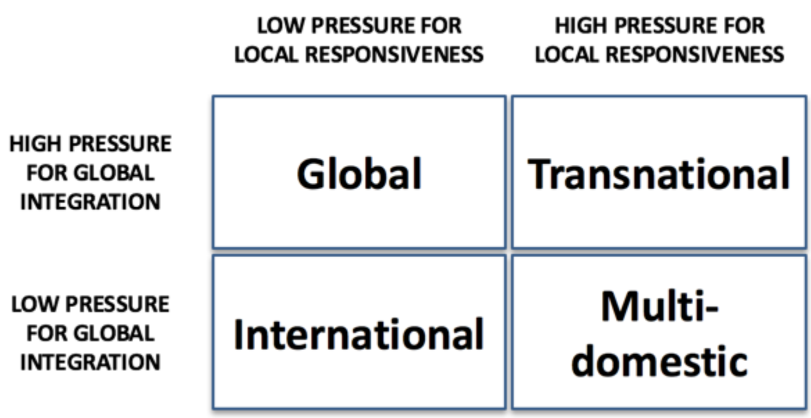
**What is Glocalisation?**
Glocalisation describes a product or service that is developed and sold globally, but is also adapted to meet the needs and wants of customers in a local market.

**Marketing Approaches**
The three approaches included in the specification can be summarised as follows:

| Domestic / Ethnocentric | Mixed / Geocentric | International / Polycentric |
|---|---|---|
| Assumes that work works in home markets will also work in international markets<br>Effective if international consumers value authenticity | Recognises differences in national markets<br>But main aim of marketing strategy is to build a truly global brand | Recognises that every national market requires a different marketing mix<br>Products designed specifically to meet local needs |

**Alternative Model – Bartlett & Ghoshal**
The Bartlett & Ghoshal Model indicates the strategic options for businesses wanting to manage their international operations based on two pressures:

- Local responsiveness, and
- Global integration




The two "pressures" or forces on firms wanting to compete in international markets, which determine the four grids in the box above are:

**Force for local responsiveness**

**Topic: Marketing**
*4.3 Global Marketing*

This considers questions such as:

- Do customers in each country expect the product to be adapted to meet local requirements?
- Do local (domestic competitors) have an advantage based on their ability to be more responsive?

**Force for global integration**
This considers questions such as:

- How important is standardisation of the product in order to operate efficiently (e.g. economies of scale)?
- Is consistent global branding required in order to achieve international success?

The key features of each box in the Bartlett & Ghoshal model are summarised in the table below:

| Strategy | Pressure for Responsiveness | Pressure for Global Integration | Key Features |
|---|---|---|---|
| Global | Low | High | Highly centralised<br>Focus on efficiency (economies of scale)<br>Little sharing of expertise locally<br>Standardised products |
| Transnational | High | High | Complex to achieve<br>Aim is to maximise local responsiveness but also gain benefits from global integration<br>Wide sharing of expertise (technology, staff etc.) |
| International | Low | Low | Aims to achieve efficiency by focusing on domestic activities<br>International operations are largely managed centrally<br>Relatively little adaption of product to local needs |
| Multi-domestic | High | Low | Aims to maximise benefits of meeting local market needs through extensive customisation<br>Decision-making decentralised<br>Local businesses treated as separate businesses<br>Strategies for each country |

## Topic: Niche Markets
*4.3 Global Marketing*

| What You Need to Know |
|---|
| • a) Cultural diversity: recognition that groups of people across the globe have different interests and values<br>• b) Features of global niche markets<br>• c) Application and adaptation of the marketing mix (4Ps) to suit global niches |

**Factors Influencing Cultural Diversity**
It is important to remember that there are still a wide variety of factors that create cultural diversity in markets around the world:

- Economic development - in particular disposable incomes, health and education standards
- Language
- History & traditions
- Religious & social norms
- Weather & climate
- Attitudes to "outsiders"
- Legal systems

**Global Niche Markets**
A global niche market is a market where customers **in many countries have specific needs and wants that are not satisfied by mass market products or services.**

Global niche markets develop because of:

- Cultural differences
- Specialist expertise developed
- Different adoption of technology
- Premium / luxury demand
- Distinctive branding
- Specialist distribution

**Two Examples of Global Niche Markets**
Two great examples of global niche markets are messaging apps and ride-sharing.

| | |
|---|---|
| **Messaging Apps** | Messenger apps have become a global market<br>However, certain apps have built appeal in different markets, building on their understanding of cultural diversity<br>WeChat is the dominant app in China, not WhatsApp or Facebook Messenger |
| **Ride-sharing** | Uber, a ride-hailing service that is the world's most valuable startup wanted to dominate the global market it had effectively created<br>However, after huge losses in China, Uber decided to sell its local unit to Didi Chuxing, a Chinese rival<br>Didi Chuxing has received backing from Microsoft and Apple and is now the world's largest ride-sharing service, covering over 400 Chinese cities |

## Topic: Impact of MNCs

*4.4 Global Industries and Companies (Multinational Corporations)*

| What You Need to Know |
| --- |
| MNCs<br>a) Impact of MNCs on the local economy:<br>local labour, wages, working conditions and job creation \| local businesses \| the local community and environment<br>b) Impact of MNCs on the national economy:<br>FDI flows \| balance of payments \| technology and skills transfer \| consumers \| business culture \| tax revenues and transfer pricing |

**Multinational Companies (MNCs)**

A multinational company (MNC) is a business that has **operations in more than one country**.

