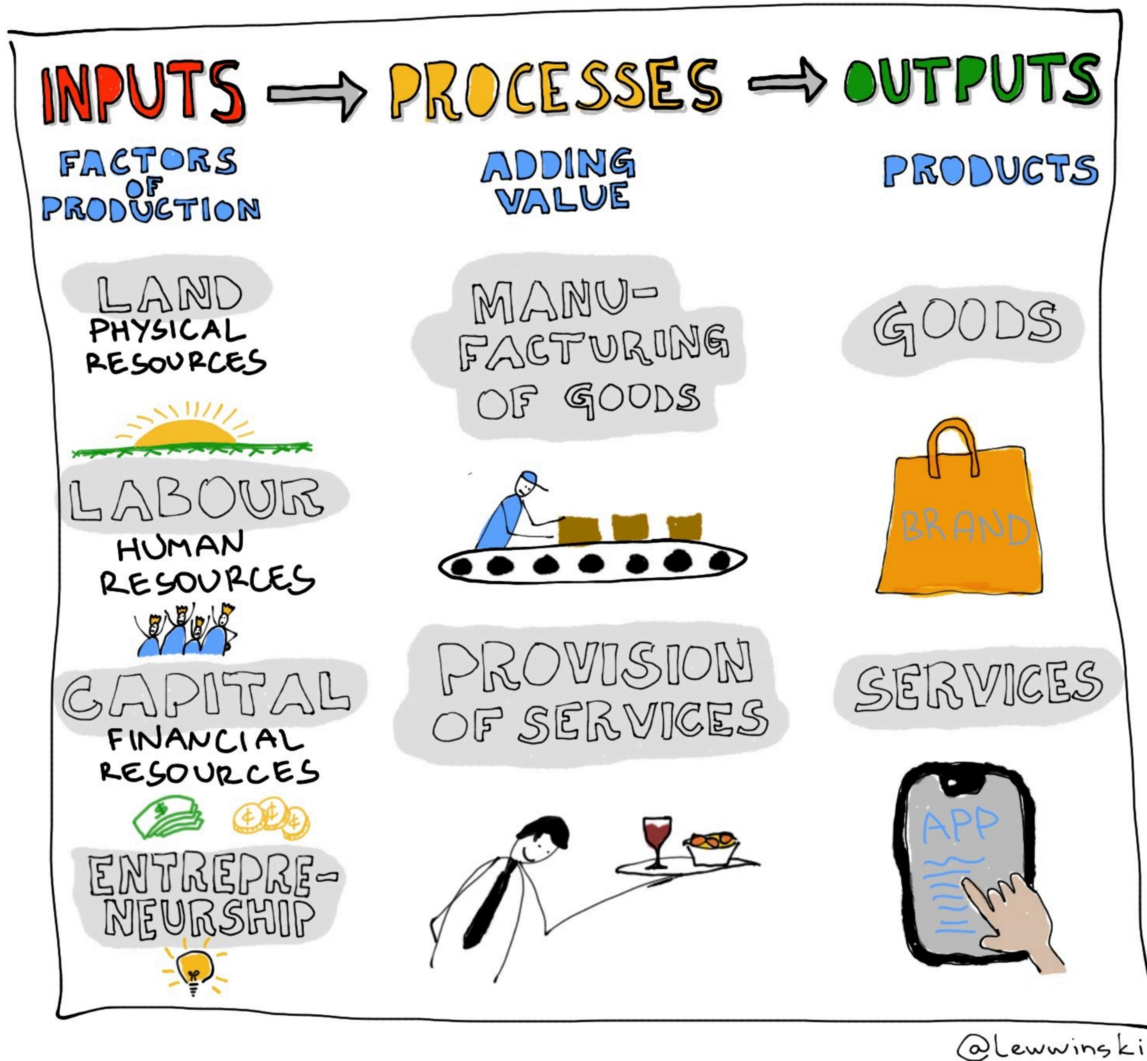
Introduction to business management

**Business** is an organisation that provides goods and services and satisfies needs and wants in a profitable or non-profitable way. This definition already includes some extra business terms that we'll talk about in a moment. I believe the easiest way to understand what business is and how it functions is **input-output model**, that I outlined for you below.




**Inputs** are the resources that businesses use in order to transform them into outputs by adding value. In traditional economic theory these resources/inputs are called **factors of production**:

1. **Land** (physical resources) — land, real estate or raw materials, for example, fish, gold, wood.
2. **Labour** (human resources) — people in business: employees and managers.
3. **Capital** (financial resources) — cash and other forms of financial resources as well as capital goods, i.e. things/equipment used in production: office chairs, desks, laptops or assembly line robots.
4. **Entrepreneurship** — skillset that combines all the factors of production in order to transform them into products (goods and services).

**Added value** is extra perks/features that are added to inputs in order to sell them to customers. If there's no added value, there's no business.

**Capital-intensive** refers to high reliance on machinery in production process.

**Labour-intensive** refers to high reliance on human labour.

**Output** is a product, that can either be tangible (good) or intangible (service).

If a product is sold by one business to another, this is a **producer good or service**. This relationship of one business to another is called **B2B** (business-to-business)

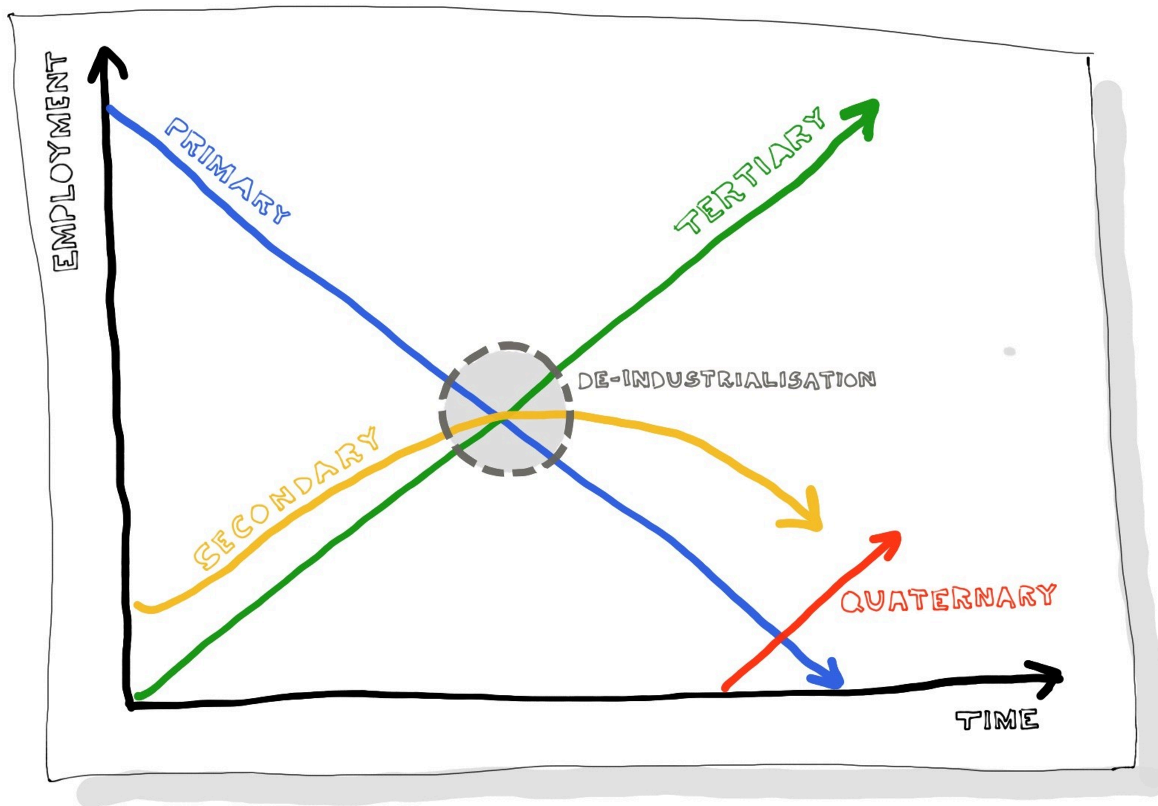
If a product is sold by business to the general public, this is a **consumer good or service**. This relationship is called **B2C** (business-to-consumer).

All businesses, regardless of their size, location and other characteristics have the same 4 **business functions**:

1. **Human resource management** (HRM) — making sure that the right people are employed and paid by the business, regularly trained, appraised and treated in accordance with Health & Safety regulations.
2. **Finance and accounts** — planning for the future costs, revenues and cash flow and keeping records of the costs, revenues and cash flow in the past, as well as financial analysis and budgeting.
3. **Marketing** — making sure the right product is sold at the right price in the right place using appropriate promotion methods.
4. **Operations management** — making sure that goods are produced using relevant methods of production and/or making sure that the most efficient processes are used to provide services.

**Economic sector** (or sector of industry) refers to all the businesses within an economy that are involved in a similar activity. So, if you want to divide all businesses in a country into economic sectors, you have to see what they do. Overall, there are four economic sectors:

1. **Primary sector** refers to all the businesses that extract raw materials: mining, fishing, forestry, agriculture, oil extraction, etc.
2. **Secondary sector** businesses transform raw materials, extracted by primary sector businesses, into goods, i.e. secondary sector refers to manufacturing.
3. **Tertiary sector** refers to provision of services: banking, education, retail stores, cinemas, transportation, etc.
4. **Quaternary sector** is quite similar to tertiary, because it also includes services, but exclusively those services that relate to data, knowledge and IT. For example, app and video game development would be an example of quaternary sector activity. However, selling these apps and video games in retail stores would be an example of tertiary sector activity.

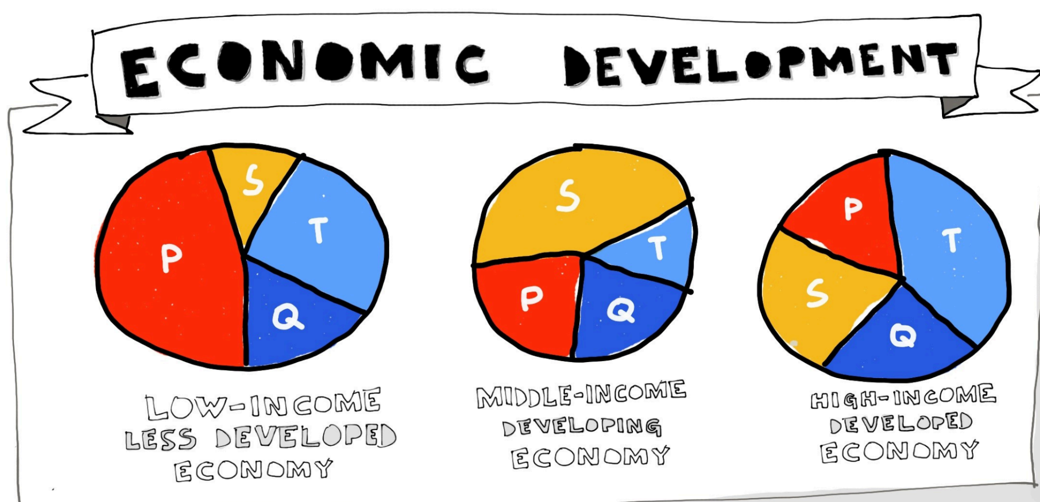



Secondary sector increases first (this increase is called **industrialisation**) as manufacturing is growing, and then after a certain point, usually when it becomes cheaper to manufacture goods in a different country, secondary sector decreases (the decrease of the secondary sector is called **deindustrialisation**). Tertiary sector is gradually increasing over time, because the more economy develops, the wealthier people usually become, and the more money they prefer to spend on tertiary sector activities, i.e. services: better education, travel, opening a bank account — all of these are services. Also, as time goes by, quaternary activities are increasing because they are proportional to technological progress and development of IT.

Economies where primary sector dominates are called **less developed economies**.

Economies where secondary sector dominates are called **developing economies**.

Countries where tertiary and quaternary sector dominate are referred to as **developed economies**.



First of all, if we're gonna talk about **startups** (new businesses), we've gotta talk about entrepreneurship.It is one of the four factors of production and an essential part of any business, that refers to a skillset (or knowledge/wisdom) that allows to combine all factors of production and start an enterprise. People who have this skillset are called **entrepreneurs**.

In addition entrepreneurs, there are also **intrapreneurs** — people who are similar to entrepreneurs but who work for a company. They are usually provided with a lot of freedom, they hire people for their team themselves, they manage their time own their own and share pretty much the same opportunities and threats as entrepreneurs, but all of this is happening within a company context.

Reasons to start up a business. There is no one right answer to what these reasons are but some of them are really common. When I ask my students what they think the main reasons are, they usually give me very good answers! Here's a top chart of what they usually say and a fancy BM-terminology version (in brackets) of what my students say:

1. "Getting rich!" (financial rewards)
2. "Doing something new" (innovation)
3. "Manage time on your own" (life-work balance)
4. "Find something others don't do" (filling in the market niche/gap)
5. "No boss" (independence)
6. "I'm the boss!" (responsibility)
7. "Hobby" (commercialising personal interest)

**Public sector** refers to part of the economy that is comprised of organisations that are created and run by governments to provide public services, for example police, public transport, healthcare, education, infrastructure. Public sector organisations are mostly funded by tax revenue.

**Private sector** refers to all organisations that are owned and created by individuals or group of people in order to satisfy needs and wants and provide goods and services. Most organisations in public sector are created to make money to their owners, which means that they are for-profit.

**Liability** is the extent to which you risk losing your personal possessions in case of the business failure, it can be limited and unlimited. **Unlimited liability** means that you personally are completely, 100%, totally, fully, etc responsible for all the business debts and losses.

**Limited liability** means that your responsibility for business losses is restricted by your initial investment, i.e your liability is limited by initial investment.

**Legal identity** is the formal registration of a human or non-human entity. For example, you are a real human being but unless you have a passport or another form of ID, you don't exist from the legal perspective. So, some businesses, for example sole traders, do not have legal

identity. Sole trader's legal identity equals to the person's legal identity. But companies, on another hand, have their own separate legal identity.

Now, if a business organisation does not have its own legal identity (just like sole traders), it means that they are **unincorporated**.

Companies, however, are **incorporated —** they do have a separate (from their owners) identity.

**Transparency** — the extent to which businesses have to disclose their financial data. Some businesses are really private and not transparent, they keep all the accounts to themselves and only share with the tax authorities.

money they made? Just go onto their website and download an annual report.
**Accountability** is the degree to which a person or business is responsible or answerable to someone

**Set-up costs** refer to how much money you need to start a business in this or that form.

**Sole traders** are people who run their businesses alone. This type of business does not have a separate legal identity, the owner and the business is the same entity, which means that sole traders are unincorporated.

**Sole traders** are people who run their businesses alone. This type of business does not have a separate legal identity, the owner and the business is the same entity, which means that sole traders are unincorporated.

**Companies** are limited liability incorporated organisations. They have their own legal identity (owner ≠ business) and are a subject of law independently from their owners and people who work for them.

Owners of companies are called "**shareholders**". From now on, when I say "owner", it implies sole traders and partnerships, when I say "shareholders", it implies companies.

Shareholders are eligible to a portion of company's profits **— dividends**. However, dividends do not have to be paid at all, or do not have to be paid regularly, it all depends on the legislation and company.

There are two main types of companies: **privately held companies** and **publicly held companies**. The key difference between them is that the former sell shares privately, only to those businesses and/or people they want to sell them to, but the latter trade their shares on the stock exchange and potentially any human being of the legal age can become a shareholder.

**Privately held companies**, due to lower transparency and not having to publish that much financial data to the public, usually have a relatively low number of shareholders, compared to publicly held companies.

**Publicly held companies** cannot just become publicly held out of nowhere. All the publicly held companies were privately held prior to "**going public**" — making their shares available for purchasing by anyone.

After making a decision to go public, privately held companies have to go through **initial public offering** (IPO) — the process of selling their shares to the public for the first time. After IPO there is no direct control over share price. Share price is determined by the market laws of supply and demand. This process where shares are sold freely on the **stock exchange** is called **flotation**.

**Social enterprise** is an organisation that has social wellbeing as its main goal, instead of making profits. That is why it is not the same as non-profit organisation. Social enterprises can make profits, or cannot, what matters is just the social wellbeing bit.

for-profit **private sector companies**. By now, you should already understand what for-profit private sector company is, so I am not going to define it.

The second type of social enterprises is for-profit **public sector companies**. Again, you should understand what it means by now. These organisations are the same as private sector companies that we've just discussed, but they operate in public sector, which means that they are created and run by government, which also means that most of them are focused on public services: medicine, infrastructure, transport, education, etc.

The last type of for-profit social enterprise is **cooperatives —** "an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise"

The last type of a social enterprise is non-profit and it is **NGOs** (**non-governmental organisations**). This term first appeared shortly after the Second World War in the United Nations and there is no universal fixed definition for NGOs, so the understanding of NGOs differs from country to country.What all NGOs have in common is that they are usually non-profit, they have public trust, they usually address public well-being issues, such as health, environmental protection, human rights.

**Goals —** what business wants to achieve in the long-term.
**Objectives —** clearly defined short-term or medium-term tasks that a business sets in order to achieve goals.
**Strategies** — medium-term or long-term plans, methods, approaches, schemes that are used to achieve goals and objectives.
**Tactics** — short-term or medium-term actions that need to be taken in order to achieve objectives.

The top level of management is called **strategic level**. Decision-makers at this level are **senior managers**. They usually set the long-term goal and define **corporate strategy**, that determines the market in which the business operates

he level of management in the middle of the hierarchy is called **tactical level**. **Middle management** is in charge of decision-making at that level and they usually determine

**generic strategy**, that determines methods of achieving competitive edge. Competitive edge is "how our business is better than others", "why would people buy from us, not from our competitors".

The lowest level of the company is called **operational level**. This is a day-to-day level that is in charge of making goals, objectives, strategies and tactics happen on a daily basis. **Junior management** is in charge of decisions at that level and they determine **operational strategy**, that defines what company needs to do on day-to-day routine level and how to make generic and corporate strategies happen.

Now it's finally time to talk about the common business objectives, which are actually the title of this part of class. I hope you understand that all this information above is essential for understanding the common business objectives. Without this info, common objectives are quite meaningless. So, common business objectives:

- **Profit** — the difference between revenues and costs (more in Unit 3).
- **Growth** — achieving an increase in one/some of the following: market share, total revenue, profit, capital employed, size of workforce, volume of output. Ultimately, growth results in higher profits (more in 1.5).
- **Shareholder value** refers to what shareholders get through company's ability to increase market capitalisation (and thus share price) and/or dividends (through increasing the profits) (more in Unit 3).
- **Ethical objectives** refer to the tasks/targets that go beyond profit-making and are in line with moral behaviour, sustainability and CSR (more later in this class).

**Strategic objectives** apply to the entire organisation, and they determine **tactical objectives** and **operational objectives**.

Corporate social responsibility (**CSR**) is a commitment to benefiting (or at least not harming) the society and environment that is achieved through setting ethical objectives. CSR is not a legal obligation, it is a positive trend that businesses set.

**Stakeholders** are people or organisations who affect or are affected by business decisions and/or have an interest (stake) in the operation of a particular business.

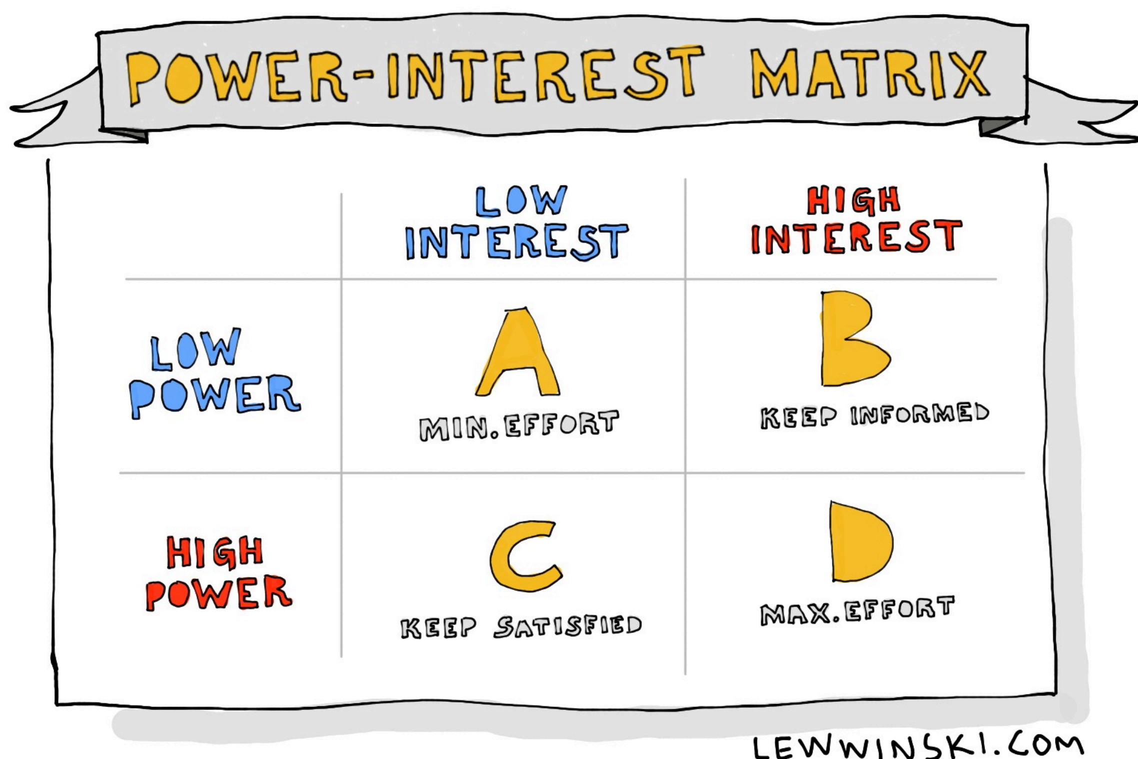
**Internal stakeholders** are the ones that are inside the business. Let's see some example of internal stakeholders and examples of their common interests and objectives.

**Shareholders** usually want to maximise shareholder value (more on that in 1.3 Business objectives).
**Managers** usually want to achieve their objectives in the shortest time and at the lowest possible costs.
**Employees** usually want good working conditions, meaningful work and maximum pay for minimum effort.
**CEO** usually wants to keep shareholders and BOD happy.

**External stakeholders** are the ones that are outside the business. Let's see some examples of external stakeholders and some examples of their common interests and objectives.

**Government** usually wants stable tax revenues, compliance with law and voters' support.
**Media** usually wants good stories that readers/viewers will like, regardless of whether the stories are positive or negative.
**Local community** wants good employment opportunities in their area and safe environment.
**Suppliers** usually want constant orders and short credit period

**Power-interest matrix** (or **power-interest model**, or **stakeholder mapping**) is a visual tool that helps to break down all stakeholders into 4 groups and prioritise the resolution of conflicts. There are two axes in this matrix — power and interest — hence the name.




**Economies of scale** (EOS) is the decrease of the average costs of production as an organisation increases the scale of operations and improves its production efficiency.

**Diseconomies of scale** (DOS) is the exact opposite of economies of scale, they happen when your average costs (**costs per unit** of output) increase as your company increases its scale of operations.

**Scale of operations** refers to how much output is produced and how big the production facility is.

**Efficiency** in this class means the decrease of AC (average costs) that is caused by changing any of the variables above: scale, fixed costs (FC), variable costs (VC), or total costs (TC), or keeping costs the same but increasing the quantity of output produced (Q).

Internal economies of scale:

- **Purchasing EOS** happen when suppliers provide a discount in exchange for buying more. The fresh orange juice example with farmer's discount is an example of this type of EOS.
- **Marketing EOS** occur when a company increases marketing budgets to advertise extensively so that customers purchase more. For example, Coca-Cola spend billions of dollars on advertising and if you think about it, probably you see Coca-Cola logo at least once a day… As a result, people always remember about Coke and are constantly reminded about it, which results in higher sales, which means that average costs of production fall.
- **Risk-bearing EOS** happen when a firm diversifies its product portfolio, i.e. produces more things in order to have a Plan B, C, etc. In this case, if product A is not sold well, then the sales of product B or C can compensate for that and thus reduce the costs of production.
- **Managerial EOS** occur when a company hires a really experienced and efficient manager who saves costs and who works as efficiently as several regular managers. This, again, results in the decrease of average costs of production.

External economies of scale:

- Technological progress: new inventions that everyone benefits from. For example, a new method of chair manufacturing is invented and all the furniture companies use it and save costs.
- Educated workforce: higher education levels in the country benefit all businesses, because additional training and supervision is not required.
- **Regional specialisation** means a certain region focuses on producing a certain thing (for example, Suzhou for silk, Hollywood for movies, Silicon Valley for IT, Bali for surfing). It means that all businesses in that region can share infrastructure, delivery costs, can negotiate better prices with suppliers, etc. Even though these businesses are competitors, why not cooperate on certain things that benefit everyone?
- Infrastructure: roads, power supplies, transportation networks, etc. The better the infrastructure, the shorter the delivery times are and the more efficient all businesses are.

Internal diseconomies of scale:

- Bureaucracy: too many procedures and paperwork may increase administrative costs.
- **Inert** (not adaptive) **working culture**: change does not take place and organisation stagnates, resulting in outdated processes and inefficiencies.
- **Complacency** (when company does not have a clear picture of reality and is overconfident in its success): for example, Kodak and Nokia thought they will remain market leaders and digital cameras and touch-screen smartphones are just a short trend in fashion.
- **Marketing DOS**: marketing failure that impacts the entire product portfolio and results in low sales. For example, there was a scandal in China when D&G created an offensive ad where a Chinese lady is eating pizza with chopsticks. That resulted in a fall in sales revenue and having to apologise to the people of China.

External diseconomies of scale:

- Infrastructure: roads, power supplies, transportation networks, etc. We've already talked about it, but from the positive perspective. If infrastructure leaves much to be desired, it can have the opposite effect in the entire industry and result in inefficiencies for all…
- Educated workforce: higher education levels in the country result in increased labour costs for all. We talked about this one too. On the one hand, educated people are great, but on the other hand they demand higher salaries. That is why in many developed economies most of the secondary sector activities are outsourced to developed economies (if this sentence doesn't make sense, please review this class).
- Increased rents: as cities and their populations grow, rent increases. Shanghai was basically a small town about 100 years ago, so imagine how cheap land in Shanghai was back then and how expensive it is now when it turned into a megapolis.
- Pollution: even though costs might not apply to businesses, employees and local community are affected negatively which will eventually have a detrimental effect on all business in a given industry…

**Size** of the business can be measured by several things:

- **Market share** — the portion of company sales in total sales in the industry
- **Revenue** — price multiplied by quantity of items sold
- **Profit** — the difference between revenue and costs
- **Workforce** — the number of employees
- **Capital employed** — investment that in used for operating the business

**Internal (organic) growth** happens when businesses grow using their own resources and capabilities.

**External (inorganic) growth** happens when businesses deal with other external organisations.

Internal (organic) growth:

- Businesses grow using their own resources and capabilities
- Low risk
- Lower potential benefits
- Slow and steady
- Relatively inexpensive
- Retention of full control
- Strengthens corporate structure

External (inorganic) growth:

- Businesses grow by dealing with other external organisations

- High risk
- Higher potential benefits
- Fast and rapid
- Requires significant finance
- Hard to control
- Challenges/weakens corporate structure

Reasons to grow:

- Economies of scale: see the first part of this class if you forgot what it means.
- Lower prices: again, because you can lower the costs due to economies of scale you can charge lower prices and attract more customers pushing your competitors out of the market.
- Increased market share: this would be the result of lower prices and decreased competition.
- **Brand recognition**: the more customers you have, the more people know and recognise your brand (more about it in Unit 4)
- Higher revenues: the more people buy, the more money you make.

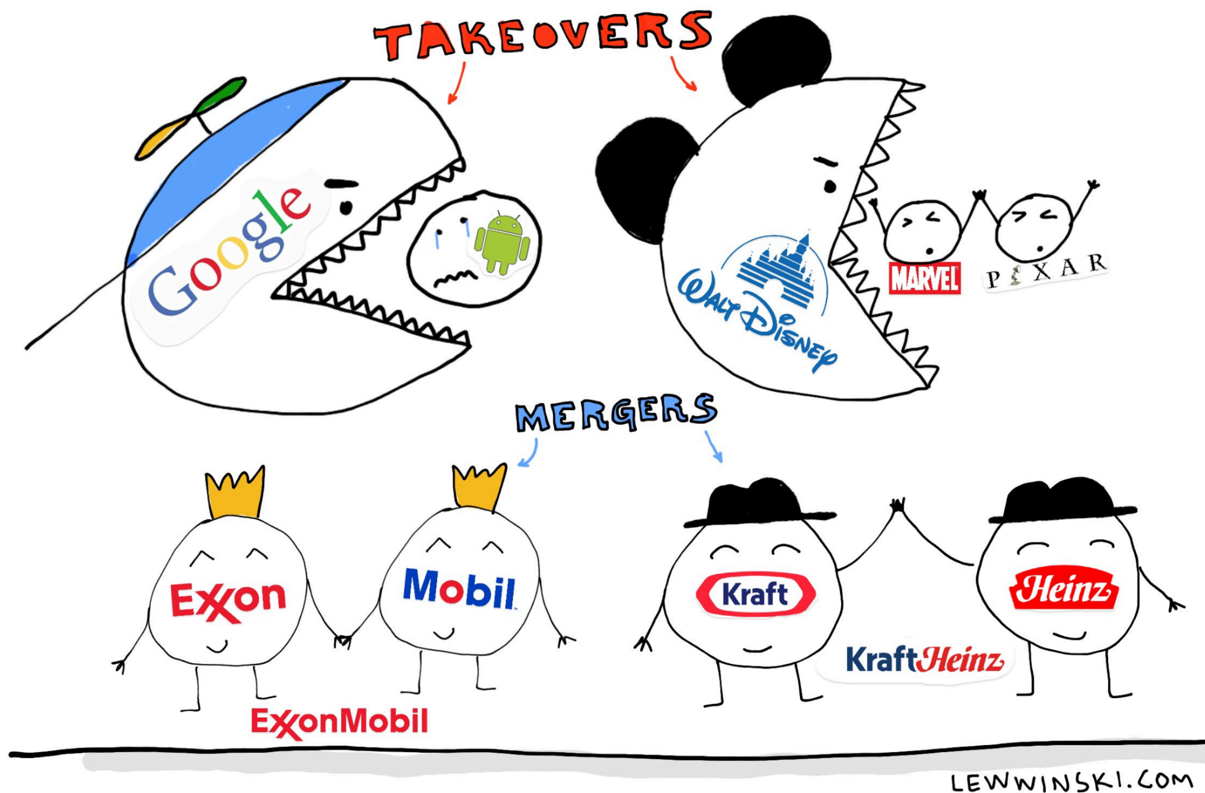
Reasons to stay small:

- Prestige/uniqueness: small businesses are perceived as something upscale, special, VIP, not for all, that creates a sense of uniqueness and prestige among customers.
- Adding more value (reminder: see 1.1 to review what added value is): this sense of uniqueness and prestige can allow businesses to charge higher prices, thus increasing the added value.
- Higher prices & profit margins: higher added value results in greater difference between revenues and costs of production, even though costs do not increase.
- Retaining control: smaller businesses are easier to manage and it is more likely for them to avoid internal diseconomies of scale.
- Less competition: smaller businesses usually specialise on a specific market niche and competition there is limited, as opposed to mass market where large businesses dominate.

**M&As** refers to mergers and acquisitions. **Merger** means two or more companies forming one larger company (A + B = AB)

**Acquisition** (or **takeover**) happens when one company takes ownership of another company (A + B = A)

With regards to public limited companies, their shares are traded on stock exchange and are available to everyone, which means that sometimes publicly held companies can be taken over even if they do not want that. This situation of undesired acquisition of a publicly held company is called a **hostile takeover**.




**Horizontal integration**: when M&As happen between companies in the same sector of industry. For example, a bank takes over another bank (both are in tertiary sector).

**Vertical forwards integration**: when a company merges with or takes over a company from a “higher” sector of industry. For example, a car manufacturer (secondary sector) takes over a car dealership (tertiary sector).

**Vertical backwards integration**: when a company merges with or takes over a company from a “lower” sector of industry. For example, a furniture shop (tertiary sector) merges with a furniture factory (secondary sector).

Some of the advantages of M&As include:

- Economies of scale (see part 1 of this class if you forgot what that is).
- Minimising risk (if one business fails, another one will back it up and act as Plan B).
- **Synergy** (when cooperation has more benefits than operating independently, when 2+2=5).
- Market leadership (being able to reduce competition and increase market share instantly).

Some of the disadvantages of M&As include:

- Managerial diseconomies of scale (see part 1 of this class if you forgot what that is).
- Cultural clash (each organisation has its own culture that might be very different from the other company involved in M&As, more about it in Unit 2).

- Increased government control and interference (large companies might face anti-monopoly issues that government has a strict control of).
- Redundancies (having to let people go (“lay off”), because two of everything might not be needed in a newly formed company. But these lay-offs are not free, people have to be paid severance pay before they leave because it is not their fault the company mo longer requires their service, more about it in Unit 2).

**Joint venture** is formed when two or more companies create a third company that operates for their mutual benefit (A and B create C).

Some of the advantages of joint ventures include:

- entry to foreign markets,
- synergy (same as in M&As),
- splitting the costs and risks,
- reduced competition.

Some of the disadvantages of joint ventures include:

- too much reliance on a partner,
- control and “final say" issues (having to agree on all decisions with a partner),
- having to share certain expertise (for example, some methods of production or some secret technologies).

**Strategic alliance** is a cooperation of two or more companies in certain aspects for their mutual benefits (A and B cooperate, C is not created). A new business entity is not created (unlike joint ventures).

**Franchising** is a way of external growth whereby **franchisor** company allows other companies (**franchisees**) to sell their products and trade under its brand (**franchise**) in exchange for **royalty payments** (regular payments for using the franchise) and franchise fee (payment to “buy” the franchise).

**Multinational/transnational company** (MNC) — is any company that operates in two or more countries. Even though usually MNCs are huge corporations, it is not required to be “huge” to be considered an MNC. What matters here is the fact that a company operates is two or more countries.

Some of the reasons why companies might prefer to enter foreign markets and become multinational are listed below:

- Increased customer base: the more countries, the more people to sell to.
- Cheaper production costs: in developing and less developing economies, labour costs are traditionally lower. That was one of the reasons why in the past 50 years many companies entered Chinese and Indian markets and relocated their production to these countries.

- Global economies of scale: modern economy goes beyond the country borders. Many countries and regions are interrelated. The same is true about economies of scale: some of them can only happen on a scale, larger than one country.
- Avoiding protectionism: very often, the only way to avoid **protectionism** (measures that the government takes to protect local economy, for example tariff and quota) in a certain country is to register an enterprise in that country, thus becoming an MNC.

**Globalisation** is a trend/process of integration of local economies into one global economy, whereby companies, organisations and people think globally, but act locally. Globalisation is one of the main reasons why MNCs emerged

here are several impacts of globalisation on people, companies, governments and other organisations, that cause both good and bad things, i.e can be an opportunity and a threat at the same time. Think about how the things below can be an opportunity and a threat at the same time:

- Cultural diversity: on the one hand, different cultures can blend and learn from each other, but on the other hand it is difficult for businesses to fit in different cultures, because they have different understandings of the same thing, different tastes and traditions.
- Level of competition: on the one hand, companies can enter a foreign market with lower competition, but on the other hand, companies will also face competition and "battle" for access to foreign markets with other MNCs.
- Ability to meet customer expectations: on the one hand, people's tastes and fashions tend to blend and become very similar, but on the other hand, people in different countries still have their own unique features, desires, needs and wants and businesses have to adjust to them.
- Number of customers: on the one hand, the more countries, the more people to sell to, but on the other hand, it comes with a need to adjust to many different customer needs.
- Economies of scale: on the one hand, businesses have great choices of location and may choose a place that allows for the highest efficiency, but on the other hand, global supply chain management is a serious and time consuming task that might result in diseconomies of scale if it's not managed well.
- External growth opportunities: on the one hand, companies have created opportunities for M&As on a global market, but on the other hand it means greater bureaucracy and having to deal with local governments and restrictions.
- Sources of finance: similar to the previous point, greater opportunities on the one hand, accompanied by greater challenges on the other hand.

On the other hand, companies might make profits in a host country but send them back to their "home country", which is called **repatriation of profits**.

2.1

Role of HR Management

**Human resources** (HR) are people that constitute the workforce of an organisation. Organisation can be a business of any size and type (not only companies), a country, a region, an educational institution, etc. Very often HR also refers to the department in an organisation.

Why is HRM important?

1. HRM maximises staff efficiency.
2. HRM minimises risk
3. HRM maintain the appropriate levels of **staff retention** (number of employees who stayed divided by total number of employees, in a given period
4. HRM develops and maintains organisational structure. HR department is in charge of creating organisation charts that help employees understand where they belong in the company, who their line manager is, who they are responsible for, etc.
5. HRM develops employees via professional development (PD) workshops and training. It is job of HR department to make sure all employees are adequately trained
6. HRM keeps employees motivated by designing appropriate financial and non-financial rewards
7. HRM helps to drive change smoothly. People do not like being told that they have to do things differently.
8. HRM is in charge of recruitment and selection
9. Redundancies and dismissals

Factors that influence HR planning

**HR planning** (HRP) is a systematic process of anticipating the staffing needs of an organisation. It does not necessarily imply expansion of workforce, it can also refer to **downsizing** (decrease in the size of the workforce), including **redundancies** (when employees are laid off because their service is no longer required, even though they do a good job) and **dismissals** (when employees are fired for not performing their tasks well).

HRP is really important and it’s inevitable, because without it an organisation is unable to achieve its goals and objectives. All organisations rely on people to a different extent and not knowing how many and what kind of employees are required is impossible when it comes to any business-related planning

With regards to internal factors, it can be (but not limited to) one or some of the following:

1. Leadership styles. The personality of the senior managers and their management and leadership preferences and styles impacts organisation to a very high extent. Leadership styles can vary (democratic, autocratic, laissez-faire, paternalistic, situational) and affect decision-making.
2. Strategies and objectives. As you remember, HRP is a link between strategic goals and HR management.

3. Finance. Resources are limited and organisations have to make decisions that are within the budgetary constraints and other financial considerations

Now let's see some examples of external factors that influence HR planning.
1. **Demographic change** refers to any change in population dynamics and trends. For example, ageing population (the increase of the age of an average citizen), life expectancy (average life span), birth rates, etc
2. **Labour mobility** means the extent to which the workforce is flexible in terms of acquiring new occupations (**occupational mobility**) and relocating to a new place (**geographic mobility**)
3. **Professional immigration** refers to moving to a different country for work.
4. **Flexitime** refers to a trend in HR practices whereby employers provide an opportunity for flexible schedule to their employees.
5. **Gig economy** is a type of an economy where strong commitments are not common, and were flexible working practices (such as flexitime, short-term temporary contracts, freelance, etc.) are common.

Change

**Change** (at workplace) is the alteration/modification of the current work practices, or, simply put, having to do things differently. The issue with change is that human beings naturally do not like change because it's scary and it requires significant effort.

Firstly, let's discuss the 4 reasons for resistance to change in more detail:
1. **Self-interest**. Employees do not understand how change benefits them personally and do not really care about distant and intangible benefits for the organisation.
2. **Misunderstanding**. Sometimes there are actually benefits to employees but they are not explained correctly or misunderstood by them.
3. **Low tolerance**. Having to change means stop doing things that are secure and safe. Some employees might not be be able to bear with it well.
4. **Different assessments of the situation**. Different people see the same thing from different perspectives. Very often, what the boss sees as an opportunity is perceived as a threat by employees.

6 approaches/strategies for reducing the impact of change and resistance to change in more detail:

1. **Education and communication**. This is the most smooth and nice way to deal with change: prepare employees to it, train them, and let them be the drivers of change.
2. P**articipation and involvement**. If employees are empowered and are part of the decision-making process in an organisation, they demonstrate more loyalty and flexibility towards change because they feel that they are part of it
3. **Facilitation and support**. This simply means being supportive and caring to employees because they might be afraid to change their working routines. Facilitation and support never hurts.
4. **Negotiation**. This implies reconsideration of the current incentives together with employees and trying to make mutual concessions for the benefit of implementing change.

5. **Co-optation and manipulation**. If the four methods above do not work, then managers might find employees who have influence over others and try to appoint them a certain role that helps to promote and implement the desired change.
6. **Coercion**. This is the least nice strategy to overcome resistance to change. It is the ultimate form of the previous strategy (co-optation and manipulation), but it implies more dramatic effects such as dismissals and loss of certain benefits.

2.2

Key terms

1. **Delegation** is the passing on and entrusting of certain tasks from managers to subordinates. Simply speaking, it's when managers give (delegate) some work to employees. Delegation is a win-win situation: managers focus more on strategic decisions by delegating tactical tasks (more about strategies and tactics in 1.3), and employees feel that they are trusted and have meaningful and interesting (hopefully) things to do.
2. **Span of control** is the number of subordinates (employees) who are directly accountable to a manager. Simply speaking, it's a number of employees under a manager. Span of control can be wide and narrow. One is not better than the other. Organisations with wide span of control have fewer layers, lower managerial costs, effective communication and larger teams that are harder to control directly.
3. **Hierarchy** is an organisational system that is based on ranking. **Levels of hierarchy** are different layers in a hierarchical structure. **Line manager** is a person directly above an employee on the next hierarchical level. There can be many line managers on different levels. Line managers are essential to hierarchical structures. Hierarchical structures are clear and easy to understand and they create a sense of belonging because people easily understand their place in the hierarchy and can see who they work with, who they are accountable to and who they are responsible for.
4. **Chain of command** is a system by which orders and instructions are passed down in an organisation. The more levels of hierarchy there are, the longer the chain of command is. Thus, chain of command can be long or short. Longer chains usually indicate narrow spans of control and their features (see the "span of control" paragraph), while shorter chains of command indicate wider spans of control and the corresponding features
5. **Bureaucracy** is the execution of tasks that are guided by excessively complicated administrative rules and procedures. Simply speaking, it refers to too many rules and procedures and paperwork in an organisation. For example, filling in the reports, tedious paperwork, long chains of command, formality, impersonal attitudes, high degree of accountability. Bureaucratic organisations are quite inflexible and hinder creativity and risk-taking because people are reluctant to do all these things if there are too many rules and if you need a permission for everything you do.
6. **Adhocracy** is the opposite of bureaucracy but it does not mean that bureaucracy is bad and adhocracy is good. Balance between the two is what leads to success. Too much of anything is bad for everything.
7. **Centralisation** is the concentration of power and decision-making in a single authority (one person or group of people). Simply speaking, it's when all decisions are made by one person or a small group of people. Centralised organisations

usually make quick decisions, have a good sense of direction among staff, are easier to control and are efficient in critical situations. However, they add pressure/stress for senior management (because all decisions are on them and they are in charge of everything), they are inflexible, **power plays** are common (it's a tactic to increase someone's power, for example when the boss says "you have to do it because I'm your boss and I said so").

8. **Decentralisation** is the transfer of power and decision-making from a single authority to several people/groups. Simply speaking, it's the opposite of centralisation. Usually decentralised organisations have employees that are more engaged and motivated and like working in teams. However, these organisations might experience increased admin costs (because there are more managers and decision-makers who need to be compensated for administrative work), decision-making might be more time-consuming (because agreement among many decision-makers is needed to proceed)
9. **Delayering** is the process of removing one or more levels in the hierarchy. It does not necessarily result in downsizing! If a management layer is removed, it doesn't mean that these people who were managers have to leave. They are most likely to be distributed among upper and lower layers of the hierarchy. Delayering implies removal of management, not necessarily removal of people (redundancies and dismissals).
10. **Matrix structure** is a system whereby employees report to several managers and work in cross-departmental teams. Simply speaking, it's when employees make different teams from employees in different departments and different levels of the hierarchy in order to complete different projects.The opposite of matrix structure is **functional structure** (traditional hierarchical structure that we talked before). However, matrix and functional structures can coexist and overlap inside one organisation.

Organisation charts

**Organisational structure** is an arrangement of professional relations at work. By professional relations I mean who is the boss, who is the manager, who are colleagues, who works in one department and who works in another, how these departments and people cooperate, etc.

**Organisation chart** is a graph that represents organisational structure by showing the relationships of accountability and responsibility. Simply speaking, it's a picture that shows organisational structure.

**Accountability** is a down-to-top (upwards) type of professional relationship which means being responsible *to* someone on the higher level of the hierarchy. For example, if you are a clerk, then you are accountable *to* your line manager.

**Responsibility** is a top-down (downwards) type of professional relationship which means being in charge of someone on the lower levels of the hierarchy. For example, if you are a school principal then you take authority over teachers. In other words, you are responsible *for* teachers.

Organisation chart shows many things that we learnt in the previous part of class. For example, the following:

1. Functional departments
2. Chain of command
3. Span of control
4. Channels of communication
5. Levels of hierarchy

There are two categories of organisation charts. The first category refers to the “height” of charts, to how many levels they have. In this category there are two types of charts: flat (horizontal) and tall (vertical). *Flat* and *horizontal* here are synonyms, same as *tall* and *vertical*, so you can choose the name that sounds more pleasing to your ear in each category

| | FLAT (HORIZONTAL) | TALL (VERTICAL) |
|---|---|---|
| CHAIN OF COMMAND | SHORTER | LONGER |
| COMMUNICATION | MORE DIRECT | MORE FORMAL |
| LEVELS OF HIERARCHY | LESS LEVELS | MORE LEVELS |
| SPAN OF CONTROL | WIDER | NARROWER |
| DELEGATION | MORE DELEGATION | MORE CONTROL |
| STAFF ENGAGEMENT | ENGAGED WORKFORCE | LESS INITIATIVE |
| ADMIN. COSTS | LOWER | HIGHER |
| "US AND THEM" CULTURE | UNLIKELY | LIKELY |
| SUITABLE FOR | CREATIVE INDUSTRIES | CRISIS MANAGEMENT |

LEWWINSKI.COM

With regards to the first category (“height”), we are going to compare **flat (horizontal)** and **tall (vertical)** in 9 different aspects. See the table below for comparison between them.

**Chart by product** indicates all the products that an organisation is providing. For example, the chart for *Yum! Brands Inc.* might include Pizza Hut, Taco Bell and KFC, and then under each product (brand, in this case), a traditional hierarchical chart by function

**Chart by function** is the most traditional kind of chart that indicates the functional departments in the organisation: marketing, HR, finance and accounts, operations

**Charts by region** show the areas in which organisations operate. Sometimes these regions overlap with real geographic areas and continents, but most of the time they refer to regions that organisations define themselves.

Change

**Project-based organisation** is a type of organisational structure that has human resources organised around projects, as opposed to the hierarchy or purpose or other factors. For example, think of a construction site. The team is assembled for construction of a building and then it is dissembled upon completion

**Shamrock organisation** is a type of organisational structure that divides the workforce into three "leafs" depending on how essential they are to the organisation:

1. **Core staff** — full-time professional workers that usually work full-time and are crucial to the organisation. They are usually the key decision-makers of the organisations. CEO, engineers, directors, administrators could be some of the examples of core staff.
2. **Outsourced (contractual) staff** are subcontractors that perform some non-core activities for the organisation. These are usually some businesses that specialise in something that is not essential to the organisation. For example, many film production companies outsource 3D visual effects to other companies. These effects are very important, but not as important as the film director, actors, and cameramen who are impossible to outsource because they are core staff members.
3. **Temporary (peripheral) staff** are workers that are employed only when needed on a part-time temporary basis. For example, amusement parks often hire some extra staff (usually students that are on summer vacation) for peak season.

2.3

Leadership and Management

**Management** is the process of dealing with or controlling people and making sure tasks are accomplished. "Management" can also refer to a group of people in an organisation who are in charge of the aforementioned things. Simply speaking, management means getting things done.

**Leadership** is the process of *leading* people. I really do not like definitions where the term is described using the term itself but I could not create a better definition.

Leadership styles

1. **Autocratic** leadership style means that leader makes all the decisions and delegates tasks, but not responsibility. Formula of this leadership would be: "do X". Autocratic leadership doesn't mean that it's bad leadership or that autocratic leader treats his/her subordinates badly. It just means that decision-making is really centralised.
2. **Paternalistic** leadership style means that leader expresses superiority and treats subordinates as if they are family members, guiding & mentoring them in order to promote their own good. Paternalistic leaders usually "know what's good for you", just like parents. And of course, very often, what paternalistic leaders think is "good for you" is not necessarily what you think is good for you
3. **Democratic** leadership style means that leader involves employees in decision-making before making the decision. In my experience, the two most common misconceptions that students have are the idea that all democratic leaders are good and the idea that democratic leaders always make decisions based on the

majority of votes. In reality, democratic leader, same as any other kind of leader, can be either good or bad

4. **Laissez-faire** leadership style means that leader has minimal interference with the work of subordinates. Employees are, in a way, on their own and are free to do work the way want as long as it's done and as long as it's done before the deadline and meets the standards. Engineers/programmers/developers in IT companies usually work under laissez-faire leadership. They usually don't have to come to the office, there's no clock-in/clock-out, only the final product and deadlines matter.
5. **Situational** leadership style means that leader chooses the most appropriate leadership style in the given situation. Different employees might require different approaches, or external environment might dictate the choice of leadership style, or organisational objectives might push the leaders towards different kinds of leadership.