Note that a business does not become an MNC simply because it sells its goods and services overseas. The key to being an MNC is that the business has **business operations** in two or more countries.

The number of MNCs has grown rapidly in recent decades, alongside the rise of globalisation. The key reasons for the emergence of MNCs include:

- Global brands seeking to drive revenue and profit growth in emerging economies (in particularly seeking rising demand from increasingly affluent consumers)
- The search for economies of scale, to reduce unit costs by concentrating production in a few key international locations
- The perceived need to supplement relatively weak demand in existing, developed economies
- The need to operate in many countries to avoid protectionism
- Increased takeover activity that has built businesses with widespread international operations

Do MNC's benefit the countries in which they operate? Supporters of MNCs point to the following advantages:

- MNCs provide significant employment and training to the labour force in the host country
- Transfer of skills and expertise, helping to develop the quality of the host labour force
- MNCs add to the host country GDP through their spending, for example with local suppliers and through capital investment
- Competition from MNCs acts as an incentive to domestic firms in the host country to improve their competitiveness, perhaps by raising quality and/or efficiency
- MNCs extend consumer and business choice in the host country
- Profitable MNCs are a source of significant tax revenues for the host economy (for example on profits earned as well as payroll and sales-related taxes)

From the perspective of the economies in which MNCs operate, critics of MNCs point to the following drawbacks:

- Domestic businesses may not be able to compete with MNCs and some will fail

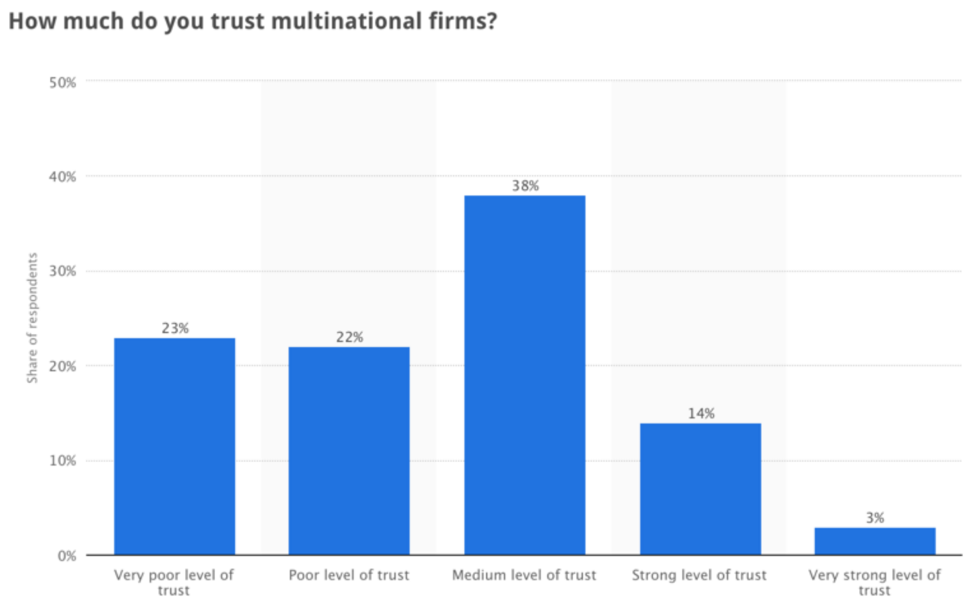
## Topic: Impact of MNCs

*4.4 Global Industries and Companies (Multinational Corporations)*

- MNCs may not feel that they need to meet the host country expectations for acting ethically and/or in a socially-responsible way
- MNCs may be accused of imposing their culture on the host country, perhaps at the expense of the richness of local culture.
- Profits earned by MNCs may be remitted back to the MNC's base country rather than reinvested in the host economy.
- MNCs may make use of transfer pricing and other tax avoidance measures to significant reduce the profits on which they pay tax to the government in the host country

### Exploring the Impact of MNCs

Whilst MNCs are significant factors in the economic growth of developed and emerging economies, their activities are subject to increasing scrutiny. A key issue is one of trust:




***Some Reasons Why Some MNCs Have A Low Level of Public Trust***

| | |
|---|---|
| **Tax avoidance by MNCs** | MNCs are accused of using sophisticated tax planning schemes to avoid paying taxes on their activities<br>A challenge of addressing MNC tax avoidance is that they operate across so many different countries |
| **Exploitation of workers & supply chains** | Some MNCs are accused of exploitation of working conditions in developing economies in search of low production costs<br>The complexity of international supply chains makes it hard for MNCs to control & monitor all aspects of their production |
| **Are MNCs damaging domestic firms?** | Uber is one of the fastest-growing MNCs and has faced significant resistance from national markets it has entered<br>However, in many national markets, domestic firms are proving able to compete effectively with MNCs –particularly in China |

**Topic: Ethics**
*4.4 Global Industries and Companies (Multinational Corporations)*

| **What You Need to Know** |
|---|
| • a) Stakeholder conflicts<br>• b) Pay and working conditions<br>• c) Environmental considerations:<br>    – emissions<br>    – waste disposal<br>• d) Supply chain considerations:<br>    – exploitation of labour<br>    – child labour<br>• e) Marketing considerations:<br>    – misleading product labelling<br>    – inappropriate promotional activities |

**Reminder - What are Ethics?**
Ethics are **moral guidelines** which govern **acceptable behaviour.**

Ethical behaviour (in life generally as well as in business) is about **doing what is morally right**.

In business, ethical standards play a crucial role in decision-making:

- Used by individuals to make choices about how to behave
- They define acceptable conduct in business
- Should underpin decision making
- An ethical decision is one that is both legal and meets the shared ethical standards of the relevant business community
- Note: different countries and cultures have different attitudes to what constitutes acceptable ethical behaviour!

**Common Ethical Issues Raised by the Activities of MNCs**

The key areas where MNCs are criticised and scrutinized in terms of their ethical behaviour include:

| | |
|---|---|
| **Pay & working conditions** | The ways that employees and management are rewarded can create significant ethical issues<br>The strong "bonus culture" in financial services is a good example of this<br>Driven by the incentive of large bonuses, do MNC management cut corners or break the rules?<br>"Fat cats" – is it ethical that MNC CEOs should be paid hundreds of more times better than the average for employees in their businesses?<br>Should MNCs be allowed to use "sweatshop" labour in low labour cost countries such as Bangladesh and Vietnam? Several high profile MNCs like Nike and Apple have been caught out by this in the past |
| **Environmental impact** | MNCs operate across the globe, so perhaps they have a particularly important role to play to ensure they do not deplete the world's natural resources.<br>Some MNCs like BP and Volkswagen have suffered significant financial |

| | |
|---|---|
| | and reputational damage from their association with environmental damage.<br>On the other and, other MNCs like Ikea and Unilever have sought to use sustainability as a core part of their approach to doing business around the world. |
| **Supply chain management** | A multinational business cannot claim to be ethical firm if it ignores unethical practices by its suppliers – e.g.<br>Use of child labour and forced labour<br>Production in sweatshops<br>Violation of the basic rights of workers<br>Ignoring health, safety and environmental standards<br>An ethical business has to be concerned with the behaviour of all businesses that operate in the supply chain – i.e.<br>Suppliers, Contractors, Distributors, Sales agents |
| **Marketing** | Marketing is an ethical minefield for most businesses.<br>Several MNCs have been damaged after been caught marketing in an apparently unethical (and illegal) way – particularly around pricing. |

## Topic: Controlling MNCs

*4.4 Global Industries and Companies (Multinational Corporations)*

| **What You Need to Know** |
|---|
| a) Factors to consider:<br>political influence<br>legal control<br>pressure groups<br>social media |

**Why Might the Activities of Multinationals Need Controlling?**
All businesses are subject to control – both through regulation of industries and government legislation.

However, it is often argued that MNCs deserve special attention, mainly as a result of the scale and scope of their operations.

Some key reasons why MNC's may need controlling include:

- To protect against exploitation by MNCs
- To discourage resource depletion by MNCs
- To ensure local culture is protected from MNCs
- To discourage abuse of market power by MNCs
- To protect domestic businesses from MNCs

**Political Influence**
Governments around the world have an uneasy relationship with MNCs.

On the one hand, they want MNCs to invest in domestic economies (FDI) to create employment and economic growth.

On the other hand, there is a nervousness about the economic power wielded by major global businesses.

Political influence on MNC activity appears to be growing, focusing areas such as:

- Tax avoidance
- Business ethics
- Dominant market positions

**Pressure Groups**
MNCs have long been the targets of pressure group activity;

- Pressure groups – are external stakeholders
- They tend to focus on activities & ethical practice of multinationals or industries with ethical issues
- Through a combination of direct and indirect action, pressure groups can damage the target MNC or industry

**Consumer Action and Social Media**

- This is another way in which business ethics can be challenged. Consumers may take action against:

  - Businesses they consider to be unethical in some ways (e.g. animal furs)
  - Business acting irresponsibly
  - Businesses who use business practices they find unacceptable
- Consumer action can also be positive – supporting businesses with a strong ethical stance & record