2.4
Motivaiton theory

**Motivation** refers to the reasons for behaving in a certain way, desire/effort/passion to succeed and reach certain achievements. It can be **intrinsic** (driven by internal factors, when you do something because you want to do it) and **extrinsic** (driven by external factors, when you do something because you will get a reward or will not get a punishment for doing it). Motivation is important, because if staff is motivated, it will result in job satisfaction that will lead to high productivity and high quality output, which will eventually result in higher profitability. Demotivated staff, on the contrary, will be dissatisfied with their job, will have low productivity and produce output of low quality, which will eventually result in low profitability.

1. According to **Taylor's Scientific Management** theory, managers are in charge of planning, direction and control, whereas subordinates are rewarded using performance-related pay: the more they work, the more money they get. In addition, according to Taylor, there is a strict division of labour and specialisation at a workplace and all the tasks and expectations are clearly set and communicated to employees. All hiring decisions are made based on "scientific" objective parameters, not on how much a manager might potentially like the candidate emotionally.
2. According to **Maslow's Hierarchy of Needs** theory, people progress in their needs from the lower to the top level: once they are satisfied with physiological needs, they will be motivated by security; once they are satisfied with security, they will be motivated by social needs, etc. The five levels of needs (from the lowest to the highest) are:

1. **Physiological** (basic) **needs**
2. **Security** (safety) **needs**
3. **Social** (love & belonging) **needs**
4. **Esteem** (ego) **needs**
5. **Self-actualisation**

According to Maslow, people can't skip any levels and won't be motivated by more than one level ahead. For example, if security needs aren't satisfied, you won't be motivated by self-actualisation, because only social needs will motivate you.

3. According to **Herzberg's Two-Factor theory**, there are two factors (surprise-surprise!) that impact motivation at a workplace. The first one is called **hygiene factors** — aspects of work that do not motivate but must be met to prevent dissatisfaction: organisational rules, regulations, policies, working conditions, pay. These things don't motivate, but their absence really demotivates. Think about school toilet: I doubt it really motivates you, but I'm sure if there was no toilet, you'd be pretty demotivated. The second kind of factors is called **motivators** — factors that lead to the psychological growth of workers and hence increase satisfaction and performance at work: achievement, recognition, responsibility, advancement. Motivators motivate, haha! But if hygiene factors aren't in place, then motivators won't work at all (think about toilet again: does achievement matter when you don't have a chance to pee?).
4. According to **McClelland's acquired needs theory**, all employees have three needs:
1. **Achievement** — desire to succeed, master skills and achieve goals. People who have achievement as their main need prefer to work on their own, prefer medium-risk tasks and work best when creative and innovative solutions are required.
2. **Affiliation** — need to be around others and be loved/admired. People who have affiliation as their main need are excellent team players, they are usually very happy but it matters to them a lot what others think of them.
3. **Power** — desire to lead and inspire others. People with this type of need make good managers and prefer high-risk tasks, but are not necessarily the happiest people in an organisation.

The trick is that only one or two of these needs dominate in different people. Once managers can understand, which needs prevail in an employee, they will be able to think of appropriate motivators.

5. According to **Deci** and **Ryan's self-determination theory**, there are 2 types of motivation: **autonomous** (when you do something because you want to, can be either intrinsic or extrinsic) and **controlled** (when you do something for reward). They don't conflict each other and one can be transformed into the other by people's own efforts. The most productive employees internalise controlled motivation, i.e make it autonomous.

According to Deci and Ryan, all people have 3 types of universal needs:

1. **Competence** — need to succeed, achieve, develop.
2. **Relatedness** — care for and be cared by others, be part of the group.
3. **Autonomy** — self-endorsed behaviour, need to be in charge of own choices and make decisions.

Employees are motivated when all 3 needs are met. So, managers should identify which of these three is least developed and make sure it becomes satisfied so that employees could be motivated to perform their tasks well.

6. According to Adams's **Equity theory**, employees compare their efforts and rewards to those of their colleagues. They become demotivated if their inputs are greater than the outputs. **Inputs** —contributions made by employee. **Outputs** — financial and non-financial rewards rewards that employees get in return for their contributions. Workers are motivated

only if their input-output ratio is equitable (fair) in relation to others in the workplace. In order to understand equity theory, consider how you might feel if your teacher gave you a low predicted grade for Business Management despite the fact that you put in a huge amount of effort into studying BM, and yet your classmate who put in very little effort was rewarded with a higher predicted grade.

7.According to Vroom's **Expectancy theory**, people act in a certain way because they expect certain outcomes for their behaviour. If there are no desired outcomes, employees will not alter their behaviour. For example, employees might think "if I work hard, I will get a promotion". According to Vroom, what drives people is **motivation force**, which equals to expectancy times instrumentality times valence (MF = E x I x V). **Expectancy** is the belief that you will achieve the goal of you work hard ("I'll get promoted if I work hard"). **Instrumentality** refers to potential benefits for achieving the goal ("I'll get a pay raise and a company car if I get promoted"). **Valence** is an evaluation of potential benefits that determines the behaviour ("but I will have to spend 20% more time at work and will have to wear a tie every single day and will spend less time with my family"). All these three things multiplied together result in motivation force, that can be weak or strong, depending on the variables.

Rewards and training

**Financial rewards** are cash benefits that are given to employees in return for their efforts and achievements. There are 8 types of financial rewards that the IB wants you to know: salary, wage (including time rate and piece rate), commission, performance-related pay (PRP), profit-related pay, employee share ownership schemes, fringe benefits. As always, it might be a good idea, to make notes using the table below

**Salary** is a type of financial reward that is a sum of money is divided by 12 and paid in equal instalments monthly. Actually, the most important point here is not that it's paid monthly (it doesn't have to be like this, it can be paid twice a month too), but that it's the same amount every time you get salary.

**Wage** is a type of financial reward where employees are paid based on the amount of output they produce (**piece rate**) or the amount of time they spend at work (**time rate**). Piece rate, on the one hand, is fair and directly relates to output produced. It's Taylor's Scientific Management (see previous part of class) in action: the more you produce, the more you are paid

**Commission** is a type of financial reward that is a percentage of the deals/sales that an employee makes. For example, real estate agent A gets 5% commission for selling a house. If he sells a house worth $100.000, he'll get $5.000. But if he sells a house worth $1 million, then commission will be $50.000!

**Performance-related pay (PRP)** is a type of financial reward that is usually a bonus that is paid in addition to salary. Simply speaking, it's like piece rate, but for jobs that don't involve production of tangible output (teaching, interior design, engineering, etc.), where the output may be hard to measure and thus performance targets are established based on metrics and KPIs other than the amount of output.

**Profit-related pay** is a type of financial reward that is based on a portion of the profit that the organisation makes. On the one hand, it motivates people to work harder. For example, manager A receives 1% of profit in addition to salary. The higher the profit, the more money manager A makes, which is supposed to motivate manager A to work harder.

**Employee share ownership schemes** is a type of a financial reward that implies giving company's shares to employees as a bonus. Companies can either give some portion of shares to employees for free or sell shares to employees at a discounted rate or use a combination of these methods. Regardless of the method, employees are incentivised to work harder because they become shareholders (owners) of the company and understand that their contributions are directly related to the value of the company (and thus share price).

**Fringe benefits** is a type of a financial reward that is given to employees in a non-cash form (company car, company accommodation, medical insurance, tuition for children, gym or spa membership, etc.)

Non-financial rewards

**Non-financial rewards** are non-cash benefits that are given to employees in return for their efforts and achievements. There are 6 types of financial rewards that the IB wants you to know: job enrichment, job rotation, job enlargement, empowerment, purpose/opportunity to make a difference, teamwork.

**Job enrichment** is a type of non-financial reward that refers to an increase of challenge and responsibility, but not the increase in the number of tasks. Simply speaking, it's a "level up" in tasks. For example, if someone's job was to teach Business Management Standard Level course, job enrichment can be teaching Business Management Higher Level

**Job enlargement** is a type of non-financial reward that refers to an increase in number of tasks, without increase in the challenge and responsibility levels. There is no "level up" in job enlargement. For example, if someone's job is to teach one group of Standard Level Business Management students, job enlargement would be increasing it to two groups of SL students..

**Empowerment** is a type of non-financial reward that refers to giving employees more decision-making opportunities and making them more in charge of their jobs. For example, empowered employees might be supervised less and provided with more freedom in how to do their jobs

**Job rotation** is a type of non-financial reward that implies changing the working station with colleagues. For example, at a car factory, a team of 3 engineers might perform 3 tasks: painting, polishing and assembly. In order to make the job for these 3 engineers more interesting, they might all learn to perform these 3 tasks and take turns, as opposed to one person always doing one type of job

**Purpose/opportunity to make a difference** is a type of non-financial reward that is providing employees with chances to be the advocate of positive social change. On the one hand, it might work very well in non-profit organisations where people usually do not work for money, but for a chance to achieve social goals.

**Teamwork** is a type of non-financial reward that implies organisation of employees into teams inside horizontal flat structures. It implies reduction of direct strict control and supervision inside teams and laissez-fair leadership

Training

**Training** is the process of providing opportunities for workers to acquire employment-related skills and knowledge. It can also be called **professional development (PD)**. Training can be short-term and long-term. In a way, when you go to college for 4 years, it is actually a long-term training, because what you basically do there is acquiring employment-related skills… Training can be non-compulsory as well as obligatory, especially in professions that involve a certain physical risk to life.

**Induction training** is a type of training aimed at introducing new employees to the organisation. It includes meeting key personnel, office tour, learning about new job role, company policies and practices. Induction training helps to settle in quicker, reduce potential mistakes, integrate into the corporate culture, get to know colleagues before actually starting work at a new place. However, job isn't done during induction training.

**On-the-job training** is a type of training that takes place on-site. It saves costs, job gets done, output is produced, trainees get a chance to get to know colleagues, and there is no need to travel outside the workplace. However, mentor's bad habits are passed on to the trainee, job isn't done very well

**Off-the-job training** is a type of training that takes place off-site. On the one hand, this kind of training is provided by professional coaches whose job is to teach. In addition, this training implies no distractions, because employees are off-site and their main task is to learn. And lastly, off-the-job training usually results in certificate of attendance which is recognised outside of workplace, so employees increase their chances of employability.

2.6

Formal vs Informal

**Communication** is the process of exchanging information via different media. The process of communication can be described in the following way: sender sends the message using a certain medium (one) or media (several) to the receiver, and then gets feedback from the receiver. **Sender** is a person, or a group of people who create the message, for example boss, colleagues, subordinates, customers, etc. **Message** can be something that is said, written, or even drawn. **Media** are the different ways to transmit the message: email, talking, notice board, Instagram, Telegram, Youtube, etc. **Receiver** is the person or group of people who the message is for. And **feedback** is the response to the message.

*Verbal, written, visual*. **Verbal** refers to what is said. **Written** — to texts that are typed or written. **Visual** refers to pictures, images, films, animation.

*Horizontal and vertical*. **Horizontal** communication happens between members of the same level of hierarchy in an organisation. **Vertical** communication goes through different levels.

*Vertical upward and vertical downward*. If a manager is sending a message to subordinates (down the hierarchy), then it's vertical **downward** communication. If a subordinate requests something from a manager, then it's vertical **upward** communication.

*One-way and two-way.* **One-way** communication is the one that has no feedback, for example, a poster on a notice board. **Two-way** communication is the one that has feedback, for example your chat with friends on your favourite messenger.

*Internal and external*. **Internal** communication happens within the organisation among internal stakeholders (employees and managers). **External** communication happens with people and groups of people that are outside the organisation (customers, government, suppliers, potential investors).

*Formal and informa*l. **Formal** communication is the one that goes through official channels of communication. **Informal** communication is the one that goes through unofficial channels of communication. It is also called "**grapevine**".

Barriers

**Communication barriers** are the circumstances that prevent effective communication. They can either be caused by an issue in the process of communication or they can be caused by other factors. Let's consider both scenarios.

If communication barrier is caused by an error in the communication process (see figure 1 in the previous part of class), then it means that there is something wrong with either sender, or receiver, or message, or media, or feedback. For example, if a company intern sends an email with an announcement about a new company policy, then everything is fine except for the sender. This kind of announcement should come from someone in a senior position, of course

Step one in overcoming the barriers to communication is to identify the cause. If it is caused by an error in the communication process, then it is important to identify which element(s) exactly caused the barrier: sender, receiver, message, feedback or media. If the barrier is caused by other factors, it is important to collect enough evidence in support of the given factor and choose an appropriate way to deal with it.

Finance

Introduction

**Capital expenditure** (CAPEX) refers to finance spent on fixed assets (land, buildings, equipment, vehicles, etc.). **Fixed assets** is any property that an organisation uses for more than 1 year. You can find CAPEX of your favourite company inside their annual report in Balance Sheet or Cash Flow Statement section. Annual report for any publicly held company is easily downloadable from their website.

**Revenue expenditure** refers to payment for the daily running of the business (wages, raw materials, electricity, etc.). Basically, revenue expenditure is the same thing as **operating expenses** (OPEX), which refer to short-term (less than 1 year) spending. The financial statement where you can find revenue expenditure (or OPEX) of your favourite company is called Profit & Loss Account (or Income Statement)

Make sure you can define all of these:

1. Capital expenditure
2. Revenue expenditure
3. Fixed assets
4. Operating expenses

Sources of finance

**Sources of finance** (SOF) are different ways to obtain monetary support for the enterprise. **Internal SOF** refer to the finance that comes from within an organisation. We will learn 3 types of internal finance:

1. personal funds,
2. retained profits,
3. sale of assets.

**Personal funds** are personal savings or money provided by family or friends. This type of finance is easy to acquire, there is no interest rate and the entrepreneur has full control over funds. However, usually personal funds are too small and using this type of finance is too risky because in case the business does not go well, someone risks losing all personal savings. Personal funds are an appropriate source of finance for unlimited liability businesses (sole traders and partnerships) who are willing to take the risk.

**Retained profits** refer to profits that remain within an organisation after all costs and dividends are paid. On the one hand, the use of retained profits is free and entrepreneur maintains full control over finance. On the other hand, retained profits are not usually available to startups, may be insufficient and may dissatisfy shareholders (if profits are retained at the expense of paying dividends). Retained profit works as a relevant source of finance for limited liability organisations that can retain sufficient funds without having to deprive shareholders of dividends.#

**Sale of assets** refer to selling unnecessary equipment and/or premises (buildings, land). There is no interest rate in sale of assets as well, which means that obtaining this type of finance is free of charge. In addition, entrepreneur, again, retains full control over how finance is spent. However, funds obtained through sale of assets are usually insignificant and it takes quite a long time to find a buyer for the assets. Sale of assets is usually appropriate for any business that is about to shut down or relocate some of its parts.

**External sources of finance (SOF)** refer to the finance that comes from outside of an organisation. We will learn 8 types of external finance:

1. share capital,
2. loan capital,
3. overdrafts,
4. trade credit,
5. crowdfunding,
6. leasing,
7. microfinance providers,
8. business angels.

**Share capital** refers to funds raised through the sale of shares. This applies to privately held and publicly held companies. The difference between them is that the former sell shares privately whereas the latter sell shares publicly on stock exchange. On the one hand, share capital is usually relatively large sums of money that have no interest rate. Unlike banks that provide loans, shareholders do not require interest payments. However, shareholders usually have to be paid dividends. What's more, founders of publicly held companies may lose control over their enterprise if they sell most of their shares

**Loan capital** is finance obtained from commercial lenders (banks). On the one hand, as opposed to share capital, there is no risk of losing control over the organisation. Bank loans come with interest payments, but they do not have any ownership and decision-making rights in the organisation. However, bank loans usually have to be secured with some property that guarantees that it will be taken by the bank in case of inability to pay back the loan. This kind of guarantee with property is called **collateral**. In addition to that, loans come with interest, which means that in the long-term you will have to repay more than what was loaned. Bank loans are appropriate when a large sum is needed without dilution of control in exchange for long-term payments

**Overdraft** is an opportunity to take more money than a business has on its account. For example, let's say your business's bank account balance is currently $0 but you have just received an order from a client and you need raw materials. If the bank that keeps your business bank account has an overdraft limit of $10.000, it means you can buy raw materials for up to $10.000 and there is no need to spend time applying for bank loans and no need to go through complicated procedures. So, on the one hand, overdrafts are really convenient and easy to acquire. However, the **credit period** for overdrafts is usually really short (shorter than for traditional bank loans) and the interest rate is really high if you do not manage to top up your bank account before the end of the credit period

**Trade credit** is, simply speaking, a kind of “buy now, pay later” situation. It is an opportunity to pay back to your supplier at a later date, within credit period (usually 30 to 90 days, depending on the industry). For example, if you produce apple juice, then local apple farm could be your supplier and give you a chance to get apples today, but pay for them next month. In this relationship, there are two parties: you (the firm that produces apple juice) are a **debtor**, and your supplier (the apple farm) is a **creditor**. The advantage is obvious: no payments made at the time of purchase, you can get supplies of raw materials right here right now but pay for them later.

**Crowdfunding** refers to obtaining small amounts of money from a large group of people (usually users of crowdfunding platforms, such as Kickstarter and Indiegogo. On the one hand, crowdfunding is available to literally everyone and it provides access to a community of donors. Usually it’s free, there is no loss of control (as in the case with share capital) and, on top of that, you can get direct feedback from the potential target market: if people donate actively, then your product/idea is a success, if not — you might want to change it.

**Leasing** is a source of finance whereby **lessee** hires an asset from the **lessor**. For example, if you opened a pizza delivery but you don’t have money for purchasing a delivery car, you can lease it. It means you’ll pay once a month (or once a year) for using the car, but you won’t become the owner of it. What’s great about leasing is that you don’t have to pay for maintenance, because you are not the owner of the leased asset! But of course if you break the leased asset and it’s your fault, you will bear all the costs… In addition, leasing is a business expense.

**Microfinance providers** are organisations that provide **microcredit** (very small loans) to low-income individuals/businesses. Microcredit is usually really easy to obtain (there is no collateral) and it helps to alleviate poverty in low-income economies. However, the interest rates are really high, because microfinance providers usually take bank loans that they have to pay back for themselves

**Business angels** are wealthy individuals investing into high-risk business in exchange for ownership. On the one hand, this source of finance is free, because there are no interest payments and no dividends to be paid. However, since business angels provide financial help in exchange for a stake in business, it might result is a loss of control for founders

**Some other factors that should be considered when it comes to choosing the appropriate source of finance are the following:**

- *Availability*: what’s available to MNCs isn’t available to sole traders. If you are to make a decision about which SOF to use, then shortlist the options that are actually available, first of all.
- *Cost*: some SOFs are free, some require interest, fee or dividend payments. Prioritise what’s important for you as a manager at a given point in time, and make the corresponding decision. If you are not sure that you are able to return the loan at a given interest rate, it is not a good idea to consider it as a source of finance.
- *Control*: some SOFs result in loss of control, some are not. For example, if retaining control is the priority, then share capital might not be the best idea. As an alternative, loan capital would be a more suitable option.

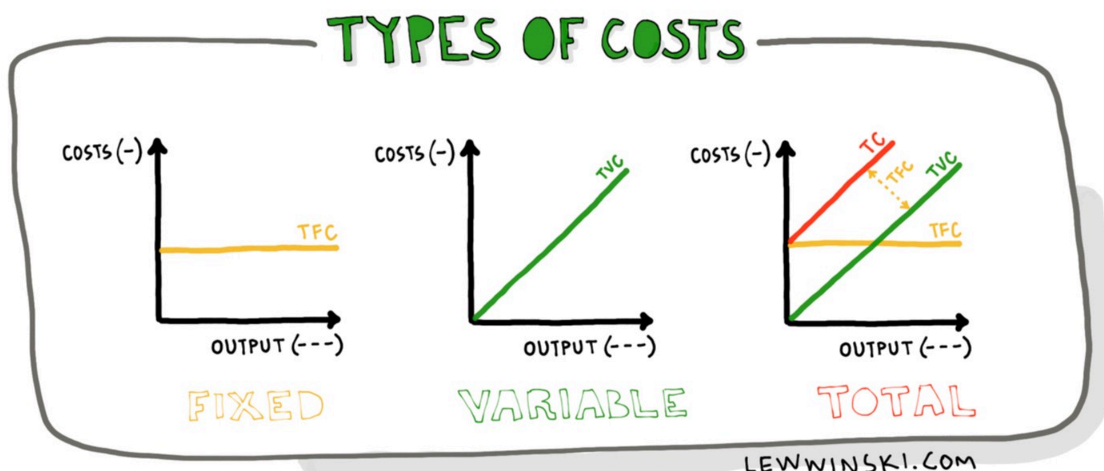
- *Time*: is finance needed to fund current or non-current assets? For example, if you would like to purchase land for a new factory, then a mortgage (long-term loan) is clearly the best option.
- *Gearing & risk*: gearing is a ratio of share capital to loan capital (we'll learn more about it later in Unit 3). High-geared organisations (the ones who rely mostly on loan capital) are less likely to be lent loans, because in the eyes of lenders they already have a lot of loans so the chances to get loan repaid are lower than for low-geared organisations.

**Costs** refer to the amount that has to be spent on purchasing the resources that are necessary to produce or sell a product. There are two categories of costs:

1. Variable and fixed costs
2. Direct and indirect costs (overheads)

**Fixed costs** are costs that a business has to pay regardless of how much it produces or sells (rent, interest, advertising, salaries, security, etc). For example, regardless of how many haircuts the barbershop provides each moth, the internet fee remains the same. Very often students think that fixed costs can't change. It is not true! They *can* change, but the main point is that the change is not caused by increased/decreased output/production.

**Variable costs** are costs that change in proportion to the level of output (raw materials, piece-rate wages, etc). For example, the more haircuts the barbershop gives, the more shampoo it'll spend on washing customers' hair. Thus, shampoo would be a variable cost. If you say "the difference between fixed and variable costs is that fixed costs don't change, but variable costs change" then you're wrong.




**Direct costs** relate specifically to a particular project or product (consultancy costs, mortgage fees, etc). If we continue the barbershop example, then shampoo would be a direct cost, because you can directly connect the cost of shampoo to the number of

customers and haircuts. Internet fee, however, would be an indirect cost, because it's impossible to say how much internet is spent per haircut, because these two variables are completely unrelated.

**Indirect costs (overheads)** are costs that cannot be traced to any particular product (rent, advertising). In addition to internet fee for a barbershop, rent could be another example of an indirect cost. Rent is paid monthly, regardless of how many haircuts barbershop gives and regardless of the type of haircut (hair, beard, hair plus beard).

**Revenue** is money/income that comes from product sales. Product sales refer to sales of goods and/or services that an organisation provides. Revenue is synonymous to **turnover** but not synonymous to profit. Profit = Revenue – Costs, while (Total) Revenue (TR) = Price (P) x Quantity (Q). Average revenue (AR) is the same as price, mathematically. Having said that, equations below should make sense to you now:

$TR = P \times Q$

$AR = TR \div Q$

$P = TR \div Q$, thus $P = AR$

**Dividends**: organisations, just like individuals, can have shares of different companies and get interest payments. For example, Microsoft owns some Apple shares, and Porsche is the majority shareholder of Volkswagen.

**Interest on deposits**: another thing that organisations can do in the same way as individuals is depositing money in a bank account and getting interest earnings.

**Merchandise**: in addition to the main trading activity, some organisations sell their souvenirs or clothes to get extra revenues. For example, Disney, in addition to making movies, sells its merchandise (toys and clothes) to fans.

**Donations**: this is usually one of the main revenue streams for popular streamers on Steam and YouTube. In addition, it is one of the main revenue streams for charities.

**Sponsorship deals**: the way it usually works is sponsor gives you financial support in exchange for an extra advertising space and publicity. For example, Emirates airlines sponsor FC Arsenal and Arsenal players have Emirates logo on their uniforms.

**Advertising revenue**: this is when an organisation is offering advertising space and charges other organisations for posting ads in this space. For example, Telegram and YouTube show ads to users who have free subscription.

**Subscription**: there are many kinds of subscriptions nowadays and it becomes a really popular revenue stream for more and more companies. For example, Apple offer iCloud storage space in exchange for a monthly fee.

**Royalties**: royalty payments are made to artists for the use of their artworks (for example, if you want to use someone's song in your film) or to franchisors for the use of franchise. Either way, royalties are payments for the use of intellectual property.

**Rental income**: some organisations own property that they rent out. You might be surprised but one of the main revenue streams for McDonalds is renting out its property to franchisees.

**Final accounts** are financial statements that are prepared regularly by the end of a certain period, usually fiscal (financial) year. Final accounts that you will learn in this class are *balance sheet* and *profit and loss account*. Very often final accounts are compared with those from previous year(s) or with those of competitors in order to assess relative performance of the organisation.

***Shareholders (owners)***: they are particularly interested in market capitalisation (how much the company is worth) and dividends, so their particular attention is directed to how much dividends the company is paying and how much revenues and profits it makes. Keep in mind that shareholders are owners of limited liability businesses (companies), but final accounts are prepared by all kinds of business entities, including organisations that do not have shareholders.

***Managers***: they care mostly about their jobs and bonuses, thus the most important parts of final accounts for managers are expenses and costs and other elements that indicate managers' performance. If costs are too high, it might mean that managers are not doing a good job of controlling expenses, which might negatively impact their employment.

***Employees*** might also make judgements about how secure their jobs are by looking through final accounts. If an organisation is regularly demonstrating increase in profits, then it might indicate safe future to its employees.

***Government*** is mostly interested in taxes being paid fully and on time, and in the absence of fraudulent illegal practices. They verify it by **audit** (independent inspection) of the final accounts.

***Suppliers*** usually check their debtors' final accounts to see if it's a good idea to offer trade credit and what the appropriate length of trade credit period should be

***Customers*** are mainly interested in how organisations they buy from distribute their profits: do they donate money to NPOs and/or do they make any charitable contributions? If organisations only retain profits in order to make owners wealthier, then customers might be reluctant to purchase from these organisations.

***Pressure groups*** *(and other NGOs)*, unlike the government, are not just checking if organisations obey the law and pay tax on time. They go beyond law and see how ethical or unethical organisations are. If they found out that organisations spend money on supporting something that harms the environment or has other kinds of negative impact on social well-being, they might make this information public and use media to put pressure on organisations in order to change their behaviour.

**Profit and loss account account (income statement)** — financial statement of an organisation's *trading* activities over one year. Actually, it doesn't have to be for one year, but most of the time it's prepared annually. Basically, this account shows how well organisation trades (sells it products and manages its costs). In accounting sense, the purpose of profit

and loss account is to show profit or surplus (for for-profit and non-profit entities accordingly) or loss (in case the “profit” is negative).

There are 3 parts in the profit and loss account:

1. Trading account
2. Profit statement
3. Appropriation account

ABC LTD (FOR-PROFIT ENTITY)

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20XX

| | $m |
|---|---|
| SALES REVENUE | 1500 |
| COST OF SALES | (500) |
| GROSS PROFIT | 1000 |
| EXPENSES | (300) |
| PROFIT BEFORE INTEREST AND TAX | 700 |
| INTEREST | (100) |
| PROFIT BEFORE TAX | 600 |
| TAX | (200) |
| PROFIT FOR PERIOD | 400 |
| DIVIDENDS | 150 |
| RETAINED PROFIT | 250 |

ABC (NON-PROFIT ENTITY)

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20XX

| | $m |
|---|---|
| SALES REVENUE | 1500 |
| COST OF SALES | (500) |
| GROSS SURPLUS | 1000 |
| EXPENSES | (300) |
| SURPLUS BEFORE INTEREST | 700 |
| INTEREST | (100) |
| SURPLUS BEFORE TAX | 600 |
| TAX | 0 |
| SURPLUS FOR PERIOD | 600 |
| RETAINED SURPLUS | 600 |

LEWWINSKI.COM

*Part 1*. **Trading account** is the part of profit and loss account that shows **gross profit** (the difference between sales revenue and cost of producing/purchasing products sold). The formula for gross profit is:

*Gross profit = Sales revenue – Cost of sales*

**Cost of sales** is the value of goods/services sold in a period of time. For goods it’s usually called **cost of goods sold (COGS)**. For services or in general you might say “cost of sales”. The formula is:

*Cost of sales/COGS = Opening stock + Purchases – Closing stock*

**Opening stock** is the cost of stock (raw materials, goods) at the start of the trading period. **Purchases** is the cost of supply/delivery of stocks. **Closing stock** is the cost of stock at the end of the trading period.

*Part 2*. **Profit statement** (or Loss statement, if things aren't going well, haha) is the part of profit and loss account that shows **net profit** (the difference between gross profit and all expenses). The formula is:

*Net profit = Gross profit – Expenses*

**Expenses** are indirect and/or fixed costs of production (rent, salaries, etc.). Keep in mind that interest and tax are separate from expenses because the organisation has no control over them. So they are shown separately after expenses in the profit statement.

*Part 3*. **Appropriation account** is the last part of profit and loss account that shows **dividends** (portion of net profit after interest and tax that is distributed among shareholders) and **retained profits** (the difference between net profit and dividends).

IVAN'S FRUIT LTD (FOR-PROFIT ENTITY)

STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 31 DECEMBER 2022

| | $ |
|---|---|
| SALES REVENUE | 230.000 |
| COST OF SALES | 60.000 |
| GROSS PROFIT | 170.000 |
| EXPENSES | (95.000) |
| PROFIT BEFORE INTEREST AND TAX | 75.000 |
| INTEREST | (12.000) |
| PROFIT BEFORE TAX | 63.000 |
| TAX | 8190 |
| PROFIT FOR PERIOD | 54.810 |
| DIVIDENDS | 13.702,50 |
| RETAINED PROFIT | 41.107,50 |

LEWWINSKI.COM

**Balance sheet** is the financial statement of an organisation's assets, liabilities and capital at a particular point in time. You can think of it as of a "snapshot" or photo of a financial situation of an organisation in a point in time: everything might change the moment after it's taken but it's still a good indicator.

Similar to profit and loss account, balance sheets have 3 parts:

1. Assets
2. Liabilities
3. Equity

| ABC LTD (PROFIT-MAKING ENTITY)<br>STATEMENT OF FINANCIAL POSITION<br>AS AT 31 DECEMBER 20XX | $m | $m |
|---|---|---|
| NON-CURRENT ASSETS | | |
| PROPERTY, PLANT AND EQUIPMENT | 900 | |
| ACCUMULATED DEPRECIATION | (100) | |
| NON-CURRENT ASSETS | | 800 |
| CURRENT ASSETS | | |
| CASH | 600 | |
| DEBTORS | 400 | |
| STOCK | 100 | |
| CURRENT ASSETS | | 1.100 |
| TOTAL ASSETS | | 1.900 |
| CURRENT LIABILITIES | | |
| BANK OVERDRAFT | 200 | |
| TRADE CREDITORS | 100 | |
| OTHER SHORT-TERM LOANS | 200 | |
| CURRENT LIABILITIES | | 500 |
| NON-CURRENT LIABILITIES | | |
| BORROWINGS – LONG TERM | 300 | |
| NON-CURRENT LIABILITIES | | 300 |
| TOTAL LIABILITIES | | 800 |
| NET ASSETS | | 1.100 |
| EQUITY | | |
| SHARE CAPITAL | 100 | |
| RETAINED EARNINGS | 1.000 | |
| TOTAL EQUITY | | 1.100 |

| ABC (NON-PROFIT ENTITY)<br>STATEMENT OF FINANCIAL POSITION<br>AS AT 31 DECEMBER 20XX | $m | $m |
|---|---|---|
| NON-CURRENT ASSETS | | |
| PROPERTY, PLANT AND EQUIPMENT | 900 | |
| ACCUMULATED DEPRECIATION | (100) | |
| NON-CURRENT ASSETS | | 800 |
| CURRENT ASSETS | | |
| CASH | 600 | |
| DEBTORS | 400 | |
| STOCK | 100 | |
| CURRENT ASSETS | | 1.100 |
| TOTAL ASSETS | | 1.900 |
| CURRENT LIABILITIES | | |
| BANK OVERDRAFT | 200 | |
| TRADE CREDITORS | 100 | |
| OTHER SHORT-TERM LOANS | 200 | |
| CURRENT LIABILITIES | | 500 |
| NON-CURRENT LIABILITIES | | |
| BORROWINGS – LONG TERM | 300 | |
| NON-CURRENT LIABILITIES | | 300 |
| TOTAL LIABILITIES | | 800 |
| NET ASSETS | | 1.100 |
| EQUITY | | |
| RETAINED EARNINGS | 1.100 | |
| TOTAL EQUITY | | 1.100 |

LEWWINSKI.COM

*Part 1*. **Assets** are items of property owned by the organisation. They can be current and non-current (or fixed). **Current assets** are short-term liquid assets that last for up to one year (cash, debtors, stock, etc). **Non-current** (fixed) **assets** are long-term assets that last for more than one year (machinery, buildings, cars, etc). So the main point here is that whatever an organisation owns for more than a year is recorded as a non-current assets, and whatever an organisation owns for less than a year is a current asset.

*Part 2*. **Liabilities** are money owed by the organisation to its suppliers and lenders. The situation with liabilities is similar to that of the assets: they can also be current and non-current (long-term). **Current liabilities** are short-term debts that are paid for within one year (overdrafts, creditors, etc). **Non-current** (long-term) **liabilities** are long-term debts that payable after one year (mortgages, long-term loans, etc).

*Total liabilities = Current liabilities + Non-current liabilities*

*Part 3*. **Equity** is the value of all assets if they were liquidated. **Liquidation** is the process of converting all assets into cash. The most liquid asset is cash, which is like water in the business world. The easier it is to convert an asset into cash (i.e to sell it for cash), the more liquid an asset is. The harder it is, the less liquid an asset is. For profit-making entities equity

is comprised of share capital and retained earnings. For non-profit entities equity consists of retained earnings only, because there are no shareholders in non-profit entities.

*Net assets = Total assets – Total liabilities*

*Net assets = Equity*

Just think about it: net assets are everything that an organisation owns minus all the debts it has.

Before we learn how to calculate **depreciation** using these two methods, we have to understand the meaning of 5 key terms that are essential to understanding depreciation:

1. **Purchase cost** is the cost of the asset at the time when it was bought.
2. **Lifespan** is how long the asset can be used.
3. **Residual/scrap value** is how much an asset is worth at the end of its lifespan.
4. **Book value** the value of an asset in the balance sheet.
5. **Market value** is the estimated price of an asset if it was to be sold.

There are several methods how to calculate depreciation. We'll learn these two methods:

1. Straight line method
2. Units of production method

Calculating annual depreciation using **straight line method** is really straightforward and easy. If residual value is 0, then:

*Annual depreciation = Purchase cost ÷ Lifespan*

If residual value is more than 0, then:

*Annual depreciation = (Purchase cost – Residual value) ÷ Lifespan*

Straight line method takes account of *time*, but **units of production method** takes account of *usage*: the more the asset is used, the higher the depreciation. Please be mindful that there are several ways to calculate annual depreciation using this method! I am suggesting the one that personally I find the most straightforward and clear.

*Annual depreciation = units of production rate (UPR) × actual quantity (Q) produced*

*UPR = (purchase cost – residual value) ÷ total quantity (Q) produced over lifespan*

***Ratio analysis** is a quantitative financial analysis tool for judging the financial performance of the business based on financial statements (balance sheet and profit & loss account). There are different types of ratios: profitability, liquidity and efficiency.*

**Profitability ratios** examine organisation's profit-making ability. The three types of profitability ratios are gross profit margin, profit margin and return on capital employed (ROCE).

**Gross profit margin** shows the percentage of *gross profit* in relation to revenue. You will need profit and loss account to obtain data for calculation of profit margin. The formula of gross profit margin is:

*Gross profit margin = gross profit ÷ revenue × 100*

The first strategy to improve gross profit margin could be increasing revenue by reducing or increasing the prices. Reduction of prices may result in increased demand and thus higher revenue. Increasing the prices may result in higher revenues if the demand doesn't fall.The downside of price increase/reduction is that it might impact brand image negatively as it can be perceived as inferior in case of price reduction or unethical in case of price increase.

The second strategy is increasing the revenue through increased promotion. This way, more potential customers will be likely to know about the product sold. However, being aware of the product does not necessarily result in purchasing the product. In addition, marketing costs might also increase with increased promotion.

Another strategy is reducing the cost of sales. As we learnt in the previous class, *gross profit = revenue – cost of sales*. So, one way to improve gross profit margin is to reduce cost of sales by using cheaper suppliers. On the one hand, cost of sales might decrease. But on the other hand, cheaper suppliers might be of inferior quality.

**Profit margin** shows the percentage of *net profit before interest and tax* in relation to revenue. You will need profit and loss account to obtain data for calculation of profit margin. The formula of gross profit margin is:

*Profit margin = profit before interest & tax ÷ revenue × 100*

*The first strategy to improve profit margin is to improve working capital by negotiating longer trade credit period. Working capital is money used in day-to-day trading operations (formula is total current assets – total current liabilities). If you negotiate longer trade credit period, it means that you postpone the payment for the supplies, which will apparently have a positive impact on working capital. Simply speaking, you'll have more cash at hand. The downside is that your creditors (suppliers, who sell things to you and provide trade credit) might not appreciate that and relationship with them might worsen. Or they might simply increase the price in exchange for longer trade credit period.*

*The second strategy is to improve working capital by negotiating discounts with your creditors/suppliers. For example, if you promise to pay for supplies earlier than usual, you will get a certain discount for early payment. That is acceptable and it might free up some cash, but it might put too much pressure on the organisation to generate revenues asap, which might result in decreased quality of output or lower motivation of employees.*

*Another strategy is to reduce expenses. As you remember from the previous class, net profit = gross profit – expenses, so reduction of expenses will clearly result in increased net profit. This could be achieved by delayering. If an unnecessary level of management is delayered,*

*then it will cut administrative/managerial costs, but it might result in loss of control over employees.*

***Return on capital employed (ROCE)*** *shows how well capital employed is used in making profit. You will need both profit and loss account and balance sheet to obtain data for calculating ROCE. The formula for ROCE is:*

*ROCE = profit before interest & tax ÷ capital employed × 100*

*Capital employed = non-current liabilities + equity*

*The higher the ROCE, the more profit organisation generates from invested capital. For example, 25% ROCE shows that for every $100 invested, $25 profit is generated. ROCE benchmarks are different in different industries but usually a benchmark of an acceptable ROCE is around 20%.*

***Liquidity ratios*** *examine organisation's ability to pay for its current liabilities. Liquidity is defined as the state of being liquid. In the business world, water is cash, i.e. cash is the most liquid asset. So,* ***liquidity*** *refers to the availability of liquid assets to an organisation. In the balance sheet, liquid assets are in the current assets section and are usually cash, debtors and stock. The two types of liquidity ratios are current ratio and acid test (quick) ratio.*

**Current ratio** compares organisation's current assets to current liabilities. The formula of current ratio is:

*Current ratio = current assets ÷ current liabilities*

Desirable ratio depends on the industry, but it is usually between 1,5:1 to 2:1. If current ratio is lower than 1:1, it indicates that organisation is experiencing liquidity problems. If the ratio is more than 2:1, it means too much of one or some of the following:

- *Cash*. Cash is a depreciating asset. Its value decreases over time due to inflation, so it not a good idea to hold too much cash.
- *Debtors*. If an organisation holds too much of debtors, it means that it sells a lot of its product on credit, i.e. it means that debtors receive products, but pay for them later. It might result in bad debt — a situation when debts cannot be repaid. This should be avoided.
- *Stock* (unsold goods). This indicates that there is too much of unsold goods that take up storage place and do not generate any value. This situation is also undesirable.

The first strategy to improve current ratio is to increase current assets by selling non-current assets for cash, not on credit. On the one hand, it will increase cash and improve the ratio, but on the other cash, as I mentioned above, holding too much of cash is undesirable because it is a depreciating asset. It's really important to be balanced here and to make sure there is just enough cash to sustain day-to-day operations: not too much and not too little, somewhere in between too much of depreciating asset and liquidity problem.

Another strategy to improve current ratio could be decreasing current liabilities by using long-term sources of finance instead of short-term. On the one hand, it improves the ratio and decreases the burden of frequent payments for short-term loans (current liabilities). But

on the other hand, you might end up having liquidity problems if there is not enough cash to pay for short-term expenses, such as wages, electricity and other fees, and deliveries of supplies. So, again, balance is essential.

**Acid test (quick) ratio** compares organisation's current assets *less stock* to current liabilities. The formula of acid test ratio is:

*Acid test ratio = (current assets – stock) ÷ current liabilities*

This ratio is very similar to current ratio, but it excludes stock from calculation, which makes this ratio more strict. It is more suitable for organisations, whose stock is not very liquid and yet is very high in value. For example, plane manufacturers like Airbus and Boeing might not use current ratio, because it would not be a good indicator of liquidity. Their stocks (planes) are really high in value and are slow to produce and sell, so it would make more sense to completely exclude stocks from the equation in order to assess the "real" liquidity of the organisation.

he strategies to improve acid test ratio are the same as for current ratio, but in addition to them, the organisation might get rid of stocks quickly by selling them with a discount. On the one hand, it will improve liquidity because there will be more cash. But on the other hand, discount means lower revenue, which might have a negative effect on profitability.

**Ratio analysis** is a quantitative financial analysis tool for judging the financial performance of the business based on financial statements: balance sheet and profit & loss account. There are different types of ratios: profitability, liquidity and efficiency. The first two types of ratios were covered in the previous class, and efficiency ratios are covered here in this class for HL students only.

**Efficiency ratios** examine organisation's performance in terms of how it uses its resources (i.e. assets and liabilities). The four types of efficiency ratios are stock turnover, debtor days, creditor days and gearing.

**Stock turnover ratio** shows how quickly the organisation sells and replenishes its stock. Stock here refers to stock of finished goods. There are two ways to calculate stock turnover: by number of times per year and by number of days. The corresponding formulae of stock turnover ratio are:

*Stock turnover (number of times) = cost of sales ÷ average stock*

*Stock turnover (number of days) = average stock ÷ cost of sales × 365*

*Average stock = (opening stock + closing stock) ÷ 2*

**Debtor days ratio (receivables)** shows how long it takes to collect debts. This usually applies to customers who bought goods from you using trade credit, i.e. when they got their goods at the time of purchase, but they pay for them later, within the credit period. In this relationship, you are a creditor, and your customers are debtors. The formula of debtor days ratio is:

*Debtor days = debtors ÷ sales revenue x 365*

**Creditor days ratio (payables)** shows how long it takes to pay creditors. This is quite the opposite of debtor days ratio. In this relationship, you are a debtor, and your suppliers are creditors. The formula for creditor days ratio is:

*Creditor days = creditors ÷ cost of sales x 365*

**Gearing ratio** shows the extent of organisation's reliance on loan capital. Highly geared organisations might be a high-risk investment but might have a higher growth potential. Low geared organisations are the opposite: they might be low-risk investment but have lower growth potential. Highly geared firms are also less likely to pay dividends, because they have to pay for their long-term debt obligations first. The formula for gearing is:

*Gearing = loan capital ÷ capital employed × 100*

**Loan capital** is the same as non-current liabilities. **Capital employed** is a sum of non-current liabilities and equity. Equity in for-profit organisations consists of retained earnings and share capital, for non-profit organisations it consists of retained earnings only

The higher gearing ratio is, the more dependent on long-term borrowing and interest payments organisation is and therefore the lower net profits are (because interest payments are an expense). High gearing is considered to be above 50%, low gearing is considered to be below 50%.

| INSOLVENCY | BANKRUPTCY |
| --- | --- |
| SITUATION | PROCESS |
| CAN'T PAY ON TIME | CAN'T PAY AT ALL |
| CURRENT LIABILITIES > CURRENT ASSETS | |
| CURRENT RATIO & ACID TEST RATIO | |
| FLEXIBLE | INFLEXIBLE |

LEWWINSKI.COM

**Insolvency** is a *situation* when an organisation is not able to pay its debts *on time*. This is a kind of situation when current liabilities exceed current assets. The ratios that indicate insolvency are current ratio and acid test ratio. When these two ratios are less than 1:1, it is clearly an evidence of liquidity problems and insolvency.

**Bankruptcy** is a *process* that organisation goes through when it is not able to pay its debts *at all*. Similar to insolvency, the indicator of inability to pay debts is current and acid test ratios that are lower than 1:1, which means that current liabilities are greater than current assets.

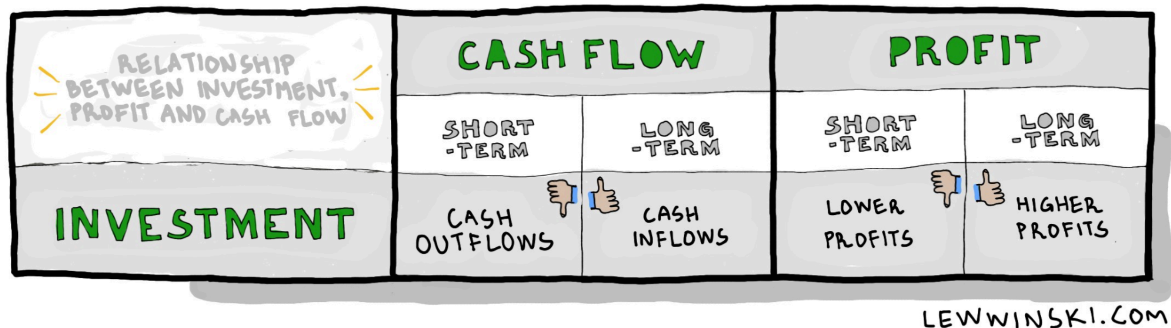
Unlike insolvency, bankruptcy is the last resort. Negotiation with creditors cannot be a solution to bankruptcy, because it is already too late to negotiate. If insolvency is flexible in terms of how it can be resolved, then bankruptcy is inflexible.

**Cash** is the most liquid asset of the business. It is like water of the business because it is essential and because it flows

**Cash flow** refers to money coming in and going out of the business. Money coming in are cash **inflows**, money going out are cash **outflows**. Ideally, businesses should have sufficient cash at any point in time.

**Profit** is positive difference between revenue and costs. If this difference is negative (i.e. if costs exceed revenues), it means that a business is experiencing **loss**.

**Investment** refers to the purchase of non-current assets that generate future earnings. It can also refer to purchase of stock/shares, M&As and many other things, but let me make it clear to you once and for all.




**Cash flow forecast** is a document that shows predicted movement of cash in and out of business per time period. Cash flow forecast is a forwards-looking document, because it shows a *prediction* of the future cash flow.. If the same document is backwards-looking and is based on existing *past* data, then it is called **cash flow statement**

CASH FLOW FORECAST FOR ABC LTD OR ABC FOR THE FIRST THREE MONTHS OF 20XX

| ALL FIGURES IN $m | JANUARY | FEBRUARY | MARCH |
|---|---|---|---|
| OPENING BALANCE | 8 | 2 | 1 |
| CASH INFLOWS | | | |
| CASH SALES REVENUE | 300 | 300 | 300 |
| TAX REFUND | | 3 | |
| TOTAL CASH INFLOWS | 300 | 303 | 300 |
| CASH OUTFLOWS | | | |
| RENT | 2 | | |
| PACKAGING | 15 | 15 | 15 |
| SALARIES & WAGES | 50 | 50 | 50 |
| COST OF SALES | 220 | 220 | 220 |
| HEATING & LIGHTING | 4 | 4 | 4 |
| DELIVERY | 15 | 15 | 15 |
| TOTAL CASH OUTFLOWS | 306 | 304 | 304 |
| NET CASH FLOW | (6) | (1) | (4) |
| CLOSING BALANCE | 2 | 1 | (3) |

LEWWINSKI.COM

**Opening balance** is the amount of cash at the beginning of trading period. It equals to preceding month's closing balance. For example, opening balance for June is the same figure as May's closing balance.

**Cash inflows** come from sales revenue, debtors, loans, interest received, sale of assets, rental income, etc. Anything that refers to money going inside the business is a cash inflow.

**Cash outflows** are expenses, such as rent, wages, purchase of stocks, tax, creditors, advertising, interest payments, dividends, etc. Outflows are the opposite of inflows, i.e. they are money going out of the business.

**Net cash flow** is the difference between cash inflows and cash outflows. It needs to be positive to avoid bankruptcy. If net cash flow is negative for a few months in a row, it is a clear indicator of cash deficiency and liquidity problems. Remember that there are also liquidity ratios that serve as indicators of liquidity issues.

**Closing balance** is the amount of cash at the end of a trading period. In other words, closing balance equals to opening balance plus net cash flow.

If you are a **creditor** (you sell products to your debtors and let them pay later), then you might shorten credit period (the time period within which your debtors are obliged to pay). On the one hand, you will receive cash payments earlier. On the other hand, the relationships with debtors might deteriorate and they might be looking for new suppliers.

If you have too many debtors or even bad debt (a situation when you aren't able to get payment for your products) then you might use a source of finance that is called **debt factoring**. The way it works is debt factor buys debts from you in exchange for a fee. For example, A owns $100 to B by next year. If A needs cash urgently, then debt factor may pay $90 to A right now and collect the debt from B in the due time, earning $10. On the one hand, A might get cash payment earlier and improve working capital. On the other hand, A won't get full payment because debt factors always work for a fee that is a certain percentage of the debt.

**Overdraft** is another solution to cash deficiency. If cash flow forecast shows the periods when cash is insufficient, then the organisation might plan an overdraft beforehand. The upside is that it is easy to obtain cash using overdraft: the procedure is usually simple and quick. But the downside is that delayed overdraft repayments have enormous interest rate, so it is better not to delay overdraft payments to avoid the risk of overpaying.

**Sale-and-leaseback** is another source of finance that can enhance cash inflows. The way it works is by selling non-current assets and leasing them back immediately. For example, a restaurant sells its pizza oven to someone, but this pizza oven is leased by the restaurant immediately at the time of purchase. It never has to leave the restaurant. The only thing that's changed, is that restaurant is no longer the owner of that pizza oven and it has to lease it from the new owner, paying a fee every month for using it.

Now let's discuss the strategies to decrease cash outflows:

- If you are a debtor, you may ask your creditors (suppliers) to postpone payment for you, i.e to increase credit period. On the one hand, you are delaying cash outflows. On the other hand, you are ruining relationship with creditors.
- Another way to decrease outflows is to find suppliers who are cheaper. On the one hand, you'll decrease the outflows and will retain more cash. But, the downside is that "cheaper" often means "worse", so the quality of produced goods may deteriorate.
- Another way is to reduce expenses. This can be any overhead (indirect cost): internet fee, advertising costs, coffee machine in the office, etc. Cutting some of the expenses will release some cash, but might also result is staff demotivation (if you take away the coffee machine, haha), or decreased brand awareness (if you cut advertising costs).
- Another way to improve cash flow is to use **hire purchase** — a source of finance that allows to pay for the purchase of non-current (long-term) assets in several instalments, as opposed to one-off payment. This way, if the organisation is in need of some non-current assets (machinery, equipment, etc.) but does not want to spend too much cash at once, payment may be broken down into several smaller instalments.

**investment** is a purchase of an asset that will potentially generate future earnings. **Investment appraisal** refers to quantitative techniques that are used to evaluate the pros and cons of investment opportunities. The three investment appraisal techniques that we'll learn in this class are:

1. Payback period (PBP)
2. Average rate of return (ARR)
3. Net present value (NPV) (HL only)

**Payback period (PBP)** is the length of *time* required for an investment to recover its initial cost of investment (**principal**) in terms of profit.

PBP = initial investment cost ÷ cash flow from investment per period

*PBP = additional cash inflow needed ÷ annual cash flow in the next year × 12 months (+ no. of years)*

*Average rate of return (ARR) is average profit on investment expressed as a percentage of the initial investment (**capital costs**). So, if PBP shows time, then ARR shows percentage. After calculating ARR, managers usually compare it to the interest rate in the banks.*

*ARR = (total returns – capital costs) ÷ years of use ÷ capital costs × 100*

***Net present value (NPV)** is the difference between present values of future cash flows and original cost of investment (principal). As always, it might sound difficult but in fact it is not. First of all, we have to establish that cash is a depreciating asset because it loses its value over time.*

*So far, we've established that **present value** is today's value of future cash. In order to calculate present value, we need to multiply the sum by a **discount factor** from the table below:*

DISCOUNT TABLES

| Years | Discount rate | | | | |
|---|---|---|---|---|---|
| | 4% | 6% | 8% | 10% | 20% |
| 1 | 0.9615 | 0.9434 | 0.9259 | 0.9091 | 0.8333 |
| 2 | 0.9246 | 0.8900 | 0.8573 | 0.8264 | 0.6944 |
| 3 | 0.8890 | 0.8396 | 0.7938 | 0.7513 | 0.5787 |
| 4 | 0.8548 | 0.7921 | 0.7350 | 0.6830 | 0.4823 |
| 5 | 0.8219 | 0.7473 | 0.6806 | 0.6209 | 0.4019 |
| 6 | 0.7903 | 0.7050 | 0.6302 | 0.5645 | 0.3349 |
| 7 | 0.7599 | 0.6651 | 0.5835 | 0.5132 | 0.2791 |
| 8 | 0.7307 | 0.6271 | 0.5403 | 0.4665 | 0.2326 |
| 9 | 0.7026 | 0.5919 | 0.5002 | 0.4241 | 0.1938 |
| 10 | 0.6756 | 0.5584 | 0.4632 | 0.3855 | 0.1615 |

LEWWINSKI.COM

*Now, **net present value** is a sum of present values minus original cost of investment, as the formula below states:*

*NPV = Sum of present values – Original cost*

***Marketing***

*To begin with, just a reminder that **marketing** is one of the four business functions, that refers to making sure the right goods and services are provided to the right customers in the right place and the right time.*

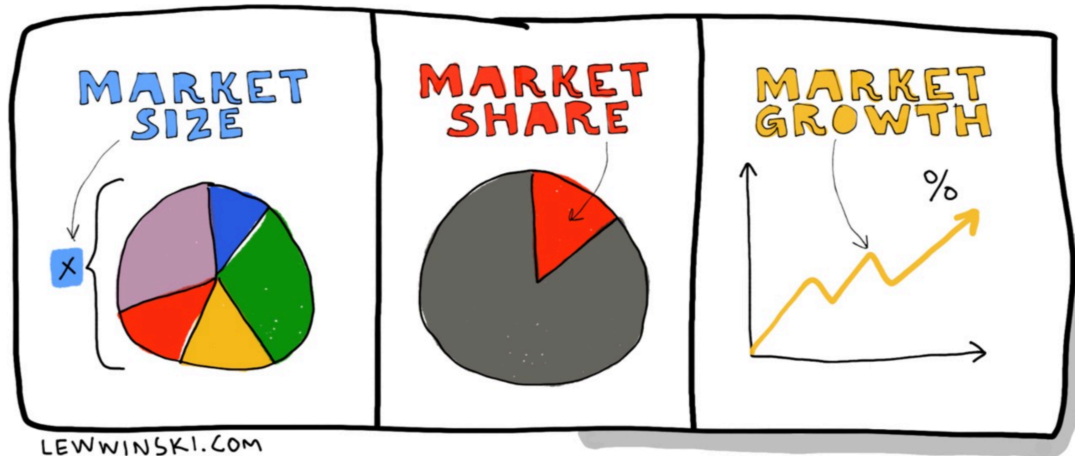
***Market orientation** is an approach to marketing that is focused on market research. Simply speaking, market oriented businesses think about what to sell, not about what to produce*

*On the one hand, market orientated approach helps the business to quickly reply to market/customer needs and wants because of continuous market research. Market oriented businesses always know what their customers want and their main goal is to make sure they are selling exactly what people need. On the other hand, market research is a time consuming and expensive process, so reliance on market research is costly for market-oriented businesses.*

***Product orientation** is an approach to marketing that is focused on innovation. Simply speaking, market oriented business think about what to produce/invent, not about what to sell. The main idea here is that product oriented businesses try to develop unique innovative products that do not even have alternatives. Thus, this approach is inwards-looking, which means that it is not focused on the customers and market research, it is focused on the business itself and the product.*

*Before we move on to the next part of this class, let's see which factors may impact the choice of an approach, which factors managers consider when they think "are we market oriented or product oriented?":*

- *First of all, it's nature of the product. If the product that you are offering is pizza, then it would be quite hard to be product-oriented… Clearly for products like pizza market oriented approach is more suitable.*
- *Secondly, **barriers to entry** (obstacles that prevent businesses from entering different markets) matter. For example, competition. If the competition in a certain market is intense, then how will you try to minimise it: by understanding what customers want (market-oriented) or by providing something unique that has no alternatives (product-oriented)?*
- *Lastly, organisational culture impacts the choice of an approach to marketing. If an organisation is working under the assumption that "customer is always right" then it clearly refers to market orientation. However, if the company's slogan is "Think different" (Apple), then it forms a culture of innovation, risk taking and creativity, which are the features of a product oriented approach.*




***Market*** *can refer to many things: all the people that purchase a certain product, or a place where trade happens, or products that are offered by businesses.* ***Market size*** *refers to the total sales in the industry. It can be measured by value (dollars, yuan, rupiah, etc.) or by volume (number of items sold, for example number of smartphones).*

*Market size = cumulative sales of all organisations in the industry*

***Market share*** *is the percentage of the total sales in a market that a business makes up, i.e. a firm's portion in total sales in the market/industry. Even though market share is always expressed as a percentage, this percentage may refer to either value (dollars, yuan, pound, etc.) or to volume (number of smartphones, items of furniture, laptops, etc.).*

*Market share (%) = organisation's sales ÷ total sales in the industry × 100*

*Usually, the higher the market share, the higher the* ***market power*** *(a firm's ability to establish the "rules" in the market, for example manipulate the price by controlling the supply).*

***Market growth*** *is the percentage of the positive change in market size. It can also be measured by value or by volume, similar to market share. But, it refers to the industry (not to the firm, like market share). Formula is also pretty simple and straightforward:*

*Market growth (%) = (market size now – market size before) ÷ market size before × 100*

*As we learnt in the previous part of class,* ***market share*** *is a firm's portion in total sales in the market/industry. If you know market share of all firms in the industry/market, then you will be able to identify the* ***market leader*** *— the firm with the highest market share in the industry.*

*On the one hand, high market share or the highest market share (i.e. market leadership) can allow the firm to use economies of scale by being able to produce more items at lower average costs. In addition, market leadership or high market share may result in high* ***market power****, which means that a firm is able to become a benchmark for other firms in the*

*industry. And lastly, market leadership and high market share are indicators of high demand, which means that customers are familiar with the firm's brand and recognise it well which, in turn, results in customer loyalty and repeat purchases.*

*On the other hand, market share/leadership is not in any way an indicator of profitability. A firm might set a very low price for its products and, as a result, attract a lot of customers and increase its market share, but, at the same time, not be very profitable because of the low price… So, achieving high market leadership is relatively easy, but making sure you are a profitable market leader is a real challenge. In addition, once a firm reaches a high market share or even achieves market leadership, the priority switches to maintaining high market share or leadership. This is not a simple task and the ways to maintain it depend on the firm's marketing approach (see the first part of this class).*

***Marketing planning** is the process of setting marketing objectives and determining marketing strategies for their achievement. It is no different from any other planning, it's just that it's about marketing this time. Once marketing objectives and strategies are determined, they need to be recorded in a document that could act as a guide to decision-making. This document is called (surprise-surprise!) **marketing plan**.Marketing planning is a systematic, cyclical, reflective process of setting and resetting marketing objectives and strategies for their achievement.*

*On the one hand, marketing planning (same as any other kind of planning) reduces risks: the more you've planned, the more prepared to changes you are. In addition, it fosters interdependence: all business functions are related, so a good marketing plan will take account of all the functional departments of organisations and will ensure their collaboration. Lastly, marketing planning motivates staff: once you have a plan that includes objectives and*

*strategies, you know what to do and you are very much likely to be trying to work towards achieving these objectives.*

*However, on the other hand, marketing planning does not guarantee success: regardless of how hard and thoroughly organisation plans, there will definitely be some unforeseen changes. I doubt there is any organisation that was planning to operate under covid lockdowns and restrictions, but covid and lockdowns happened anyway. In addition, marketing planning is time-consuming and costly: it might be quite easy to plan if you are a sole trader, but once you put yourself into a large multinational company's shoes, marketing planning might look like a big challenge.*

***Market segmentation** is the process of dividing potential customers into groups with similar characteristics. That is what you did in steps 2 and 3 of the "dividing the market" exercise.*

***Market segment** is a group of customers with similar characteristics.*

*There are three main ways of market segmentation, i.e. three main ways how to divide customers. **Demographic segmentation** is a process of dividing the market (customers/consumers/users) by age, gender, ethnicity, marital status and other demographic characteristics. **Geographic segmentation** is a process of dividing the potential market by continent, country, region, province, climate zone, etc. And lastly, **psychographic segmentation** is a process of dividing the market by people's lifestyles, hobbies, wealth, "class" (middle, high, middle high, etc.), "collar" (blue collar vs white collar).*

***Targeting** is the process of selecting the relevant market segments to sell to. That is what you did in step 4 of the "dividing the market" brain exercise. **Target market** refers to potential customers that share similar characteristics.*

***Undifferentiated (mass) targeting** is basically not targeted at all, it's pretty much covers all human beings. For example, Coca-Cola, Pepsi, Kleenex could be examples of firms using undifferentiated targeting.*

***Differentiated (segmented) targeting** selects a few segments and targets them differently. For example, Nike, Dior, Toyota might do it. Their products might also be pretty much for everyone but different group of customers have to be approached differently. Let's say, if Dior wants to sell male perfume and female perfume, it is very much likely to approach these two target markets differently, whereas for Coke (that is non-targeted), gender (or anything else) doesn't matter that much…*

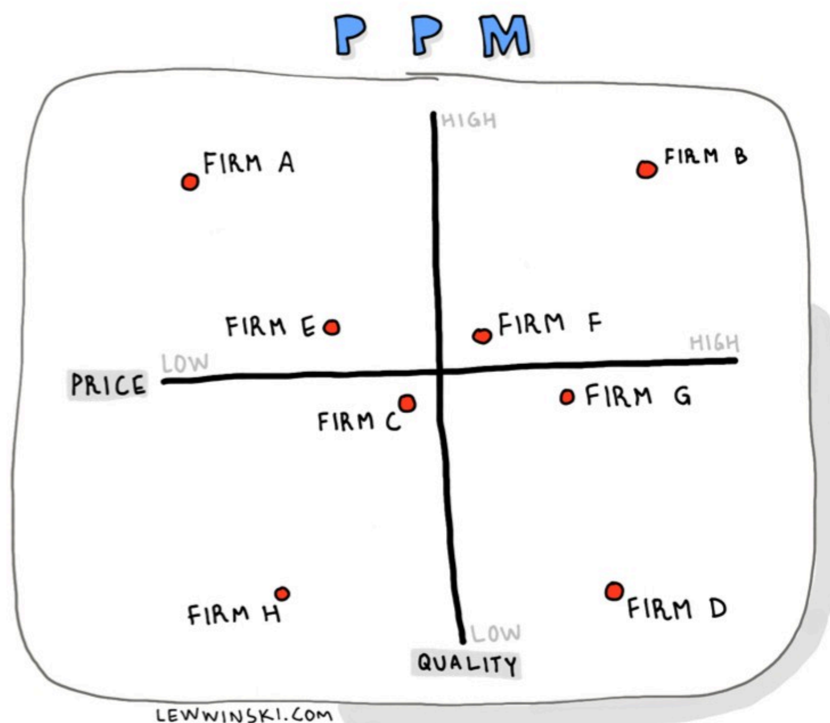
***Concentrated (niche) targeting** is aimed at a very specific and narrow group of customers/consumers/users. For example, Billabong targets surfers, Burton targets snowboard riders, lewwinski.com targets IB DP Business Management students.*

*And lastly, there is also **consumer profiling** (that you did in step 5 of the brain exercise) — the process of outlining the description of a "perfect customer" by listing their key characteristics. It's very similar to targeting, and is basically a written summary of targeting and segmentation. **Consumer profile** is a description of a potential customer. This potential customer in a consumer profile can be a person that might not exist in reality, for example*

*he/she might have a range of ages (as opposed to one age), several genders, multiple lifestyles and live in different locations at the same time.*

*The last concept that we'll explore in this part of class is* ***positioning****. It refers to the process of presenting the brand/product in a specific way in order to create the desired customer perception. Positioning is something that a business can manipulate by alternating its product, price, promotion, and change. But perception is something that firms do not have direct control over*

***product perception map or PPM*** *— a visual tool that outlines customers' perceptions on brands/products. Once again, PPM should be based on customers'/consumers'/users' perceptions, not on what the business thinks of itself and it should be supported by market research data!*




***Premium products*** *(high price, high quality),*

***Cowboy products*** *(high price, low quality),*

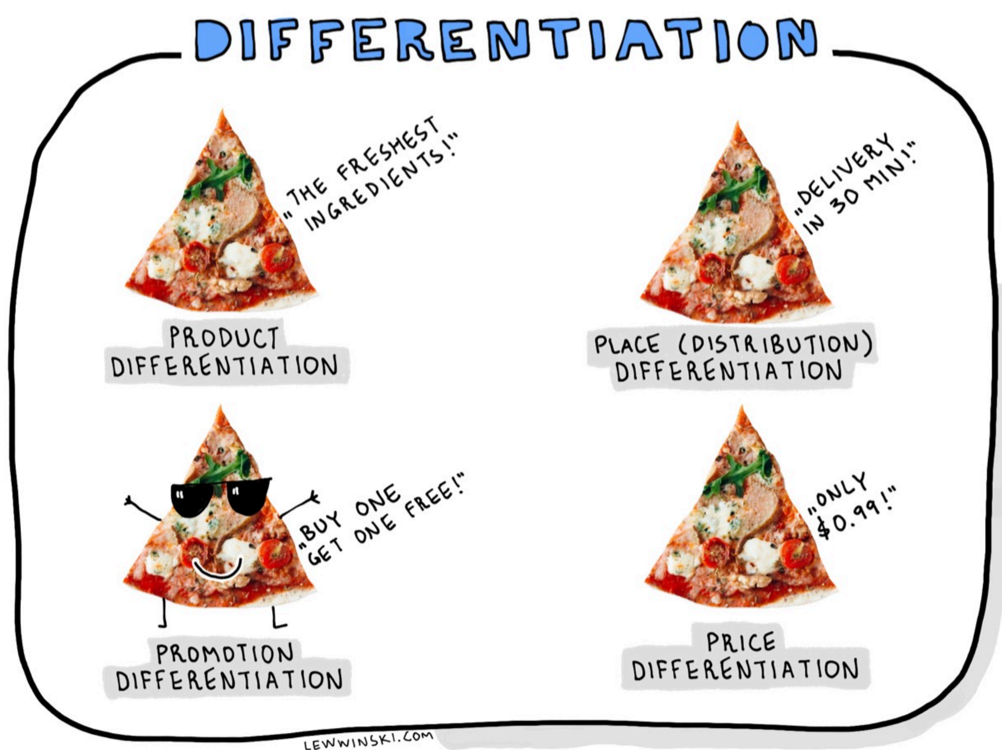
***Economy products*** *(low price, low quality),*

***Bargain products*** *(low price, high quality).*

***Niche market*** *is a very specifically and narrowly defined group of potential customers. For example, male teenagers 15~16 years of age from middle class families in Switzerland who like adventure video games. So, nice market products are for a specific (very specific!) group of people.*

***Mass market*** *is quite the opposite of* ***niche market*** *in many ways. It is very unspecific and broadly defined group of potential customers. As opposed to highly targeted niche markets, mass markets are non-targeted. We may say that mass market products are "for everyone". Consumer profiles for mass market customers sound very broad and "unrealistic", meaning that the customers are described using a range of ages, genders, lifestyles, and other characteristics.*

***Unique selling point (USP)*** *is a special feature of a product or organisation that helps it to stand out among competitors. This way, different businesses that are in the same industry (i.e. offer the same product) can emphasise different features of this product to help them stand out (differentiate) among competitors.*




***Differentiation*** *is the process of using the USP in such a way that customers perceive the product or organisation as unique and different from those that are offered by competitors. As you can see, USP and differentiation are closely related, but the former is a feature and the latter is a process.*

*So, now you know how businesses can differentiate themselves and their products from competitors. Just to recap, in order to do that, they can use differentiation strategies based on the elements of the marketing mix*

- *product differentiation,*
- *price differentiation,*
- *promotion differentiation,*
- *place (distribution) differentiation,*
- *processes differentiation,*

- *people differentiation,*
- *physical evidence differentiation.*

***Sales forecasting** refers to quantitative & qualitative techniques of predicting the future sales*

***Variation** is the difference between the actual past data and trend (moving average). It helps to identify the periods with the highest fluctuations from the trend. This data is used to adjust marketing planning accordingly. Let's see the table below.*

VARIATION

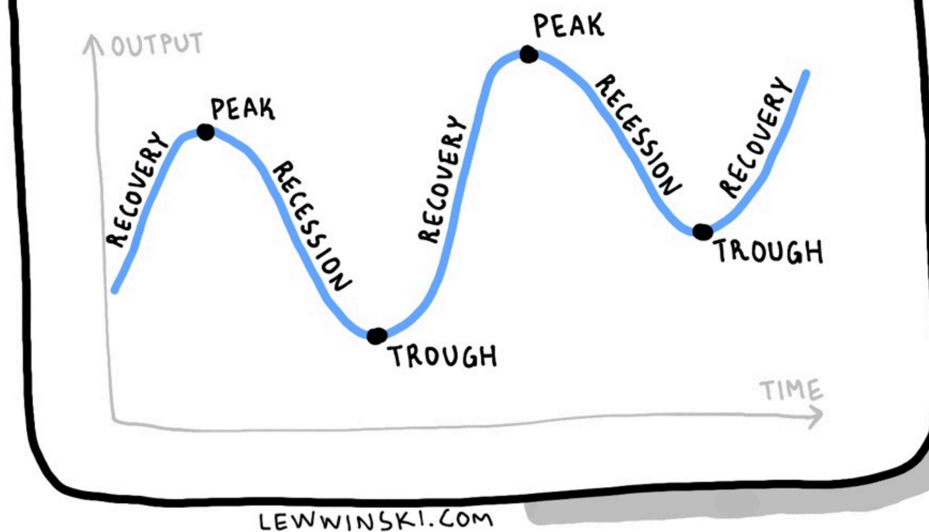
| YEAR | SALES (£m) | 3-Y AVG | VARIATION |
|---|---|---|---|
| 1 | 1,2 | | |
| 2 | 1,1 | 1.2 | -0,1 |
| 3 | 1,3 | 1,3 | 0 |
| 4 | 1,5 | 1,4 | 0,1 |
| 5 | 1.4 | 1,53 | -0,13 |
| 6 | 1,7 | 1,63 | 0,7 |
| 7 | 1,8 | 1,73 | 0,7 |
| 8 | 1,7 | 1,8 | -0,1 |
| 9 | 1.9 | 1,86 | 0,04 |
| 10 | 2 | | |

LEWWINSKI.COM

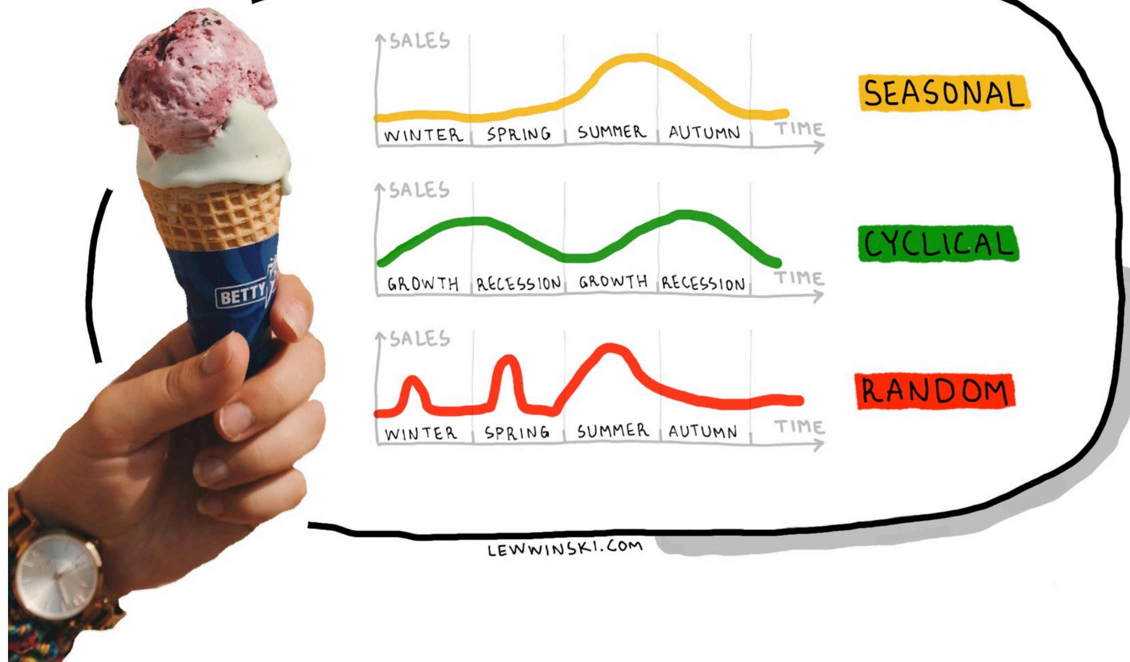
***Time series** is simply a sequence of data (in our case, sales) recorded at regular intervals. And **time series analysis** refers to identifying the fluctuations and patterns in the past data and the reasons for them. Again, this is done in order to improve sales forecasting. Simply speaking, by analysing past data, managers are trying to find patterns and reasons for these patterns that will help them to predict future sales more accurately.*

***Seasonal fluctuation**s are based on (surprise-surprise!) the seasons of the year. For example, ice cream consumption and its sales is higher in the summer and lower in winter. Or sales of warm coats are higher in winter.*

***Cyclical fluctuations** are based on the stages of the **business cycle** — a series of economic expansion and contraction (see Figure 3 below). For example, people usually spend less money during economic recession and more money during economic growth.*




*And lastly, **random fluctuations** are unpredictable and not based on anything and do not fall under regular seasonal or economic trends. For example, if people start buying eggnog (Christmas beverage) in August, that would be a random fluctuation.*




*On the one hand, sales forecasting assists marketing planning: with an accurate sales forecast, managers are able to adjust the marketing mix according to the projected demand. From the financial perspective, sales forecasting helps to maintain liquidity: businesses need*

*more cash when demand is high in order to be able to produce more goods in response to demand fluctuations.*

*On the other hand, sales forecasting is a technique that works under the assumption that the future is based on the past, which might not actually be true all the time… Besides, even though it is data-based, it still is just a prediction that may never come true due to unforeseen changes. Additionally, sales forecasting requires thorough work of managers and data analysts which is time-consuming and costly.*

***Market research** is the process of gathering and analysing information about the market and customers' needs and wants in order to determine the marketing strategy. Key words in this definition are information, needs, wants, strategy.*

*In terms of time and regularity, market research can be either systematic (continuous, regular) or **ad hoc** (only when necessary, irregular). Market research is definitely not something organisations do only once at the start-up stage*

*So, why do organisations carry out market research? There may be plenty of reasons for that and, of course, these reasons are different for different organisations, but let's try to average them out and summarise. Some of the most common reasons are:*

*1. It reduces risk. If an organisation knows its customers well or understands its relative position in the industry, it is more prepared to satisfy customers' needs and wants in the most cost-effective way and there is no need to exercise the "trial and error" method, wasting time and finance on unnecessary actions.*

*2. It provides up-to-date data. As I mentioned earlier, markets are not static and external environment is constantly changing, so market research data gets outdated really quickly, that is why it is important to conduct market research regularly in order to "keep the hand on the market's pulse".*

*3. Market research assists in setting goals, objectives, strategies and tactics. In order to avoid the situation when decisions are made based on the manager's gut feeling, market research helps to make informed data-based decisions.*

*4. For market-oriented businesses, market research helps to identify customers' needs and wants and help businesses to meet them by providing the desired products. For product-oriented businesses, it helps to identify the "empty" market niche and offer unique innovative products or to collect data with regards to how customers perceive their innovative products.*

*5. Market research assists (and is part of) marketing planning. It helps managers to plan and to set marketing goals, objectives, strategies and tactics.*

*6. Market research helps to forecast sales by collecting quantitative and qualitative data about customers, market and competitors.*

*7. Market research helps to make the most important marketing decisions and apply the marketing mix to its products: 4Ps (product, price, promotion, place) for goods and 7Ps (4Ps + people, processes, physical evidence) for services.*

***Primary research*** *means gathering new first-hand data. Sometimes it is called "field research". Primary research involves collection of information that does not exist yet. An example of primary research can be a survey among local people about their favourite pizza restaurant in town.*

*On the one hand, primary research allows to collect up-to-date information that is in line with the organisation's needs. If you use data that is already collected by someone else, then you have to keep in mind that someone else collected that data for their own needs and it might not align with yours. But when you collect data yourself, then you are free to do it however you want.*

*However, primary research is expensive and time-consuming. The price that organisation has to pay for all the advantages of primary research is investment into time, people and design of the research.*

***Survey*** *is a type of primary research when respondents are asked to fill in the document that contains a set of questions. This method is suitable for collecting "quick" data about customers' perceptions and purchasing habits*

***Interview*** *is a face-to-face meeting with the aim of collecting information. Interviews can be* ***structured*** *(there is a fixed set of questions that interviewers go through with all respondents),* ***semi-structured*** *(interviewers go through a fixed set of questions with all respondents but may ask for extra information if needed), and* ***unstructured*** *(interviewers just have an understanding about what they want to find out but they approach different respondents differently).*

***Focus group*** *is a small gathering of 6~10 people that is assembled to participate in a discussion about brand/product. Focus groups are suitable for gaining insights into customers' preferences, purchasing habits, consuming behaviour. Focus group is not like an interview, there is no back-and-forth Q&A, it is more like a natural conversation, and participants of focus groups are thus more relaxed and more inclined to share their real beliefs and ideas.*

***Observation*** *is a process of monitoring something or someone. It may be controlled (in laboratory conditions) or real-life (not in a lab, in a natural environment). This method is suitable for observing behaviour and identifying patterns, for example, queueing times, shelf space, traffic and peak hours.*

***Secondary research*** *means gathering existing second-hand data. Sometimes it is called "desk research". Secondary research involves collection of information that already exists and data that was collected by someone else.*

*On the one hand, secondary research saves a lot of time, it is already available and access to information is relatively quick, compared to primary research. However, secondary research uses information that is usually available to everyone else, so it does not give managers advantage over their rivals*

***Market analysis** is a publication/report about particular markets. Market analyses usually include information about market shares, market growth, market leadership, trends and forecasts.*

***Academic journal** is a periodical peer-reviewed publication from educational institutions. Academic journals include theoretical information about different business tools, techniques and theories that are used for analysing data.*

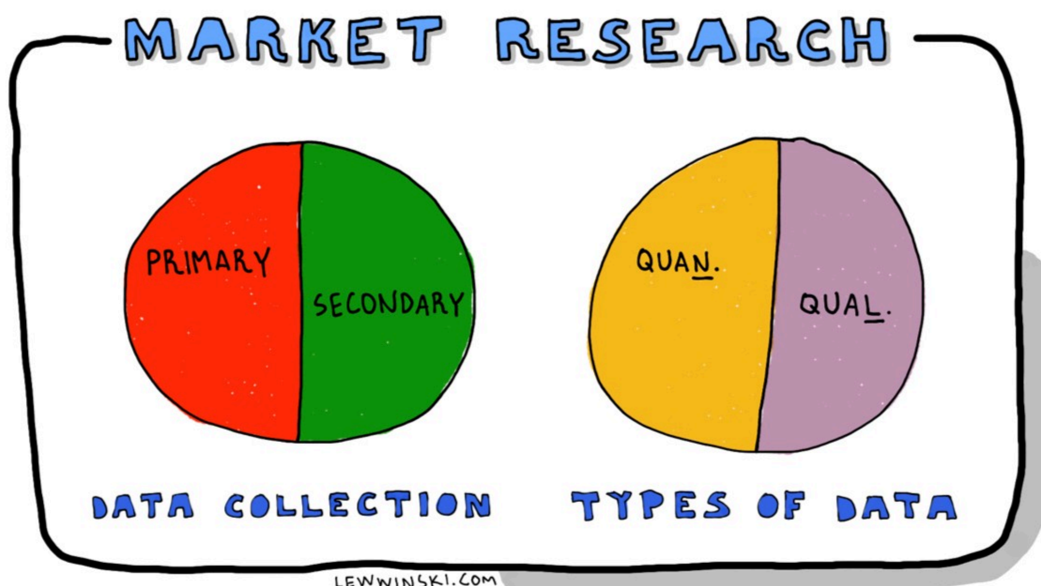
***Government publication** is an official document provided by the government. For example, publications about unemployment rates, demographics, life expectancy and economic growth — all of these are usually provided by different government agencies/offices in most countries.*

***Media article** is a text that is published in a newspaper or a magazine. The examples of business-related magazines and newspapers are The Economist and McKinsey Quarterly. Media articles are suitable for collecting information about opinions, analytics and different perspectives on business issues.*

***Online content** is anything that is posted online: videos, blogs, pictures, reviews. It is suitable for gathering direct feedback from customers.*

***Quantitative research** refers to collecting measurable numerical data (**"hard" data**), for example: market share, market growth rate, customer numbers, average cheque, sales, etc. Primary market research methods that are usually quantitative are survey and observation. Since hard data is numerical and is not open to multiple interpretations, it is considered to be objective.*

***Qualitative research** refers to collecting non-numerical data that is hard to measure (**"soft" data**), for example: opinions, reasons for behaviour, preferences, attitudes, approaches. Primary market research methods that are usually qualitative are focus group and interview. Since soft data is qualitative (non-numerical) and is open to multiple interpretations, it is considered to be subjective.*



*Primary market research includes two kinds of people: researchers and respondents. Respondents are usually customers/consumers/users. Most of the time, it is impossible to have all potential customers/consumers/users (population) as respondents, so only a portion (sample) of them is selected. Now let's wrap it up with some terminology:*

- ***Population** — all potential respondents (customers, consumers, users).*
- ***Sample** — a small representative part of the population.*
- ***Sampling** — the process of selecting the respondents that represent the population using sampling methods.*

***Quota sampling** is a sampling method whereby population is divided into representative groups and a fixed number of respondents (quota) in each group is then involved in research. In quota sampling, population is usually divided by gender, age, lifestyle, or other characteristics relevant to the business/product.*

***Random sampling** is a sampling method whereby all members of the population have equal chances to be selected as respondents. It works well for mass markets where products are basically for everyone and there is no need to divide the population into groups with similar characteristics.*

***Convenience sampling** is a sampling method whereby the researcher selects respondents that he/she has the most convenient access to. For example, if Ivan runs a fruit shop in the neighbourhood, he might just interview/survey some of his regular customers. This sampling method works well for smaller businesses that have a small population.*

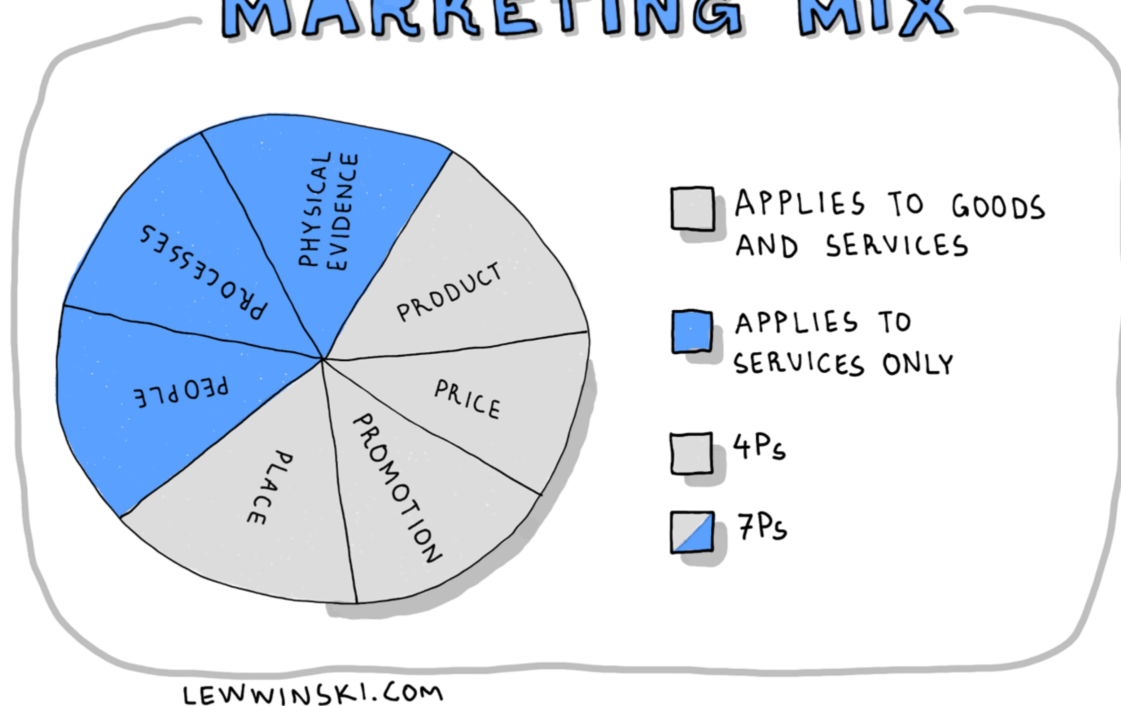
***Marketing mix** is a set of decisions to be made in product marketing. Products are either goods (if they are tangible) or services (if they are intangible). Different marketing mixes apply to the two types of products.*

*For goods, there are 4 decisions to be made:*

- *Product*
- *Price*
- *Promotion*
- *Place (Distribution)*

*For services, in addition to the 4 decisions above, there are three more decision to make:*

- *Processes*
- *Physical evidence*
- *People*




***product** is what organisations offer for sale. It can either be tangible or intangible. Tangible products are called **goods** and intangible products are called **services**. In addition to tangibility, products can be divided based on who they are sold to. If they are sold to the general public, to "normal people", as students often say, then they are **consumer products**. In other words, they are **B2C** — business to consumer. If products are sold from business to another business, then they are **producer products**, or **B2B**.*

***FMCGs** — fast-moving consumer goods. These are the goods that do not expire quickly but wear-off quickly and thus are purchased often. For example, toilet paper, tooth brush, toothpick, etc. All these products can be stored for centuries, but since people use them often, they make repeat purchases of FMCGs often too. This explains the "fast-moving" bit of the concept.*

***Perishables** — goods that expire/decay quickly. For example, food.*

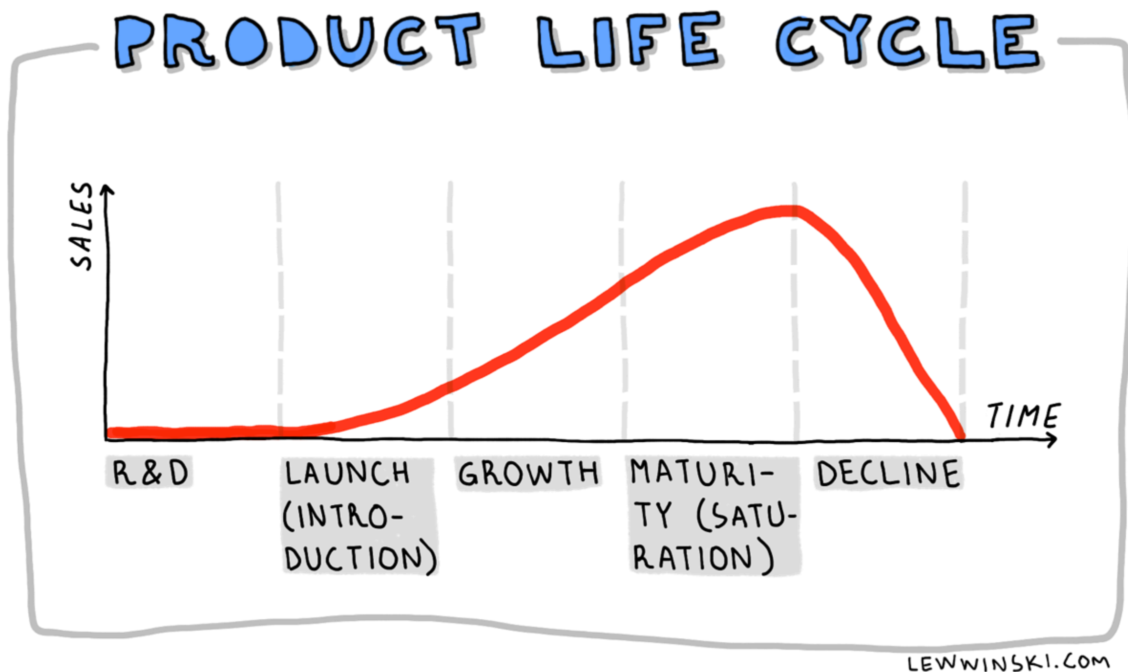
***Durables** — goods that have a long lifespan: washing machine, car, laptop, smartphone.*

***Speciality goods** — goods with unique characteristics that are usually distributed through limited distribution channels only. For example, designer clothes.*

***Product life cycle** is the succession of stages that a product goes through from launch to decline. The two variables of the product life cycle are time and sales. The stages that the product goes through are:*

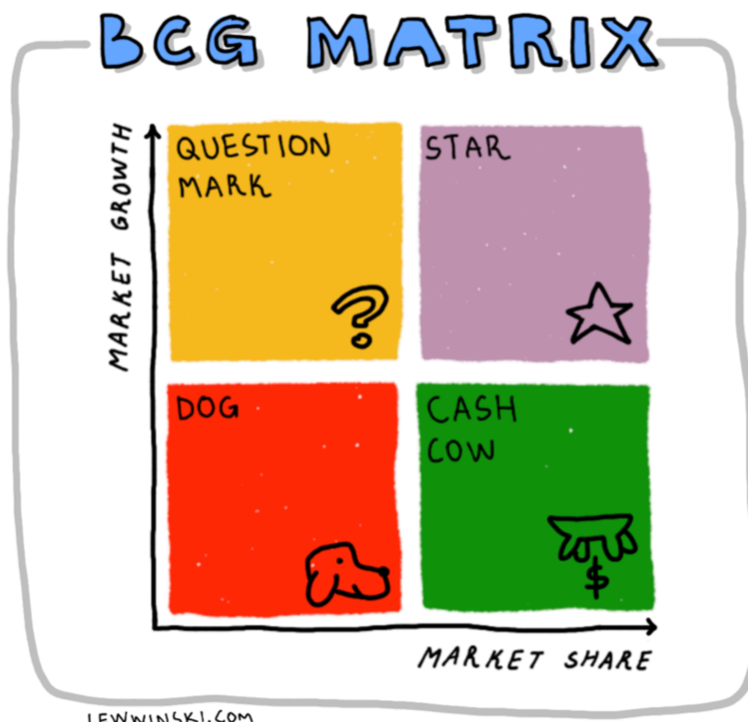
- *Research and development (R&D)*
- *Launch/Introduction*
- *Growth*

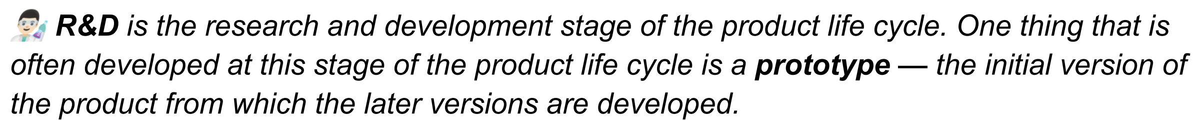
- *Maturity/Saturation*
- *Decline*




***Product portfolio** is all the products provided by an organisation. For example, Apple's product portfolio is iPhone, iPad, MacBook, Apple Watch, Apple TV and all other products that they offer… **Product portfolio analysis** refers to evaluation of all the products provided by an organisation.*

***BCG matrix** is a product portfolio analysis tool that examines the products in terms of market share and market growth. Once you know your product portfolio and you have data about your market share and market growth, you will be able to put all the products you offer into 4 categories using BCG matrix from the picture below.*

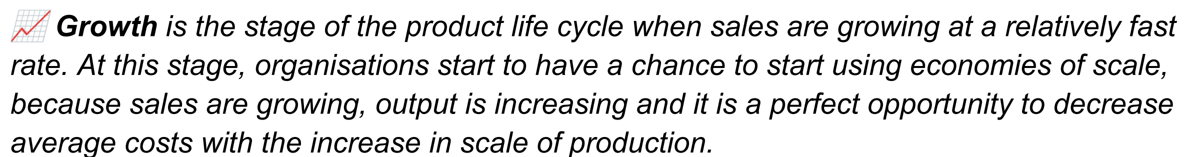




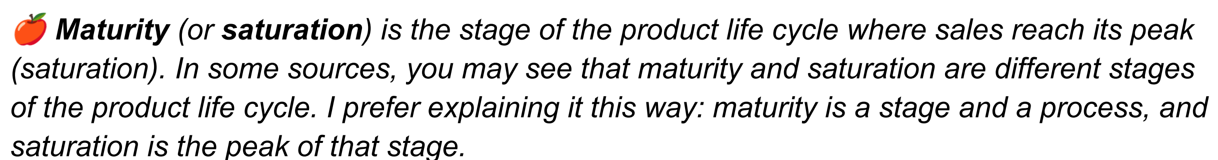
👨🏻‍🔬 ***R&D*** *is the research and development stage of the product life cycle. One thing that is often developed at this stage of the product life cycle is a* ***prototype*** *— the initial version of the product from which the later versions are developed.*

*At this stage, there is high reliance on investment, because R&D requires heavy investment... At the same time, there are no profits and there are only cash outflows… Thus, marketing managers try to move on to the next stage as soon as possible, in order to generate profits to cover all the R&D costs.*

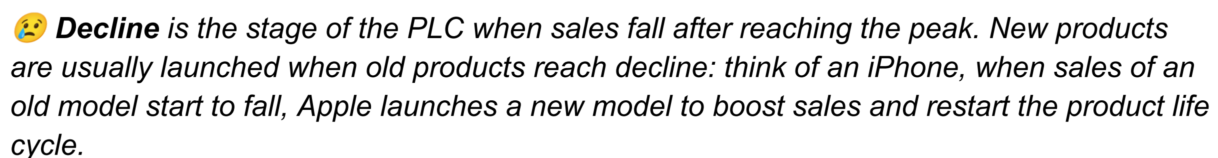
🚀 ***Introduction*** *(or* ***launch****) is the stage of the PLC when the product becomes available for purchasing for the first time.*



📈 ***Growth*** *is the stage of the product life cycle when sales are growing at a relatively fast rate. At this stage, organisations start to have a chance to start using economies of scale, because sales are growing, output is increasing and it is a perfect opportunity to decrease average costs with the increase in scale of production.*



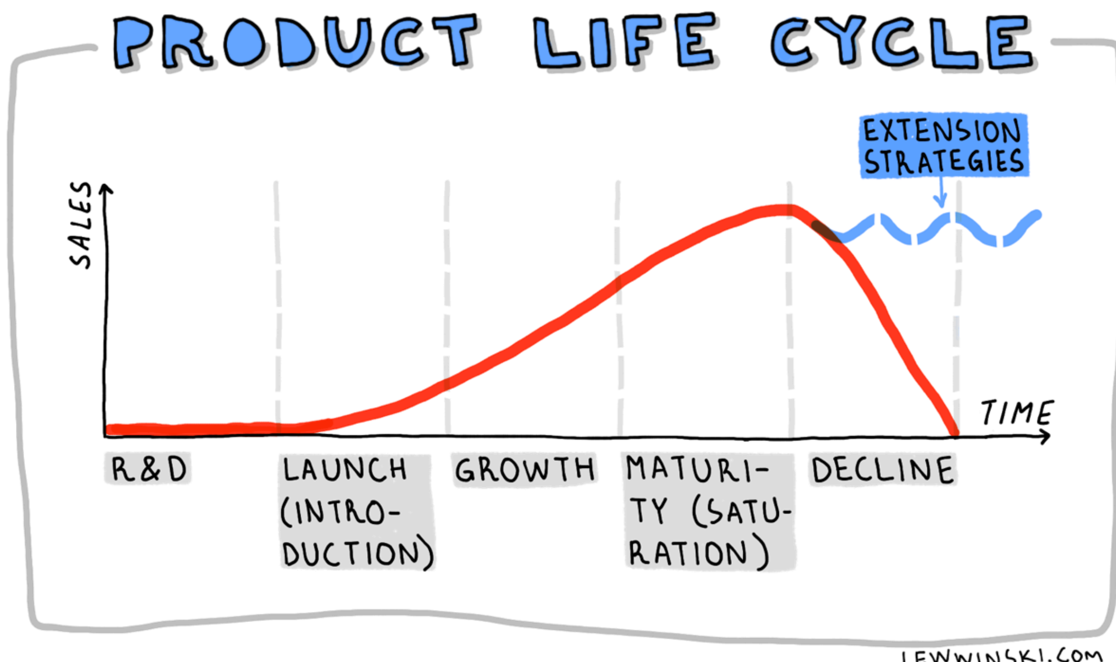
🍎 ***Maturity*** *(or* ***saturation****) is the stage of the product life cycle where sales reach its peak (saturation). In some sources, you may see that maturity and saturation are different stages of the product life cycle. I prefer explaining it this way: maturity is a stage and a process, and saturation is the peak of that stage.*

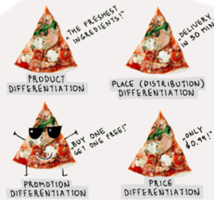


😢 ***Decline*** *is the stage of the PLC when sales fall after reaching the peak. New products are usually launched when old products reach decline: think of an iPhone, when sales of an old model start to fall, Apple launches a new model to boost sales and restart the product life cycle.*

*Cash cow product turns into a dog at a decline stage, because both market share and market growth are falling. Price decreases in order to get rid of stocks as soon as possible. Promotion is minimal because there is no point in increasing awareness or reminding about the product anymore.*

***Extension strategies*** *refer to organisation's action plan to avoid decline and prolong maturity stage of the product life cycle. If we put extension strategies onto a product life cycle chart, it'll look like this:*






***Market development*** *is one of the strategies from Ansoff matrix — a business tool from BM Toolkit. It refers to selling existing products in new markets. For example, Google often sells its products in the US market only (Pixel smartphone, Pixelbook, Google Nest, Pixelpass, etc.), and if the sales are successful, they start offering their products in new markets in order to prolong the product life cycle of their products.*

***Redesigning*** *is an extension strategy that refers to modifications of existing products. You probably heard of "limited edition" of different products, so the purpose of them is actually to prolong sales of an old product. For example, Volvo, unlike most car manufacturers, does not update its product portfolio for a quite a long time.*

***Targeting new segments*** *is an extension strategy that is similar to market development. The difference is that market development often refers to new geographic locations, while new market segments often refers to the same location but new kind of people (with different lifestyles, or different ages, or different occupations).*

***Price reductions*** *refer to an extension strategy when price cuts encourage higher purchases. Seasonal sales of clothes are an example of this strategy.*

***Repackaging*** *refers to changing the package of a product without changing the product itself. Think about Coca-Cola, again. They change their bottles every once in a while and it seems to be a successful strategy: even though customers know the taste of Coke, they might be willing to buy Coke just because the bottle looks "cool" and they've never drank Coke in that bottle before.*

***Differentiation** is an extension strategy that refers to using the unique selling point (USP) in such a way that customers perceive the product or organisation as unique and different from those that are offered by competitors.*

***Brand** is a combination of name, symbol and other characteristics that is associated with a certain business/product. **Branding** is the process of attributing a set of characteristics to a business/product that adds value and differentiates it among competitors.*

😍 ***Brand awareness** is the extent to which people are able to recognise a brand. The most well-recognised brand is Coca-Cola. It is recognised by 94% of people! Brand awareness is very important at the launch stage of the product life cycle because the higher it is, the faster the product can reach the growth and maturity stage.*

👷 ***Brand development** is a strategy that aims at strengthening the brand and improving its awareness. Some examples of brand development are: sponsoring events or sports teams to support causes that align with core values.*

🐶 ***Brand loyalty** is customers' dedication to make repeat purchases of the same brand. It is usually improved via word-of-mouth (**WOM** — person-to-person oral communication) and **brand ambassadors** — celebrities who are using the brand in public appearances. When people hear good stories/reviews about certain products/brands, they are more likely to purchase them more often.*

💰***Brand value** is a premium that customers are willing to pay above the actual value of the product. If a new unknown company creates a smartphone that is as good as iPhone, they will still not be able to change prices as high as Apple's just because their brand is completely unknown and does not have much value.*

***Price** is the amount of money required/given in payment for something. When it comes to marketing mix, it refers to the decision about the appropriate pricing strategy. Standard Level students are expected to be able to discuss five pricing strategies, and Higher Level students — eight (plus price elasticity of demand). All the pricing strategies in IB BM syllabus are:*

1. *Cost-plus pricing*
2. *Penetration pricing*
3. *Loss leader pricing*
4. *Predatory pricing*
5. *Premium pricing*
6. *Dynamic pricing (HL)*
7. *Competitive pricing (HL)*
8. *Contribution pricing (HL)*

***Cost-plus pricing** is a pricing strategy whereby managers add a markup to cost in order to determine the price. **Markup** is a percentage that is added to direct costs of a product. It is not the same as profit margin!*

***Penetration pricing*** *refers to setting a low price in order to penetrate the market and attract more customers. This strategy is usually used either by new businesses or by existing businesses that offer new products.*

***Loss leader pricing*** *refers to selling some products at a loss in order to attract more customers to buy other products. This strategy is often used by supermarkets. For example, they might offer apples or toilet paper (or any other thing they sell) at a price that is lower than the costs!*

***Predatory pricing*** *is a temporary measure to squeeze competitors out of the market by offering lower prices. If several competitors try to use predatory pricing against each other, it turns into a* ***price war****.*

***Premium pricing*** *means setting a high price for premium high-quality products (designer clothes, supercars, luxury watches). Premium pricing creates a brand image of something scarce, unique, special, expensive, not affordable by most people.*

***Dynamic pricing*** *refers to a strategy whereby prices change depending on the circumstances (time, demand, supply, etc.).*

*In* ***competitive pricing*** *strategy, price is determined based on competitors' prices. This pricing decision is market-oriented and relies on a thorough market research.*

***Contribution pricing*** *is when contribution is the main determining factor in a pricing decision. Contribution equals to selling price (P) minus average variable costs (AVC): Contribution per unit = P – AVC. Knowing total contribution and fixed costs, firms are able to set prices that allow to make profits and cover all costs.*

***price elasticity of demand (PED)*** *refers to the extent to which demand is affected by price changes. It is calculated by dividing the percentage (%) of change (Δ) in quantity (Q) demanded (D) by percentage (%) of change (Δ) in price (P):*

$PED = \%\Delta QD \div \%\Delta P$

*Based on the results of this simple calculation, price elasticity can be:*

- ***Inelastic****: if it's between 0 and 1. It means that change in price doesn't affect demand much.*
- ***Unit elastic****: 1. It means percentage of price change equals to percentage of demand change.*
- ***Elastic****: more than 1. It means that small change in price affects demand greatly.*

***Promotion*** *means communicating messages about the product and/or brand to customers. Promotion usually serves one or several of the following objectives: to inform, to persuade, to remind. There are three aspects of promotion: above-the-line (ATL), below-the-line (BTL) and through-the-line (TTL).*

***ATL*** *refers to promotion through mass media, that is non-targeted. For example, a TV commercial on a national TV station is an example of ATL promotion. It is pretty much for*

*everyone and the main goal of ATL promotion is to increase awareness about a product and/or a brand.*

***BTL** refers to direct, targeted promotion, not using mass media. For example, sales promotion that is displayed in the shop window is an example of BTL promotion. It targets only a specific group of customers and the main goal of BTL promotion is to secure sales.*

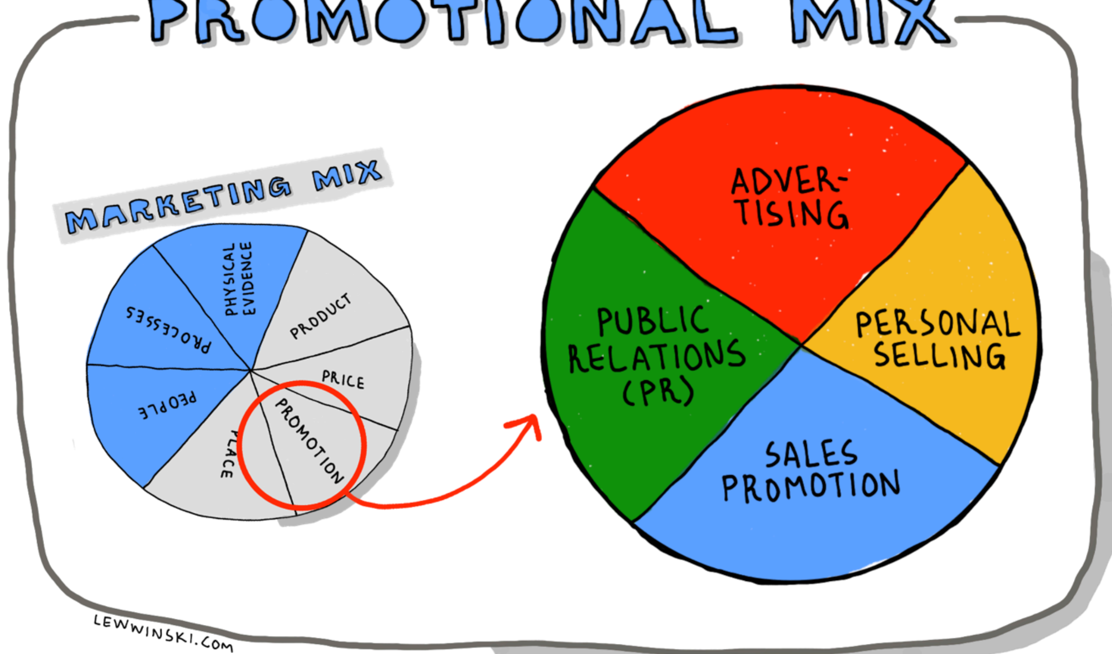
ASPECTS OF PROMOTION

| ATL | BTL |
|---|---|
| MASS MEDIA | NON-MASS MEDIA |
| NON-TARGETED | TARGETED |
| INCREASES AWARENESS | SECURES SALES |
| REACHES WIDE AUDIENCE | REACHES A SMALLER AUDIENCE |
| EXPENSIVE | RELATIVELY CHEAP |

LEWWINSKI.COM

*ATL and BTL are quite outdated concepts that were coined in 1950s. However, they are still widely used and it is a good idea to know what they mean. Nowadays, promotion often includes elements of ATL and BTL at the same time.*

*Nowadays, promotion often includes elements of ATL and BTL at the same time. For example, when a nation-wide TV commercial is supported by in-store sales promotions. This kind of promotion, that includes elements of both ATL and BTL, is called through-the-line promotion (**TTL**).*



*The purpose of **informative advertising** is to tell the customers about the features of the product. It usually appeals to people's logic. Some examples of informative advertising techniques are:*

- ***comparative advertising** (when advertising includes comparison of product features with those of competitors' products),*
- ***numerical factor** (when advertising is providing a lot of numerical data about the product features).*

*The purpose of **persuasive advertising** is to convince the customers to buy the product. This kind of advertising usually appeals to emotion. Some examples of persuasive advertising:*

- ***bargain appeals** (when customers are encouraged to buy more in exchange for a certain benefit, such as a discount that only works until the end of the day),*
- ***celebrity endorsement** (when a celebrity is featuring an ad or commercial),*
- ***feel good factor** (when advertising includes images of happy people that use the advertised product),*
- *guarantees (when advertisement is promising certain conditions to buyers),*
- *sex appeal (when advertisement includes sexy images),*
- *slogans and jingles (mottos and short music pieces that reinforce brand image),*
- *three yes technique (when advertisement asks questions that customers can potentially say "yes" to three times in order to achieve higher engagement levels).*

*The next form of promotion (or element of the promotional mix) is **personal selling**. It means person-to-person sales/purchasing experience. Basically, it refers to what happens exactly at the time of purchase and how exactly sale is made. For instance, sales managers in car dealerships, in-store shop assistants, telephone or videoconference sales are all examples of personal selling.(Subeesh moment)*

*The next form element of promotional mix is **public relations (PR)**. It refers to professional maintenance of a favourable public image that includes promotional activities that are aimed at increasing the brand value, (re)positioning a brand/product, enhancing a brand image.*

*An interesting example of "there is no such thing as negative publicity" attitude is McDonald's that changed its name in China. It used to be called "mai-dang-lao", which doesn't really mean anything but sounds like "McDonald's" in English. Now it is called "jin-gong-men", which means "golden arch".*

*The last form of promotion (or element of promotional mix) is **sales promotion**. It means short-term measures that are conducted in order to increase sales. For example, **BOGOF** (buy one get one free), coupons & vouchers, free samples, competitions, "free" gifts, loyalty schemes, discounts, prizes, etc.*

***SMM** refers the use of social media platforms (Instagram, WeChat, YouTube, Twitter, etc.) to promote a product and/or brand. The advantages of SMM are:*

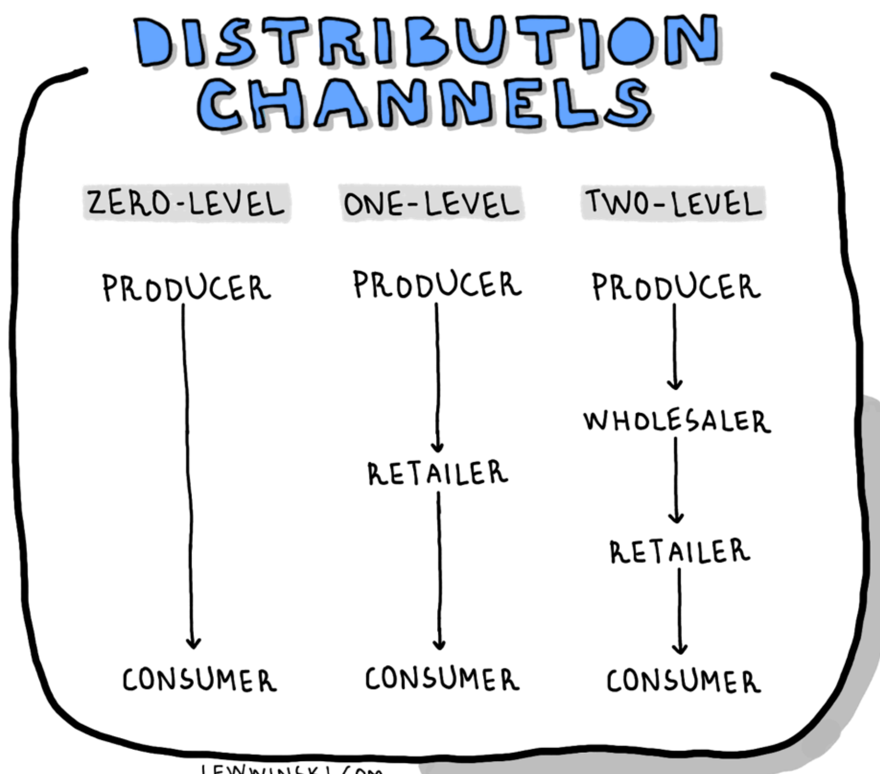
- *Clear KPIs and metrics. For ATL, it is impossible to know how many people purchased a product right after they saw an ad, but with SMM it’s really easy to do as long as customers click the link and make a purchase.*
- *Direct response. Again, unlike traditional promotional methods, the time between promotional activity and potential purchase is minimal: customers can click and buy only a few seconds after they see an ad.*
- *Cost-efficiency. SMM is relatively inexpensive (compared to ATL) and it is easy to measure its success. Thus, for minimal budgets, organisations may get fruitful outcomes.*
- *Improved brand awareness and new segments. Young people, the so-called Gen Z do not really watch TV and are very critical about traditional ATL methods, so SMM helps to target those market segments that are not responsive to ATL.*

***Place** (distribution) refers to the decision with regards to how products reach the end consumer or user through different **distribution channels** (chain of people and organisations that a product goes through on its way from producer to end consumer). This decision is about delivering the right product to the right consumer at the right place at the right time.*

***Zero-level** is a type of distribution channel that has zero intermediaries. Products are sold to consumers directly from the producer. Some examples of this type of distribution are: e-commerce, mail order catalogues, booking a room directly in a hotel. In all cases, consumer deals directly with the manufacturer/provider.*

***One-level** is a type of distribution channel with one intermediary. Premium goods and goods in high quantities are usually sold this way. Premium goods, such as designer clothes, have to be sold in premium stores to maintain a brain image. In addition, premium goods producers have to control distribution and make sure it's up to the highest standard.*

***Two-level** is a kind of distribution channel with two intermediaries. It works well when producer is far from consumer (thus there is a need to have many intermediaries in between) or for really large quantities of goods (thus there is a need to break the bulk twice).*



***People** is the element (decision) of the marketing mix for services that is concerned with employee-customer relationships. Employee-customer relationships refer to all the interactions and communication between people who provide a service and people who purchase it.*

***Cultural gap** means cultural differences that prevent mutual understanding. If, due to cultural differences, employees are not able to communicate well with the customers, then customers might not enjoy their purchasing experience and it will result in brand switching or decreased brand value for the seller.*

***Processes** refers to the element (decision) of the marketing mix for services that is concerned with the purchasing experience. Simply speaking, processes are about how exactly purchase/sale is made and/or product is delivered. Some examples of processes are delivery, customer service, payment methods, waiting times, queueing times, etc.*

***Physical evidence** refers to the tangible aspects of a service. It allows consumers to evaluate and predict the quality of provided services. For example, the star rating system for hotels is basically an indicator of physical evidence in the hotels measured by certain standards and expressed as a number of stars (from 1 to 5).*

***International marketing** refers to marketing across the borders. There are many ways how to enter international markets and operate in them. Some of the ways that we will learn in this class are exports, e-commerce, external growth and foreign direct investment (FDI).*

***Exports** refer to sending products to another country for sale. It means that something is produced in country A and sold in country B. For example, Saudi Arabia is the largest oil exporter. One of the opportunities that exports provide is not having to rely on foreign partners too much*

***E-commerce** means buying and selling products online. Some if the e-commerce platforms in different countries are Taobao (China), Shopee (Southeast Asia), Wildberries (Russia), Amazon (USA)*

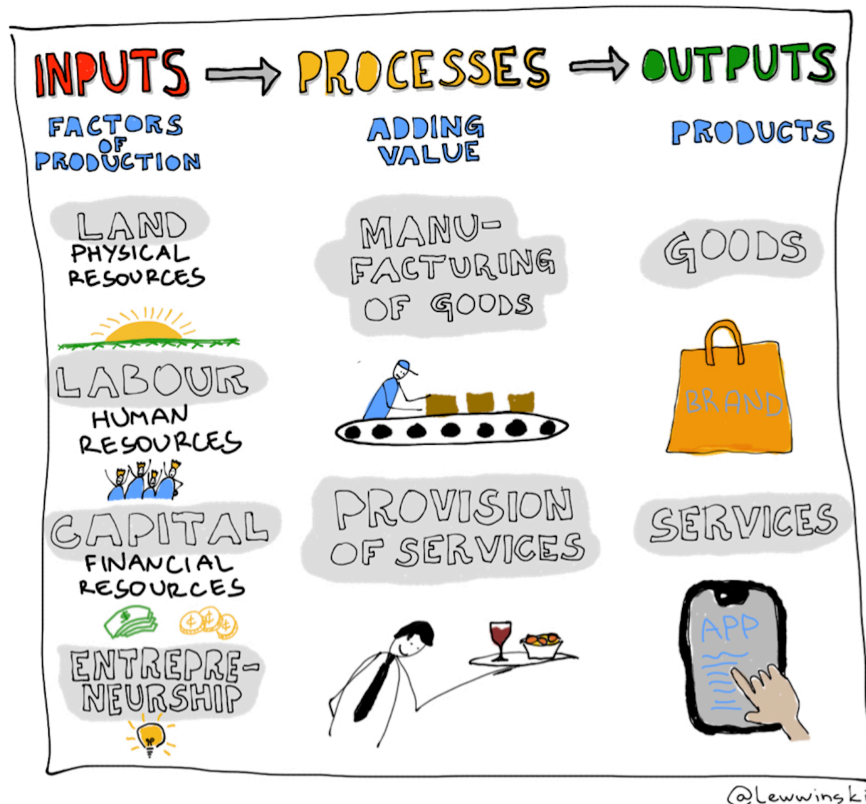
***External growth** is something that we have already learnt in Unit 1. External growth methods that we learn in class 1.5 are mergers and acquisitions (M&As), joint ventures, strategic alliances, and franchising. Please check out that class if you have no idea what these things are.*

***Foreign direct investment (FDI)** is purchase of an asset (e.g. factory) in another country. The top recipients of FDI over the past several years have been the US and China (no surprise here, haha)*

***Operations management***

***Operations management** is an area of management that refers to developing, managing and improving the production process. Operations management is also one of the four business functions, so it means that all business have it, be it a sole trader or a huge MNC. Even if we are talking about a sole trader who single-handedly runs a business, one of their functions is operations management: they think about how exactly they provide their product*

*to customers and they are trying to do it in the best possible way and improve it in order to achieve their objectives more efficiently.*



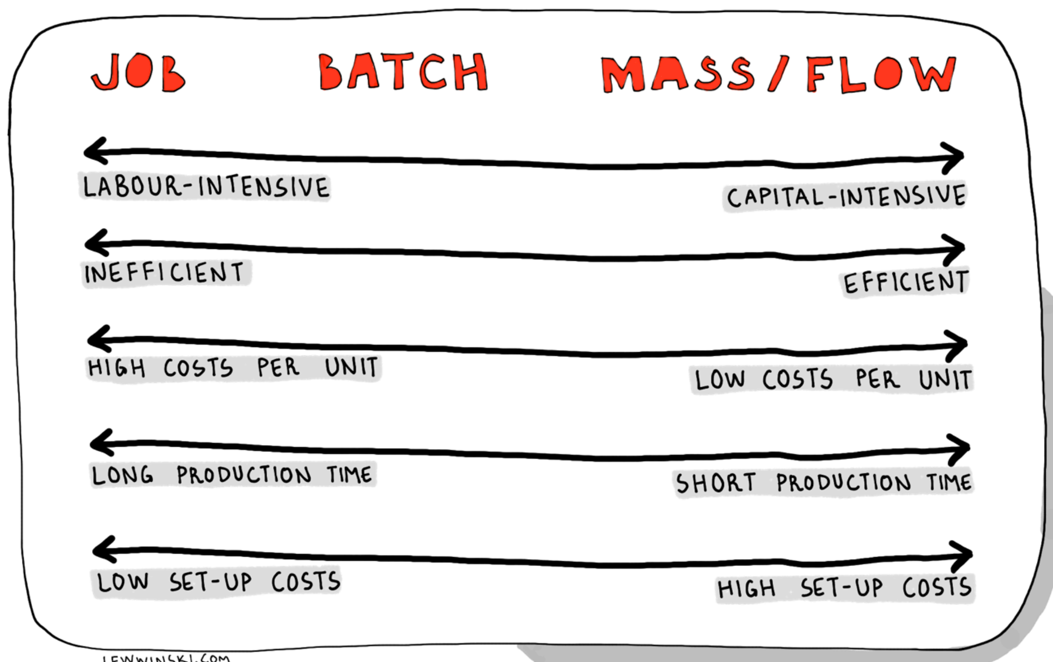

***Job production** is manufacturing of a one-off item, i.e. something that is one of a kind. For example, [Batmobile](), wedding cake, navy battleship or a spaceship. Even though there may be several identical items of the products in the examples I provided, they will be manufactured on a one-off basis.Speaking of the advantages of job production, I believe that, most importantly, it is flexible and completely in line with customer's needs and wants. Since the product is produced from scratch, there is an opportunity to customise it just the way customer wants, which makes the products so unique (think again about the examples I provided).On the other hand, of all production methods, job production is the most inefficient. Imagine an exclusive shoemaker who makes the shoe from start to end: there is no automation, there is no flow, there is no division of labour, there is just one person making a shoe little by little every day.*

***Batch production** is an operations method whereby a group (batch) of identical products is manufactured. Batch production is common for bakeries (different kinds of bread are made in batches in one and the same oven), pharmaceutical industry (different kinds of pills are produced using the same equipment) and breweries (different kinds of beer are brewed on the same equipment).Batch production is more efficient than job production because it allows to produce a group of products at the same time. Despite that, batch production allows for customisation, because different batches of products can be different.However, despite the ability to customise products, customisation applies to the entire batch only. Unlike job production, batch production doesn't allow to customise every single item.*

*Additionally, since batch production is more high-scale that job production, it requires higher stock levels of components and raw materials.*

***Mass** (or **flow**) **production** is large-scale manufacturing on a production line whereby a product is built up on every stage.On the one hand, mass/flow production method is the most efficient of all. That is because, compared to other production methods, there is no need to hire qualified workforce: the tasks that employees perform on the mass production line are very simple and monotonous: packing, sorting, wrapping, etc. However, this production method is the least customisable of all: the production line is usually set up once for a specific kind of product and it would take a lot of time and money to reset the production line for a different type of product. All the items produced are identical and there is no room for customisation at all*

***Mass customisation** is a type of mass/flow production that is flexible and allows for customisation of the final output. It is a relatively new thing and there is no one way to explain how to customise mass-produced goods but what we might say for sure is that it heavily relies on design and technology.On the one hand, benefits of mass customisation are the same as those of mass production. But there is one huge special advantage: customisation and flexibility. So, with mass customisation, organisations are still able to produce high volumes of output non-stop, but there is also a chance to customise the output.On the other hand, there is high reliance on technology in mass customisation, which means that customisable production process and technology are hard to design and require significant investment. Thus, mass customisation is time-consuming and costly to design and implement.*



***Lean production** is an approach to manufacturing that aims at reducing the waste and improving efficiency. So the two most important features of lean production, as the definition suggests, are (i) less waste and (ii) greater efficiency. Let's see what those two things mean.*

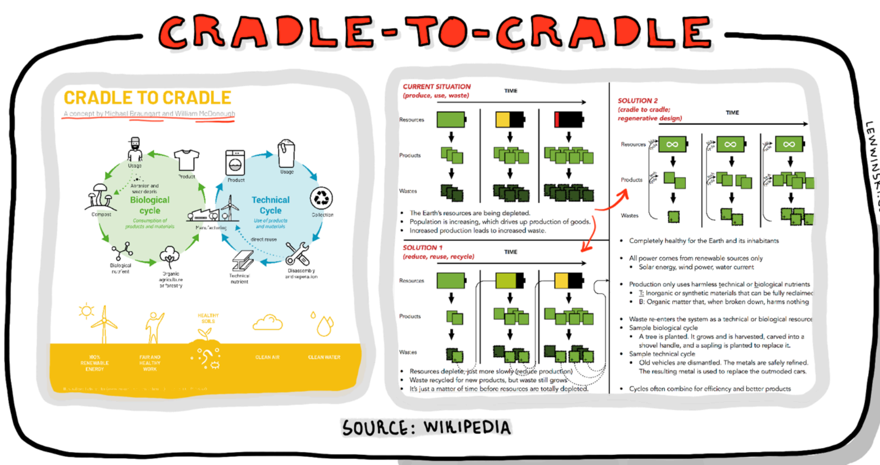
***Waste**, with regards to lean production, means inefficiency. It does not only mean physical waste/garbage, it goes way beyond that and includes raw materials, components, labour, productivity, time, space, energy, etc. So, an inefficient use of any of the things I mentioned in a previous sentence is called waste.*

***Efficiency**, with regards to lean production, means waste minimisation. You can see examples of waste in the paragraph above and you can see the ways/methods to improve efficiency in the paragraphs below.*

***Kaizen (continuous improvement)** is a method of lean production whereby small improvements are made regularly as opposed to random one-off improvements. For example, when employees suggest what can be done to improve their working station once a week (e.g. put the tools into a more convenient position or rearrange some tools to save time), that is kaizen. Kaizen is a Japanese word for continuous improvement and it was developed in Toyota. Kaizen only works when it is down-to-top in the organisational hierarchy: if the managers enforce some changes on employees, it is not kaizen; if employees suggest changes themselves, it is kaizen. One more feature of kaizen is focus on the production process, not output.*

***Just-in-time (JIT)** is a method of lean production whereby inventory (stocks of raw materials and components) is delivered only as needed, as opposed to having buffer stocks. For example, let's say, you manufacture desks and you know you need 5 pieces of wood and 10 metallic fixtures per desk. One thing you might do is order 100 pieces of wood and 200 fixtures from your suppliers, keep them in stock and use them when you have orders from customers. JIT, same as kaizen, originates in Toyota, Japan. It is the opposite of JIC (just-in-case) system of stock management that uses a buffer stock and stores materials/components for future use. Additionally, JIT only works with developed infrastructure and reliable suppliers. If delivery times are too long or suppliers do not keep their promises, JIT is impossible to implement.*

***Cradle-to-cradle (C2C)** is a sustainable approach to design and manufacturing whereby products can be recycled/reused after their lifespan. The opposite of C2C is "cradle-to-grave", which is a more traditional approach that is used by a vast majority of organisations nowadays, whereby the products turn into some sort of non-recyclable trash in the end of their lifespan. However, C2C means that waste (if any) is treated as a resource, that products after use can have a second life.*



*On the one hand, the main benefit of C2C is that it is ecologically sustainable. The whole point of it is to eliminate physical waste completely. It shifts the paradigm of traditional approaches and it encourages organisations to design and manufacture their products in such a way that there is no waste. However, it is easy to talk about it and understand what C2C is, but it is hard to implement in reality because it is not yet economically sustainable.*

***Quality*** *is the measurement of how the product fits its purpose and meets customer expectations. Quality is something that is subjective and multi-dimensional. "Subjective" means that different people might have different understanding of what high quality is and what low quality is.*

*"Multi-dimensional" means that quality has several aspects and judgements about quality usually include a variety of factors: product price, size, appearance, etc.*

***Quality management*** *is the process of ensuring that the product functions well. There are several components of quality management, but the two that are included in IB Business Management course are quality control and quality assurance.*

***Quality control*** *refers to making sure quality is maintained by testing a sample of the final output. In a few words, the way it works is: employees do their jobs, manufacture goods, and then, at the end, the produced goods (all or a sample from each batch) are tested by quality inspectors whose main job is to look for defects in order to make sure that faulty output does not get to the end customers.*

*The benefits of quality control are that faulty output is less likely to reach the customer and there is no need to develop kaizen culture (see the previous part of class) that takes some time and effort. All that's needed is to hire someone to check the final output and to make sure goods with defects are eliminated from sale. On the other hand, with quality control, employees are not motivated to maintain high quality because of the assumption that mistakes are always made anyway, so whatever they do will be wrong to a certain extent anyway*

***Quality assurance*** *refers to making sure quality is maintained by putting employees in charge of their output at every stage of production. Simply speaking, employees are their own quality inspectors.*

*On the one hand, quality assurance is motivating for employees because they are in charge of their work and they are trusted way more than in the case with quality control. Additionally, there is no need to hire quality inspectors. However, "easier said than done": in reality, it takes a long time to build trust and culture within the organisation and quality assurance will only work with full commitment of all employees.*

***Quality circles*** *refers to groups of employees from all levels of the hierarchy meeting regularly to discuss ways of improving quality. As simple as that: employees sit down together to talk about what can be done to improve production. On the one hand, it increases motivation levels and engagement of employees, it helps to implement kaizen culture and quality assurance.*

***Benchmarking** means assessing the output against the standards set by market leaders. Simply speaking, organisations might take competitor's product as a benchmark and compare their own product to it in order to see how to improve.*

*On the one hand, benchmarks work as a point of reference and a source of ideas about what to improve, meaning that there is no need to develop the standards from scratch, just take what already is available in the market. On the other hand, since benchmarking assumes competitor's product as a standard, it might involve repeating competitors' mistakes.*

***Total quality management (TQM)** is a method of managing quality that permeates the entire organisation at all levels. This basically means that attention to quality is paid by all employees at all levels of the hierarchy. TQM is a broad concept and it might include kaizen, benchmarking and quality circles.*

*On the one hand, it has positive effect on motivation, it helps to achieve zero defects in the final output, and it helps organisations to shift towards quality assurance from quality control. However, resistance to change and having to accept responsibility for one's own work and take initiative are some of the drawbacks that TQM comes with.*

***Quality standards** are criteria that products have to meet to be recognised by independent standard developing organisations. One standard that you definitely have to know is ISO 9001 developed by International Organisation for Standardisation (ISO).*

*On the one hand, quality standards are really important because they are developed with the focus on customer satisfaction. It is the whole point of standards — to make sure that whatever product is labelled with a certain standard, quality is guaranteed and customers do not have to verify it themselves. Additionally, quality standards are fair because they are the same for everyone.*

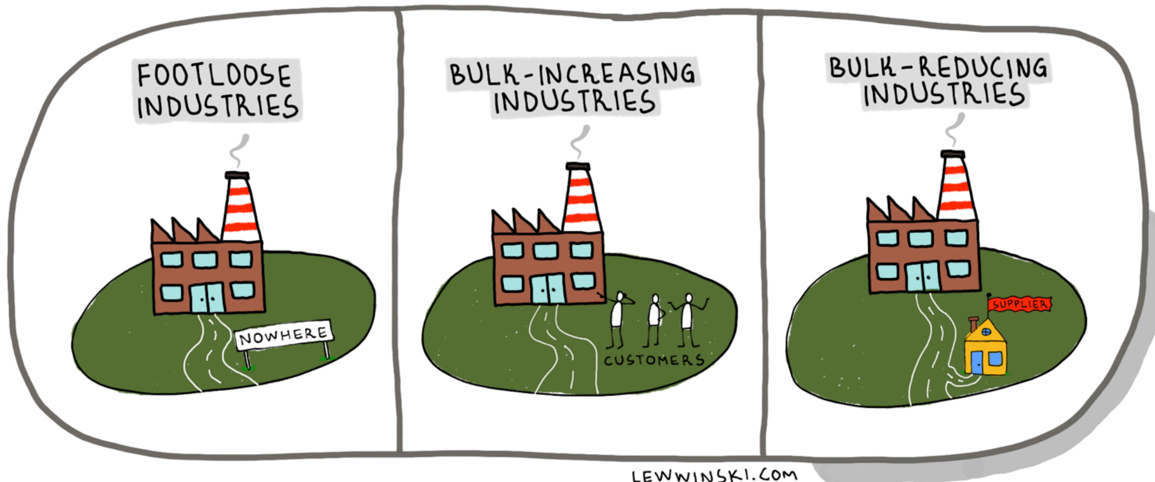
*However, all sorts of standardisation come with bureaucracy and compliance costs. If there were no standards, then customers would have to make their own judgements about all products they purchase, but it will also be very easy for organisations to launch their products without having to run them through standardisation bureaus prior to launch.*

***Location** is a particular place or position of an organisation.*

***Footloose industries** are industries that can be located anywhere without effects from factors of production. Simply speaking, all organisations that don't really care where to locate are in footloose industries.*

***Bulk-increasing industries** prefer locating near customers in order to reduce transportation costs. That is because the final output weighs more than raw materials, so it is important to be closer to customers.*

***Bulk-reducing industries** prefer locating near suppliers of raw materials in order to reduce transportation costs. That is because the final output weighs less than raw materials, so it is important to be close to suppliers of raw materials.*




*Nature of the industry. As we learnt in the previous paragraphs, organisations may be in bulk-increasing, bulk-reducing or footloose industries. Depending on the industry organisation is in, location decision will differ: either organisation will choose to locate closer to customers, or closer to suppliers, or location might not matter at all.*

*Costs. Some of the costs that determine where to locate production are transportation costs, costs of labour, costs of raw materials. All organisations definitely consider all the relevant costs while making a location decision.*

*Infrastructure. **Infrastructure** refers to a combination of systems and facilities that operate in a specific location. It usually includes transportation networks (roads, highways, rail transit, public transport, etc) and telecommunication networks (internet, research, employment, tourism, etc).*

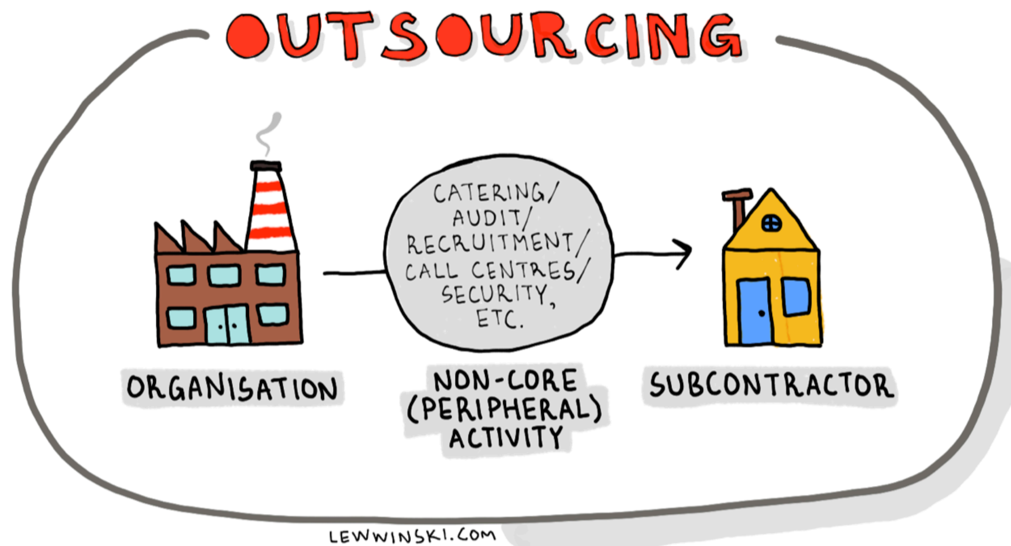
*Government incentives. Different governments offer different degrees of support to businesses. One common way of doing so is by organising **enterprise zones** — areas that offer tax concessions and/or reduced regulations to businesses that locate in those areas. This, of course, might be one of the reasons for location*

***Regional specialisation**. It refers to a concentration of a certain area on one or several industries. For example, many organisations in Suzhou (an ancient city in China) have been for centuries specialising in silk manufacturing. Even though they are competing with each other and fighting for customers, there is a benefit for them to locate in one place: they might split some of the costs and they may attract more customers, since the region is so famous for its specialisation.*

***Outsourcing (subcontracting)** refers to transferring some of the operations to another organisation. This way, organisations can outsource some of the non-core activities and focus on core activities only. Catering, audit, recruitment, call centres, security and advertising are some of the most common outsourced/subcontracted activities.*

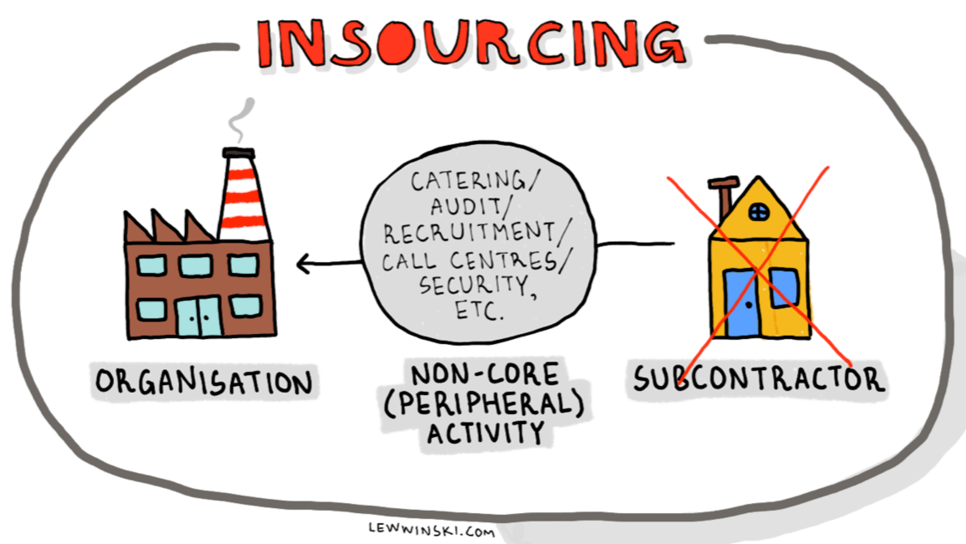
*On the one hand, subcontractors might not only be reliable professionals who are good at whatever they are doing, but they might also offer competitive prices for their work, helping organisations to cut costs. Besides, outsourcing is a great opportunity to focus on core*

*activities. On the other hand, subcontracting means having to rely on subcontractors. If they are not reliable or professional enough, it might be threat to the brand value.*




***Insourcing** means bringing outsourced operations back. We might say that insourcing is "backwards" outsourcing. If we use the previous example, when XYZ outsourced advertising to ABC, then firing ABC advertising agency in favour of internal marketing department of XYZ would be an example of insourcing, i.e. taking some of the subcontracted activities back.*

*On the one hand, insourcing allows organisations to retain full control over operations: no need to rely on subcontractors, everything is under control. On the other hand, organisations clearly have to deal with new tasks if they insource some of the activities.*




***Offshoring** is transferring some of the operations abroad. Offshoring does not necessarily involve outsourcing to another organisation! If it is a combination of offshoring (moving some*

*of the operations abroad) and outsourcing (subcontracting some of the operations to another organisation), then it is called **offshore outsourcing**.*

*On the one hand, offshoring might result in cost reduction, especially if labour costs in another country are lower than in the home country. Additionally, multinational companies might avoid protectionism if they locate some their operations in markets they exported their products to. On the other hand, exchange rates might not always be in favour of the organisation and cultural differences might hinder communication.*

***Reshoring** refers to bringing offshored operations back to the home country. We might say that reshoring is "backwards offshoring". Keep in mind that reshoring does not necessarily involve insourcing*

*One thing you have to know about is **industrial inertia**. This happens when alluring factors of a certain location are gone but operations are run there anyway.*

*On the one hand, reshoring might enhance the brand image of an organisation because provision of employment opportunities in the home country might be perceived well by stakeholders. However, similar to insourcing, bringing some of the activities back means having to deal with new tasks.*

***Contribution** is the difference between the selling price and variable costs. In other words, contribution is what is remained to pay for fixed costs.*

*There are two kinds of contribution: per unit and total. **Contribution per unit** = unit price (P) – unit (average) variable cost (AVC). **Total contribution** = total revenue (TR) – total variable costs (TVC).*

*Contribution per unit = P – AVC*

*Total contribution = TR – TVC*

*Total contribution = contribution per unit × Q*

***Break-even** (BE) is a state at which organisation's revenue equals its costs. If organisation is breaking even, it means that it does not have any profits, but also it does not experience loss. It means that revenue is just enough to cover the costs.*

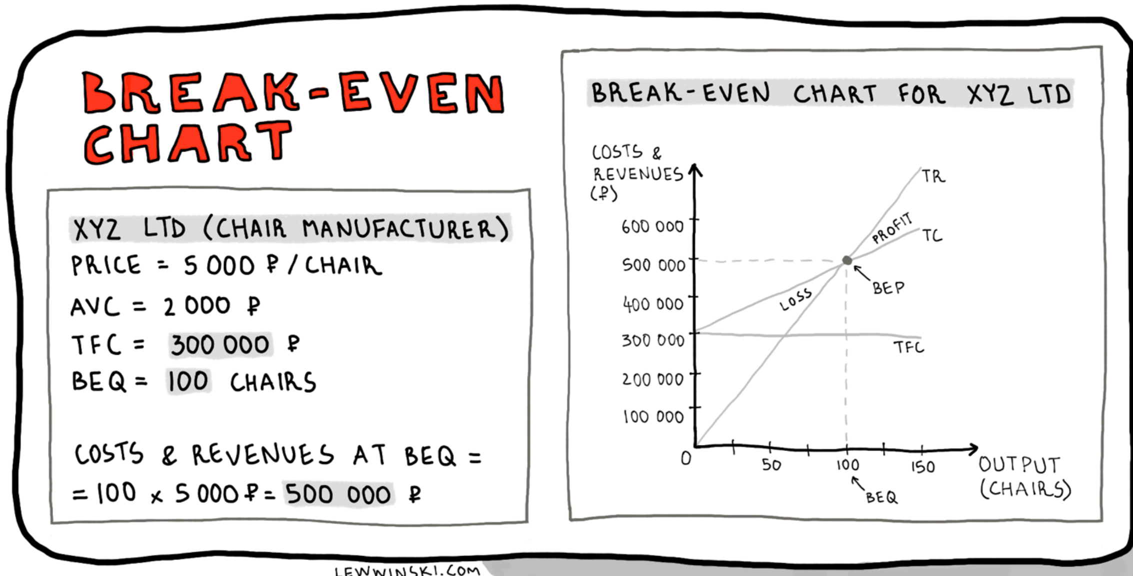
***Break-even chart** (BEC) is a graph that illustrates the value of costs and revenues against the volume of output. Basically, it is a picture that demonstrates what break-even is.*

***Break-even quantity** (BEQ) is the number of items that have to be sold in order to break even, i.e. how many units of output need to be sold in order to cover the costs. Anything that is sold beyond BEQ would be profit, and anything below would be loss.*

***Break-even point** (BEP) is the spot on the break-even chart (BEC) where total revenue (TR) and total costs (TC) intersect. Break-even point (BEP) is what represents break-even quantity (BEQ) on the break-even chart (BEC). It only exists on break-even chart.*

***Break-even analysis** (BEA) is a business management tool that is used to determine the appropriate level of sales. It includes all of the definitions above and is a decision-making process that helps managers to set the right price, or reduce costs, or make other decisions that would help organisations to maximise profits.*

*Please mind the key words in italics in the definitions above. They really help to distinguish between all those concepts that basically refer to different aspects of the same thing: BE is a state, BEC is a graph, BEQ is a number, BEP is a spot, BEA is a tool.*




*TR = TC*

*P x Q = TFC + TVC*

*P x Q = TFC + (AVC x Q)*

*(P – AVC) x Q = TFC*

*Q = TFC ÷ (P – AVC)*

*(Q in this equation refers to BEQ)*

*Profit and loss are the two sides of the same thing. **Profit** is the positive difference between revenues and costs. **Loss** is the negative difference between revenues and costs. There are two ways how to calculate profit/loss. One way is to subtract total costs (TC) from total revenues (TR):*

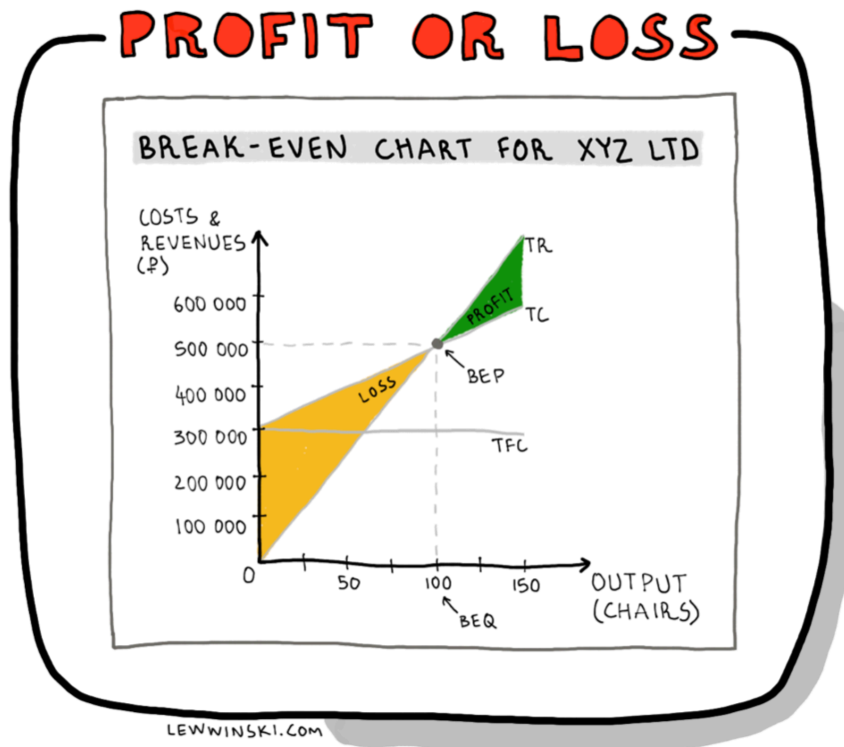
*Profit/loss = TR – TC*

*The second way is to subtract total fixed costs (TFC) from total contribution:*

*Profit/loss = total contribution – TFC*

*Just a reminder that total costs (TC) equal to a sum of total foxed costs (TFC) and total variable costs (TVC):*

*TC = TFC + TVC*




***Margin of safety*** *(MOS) is the difference between the break-even quantity (BEQ) and actual level of output. In other words, the difference between break-even quantity and how many units organisation managed to sell in reality. The greater the margin of safety, the better, because it results in more profit*

*Margin of safety can be expressed either as a number of units or as a percentage. With regards to percentage, it may be relative to either break-even quantity or actual sales. Let's see the formula and figure out what it means.*

*MOS (units) = actual output – BEQ*

*MOS (%, relative to BEQ) = MOS (units) ÷ BEQ*

*MOS (%, relative to sales) = MOS (units) ÷ actual sales*

***Target profit output*** *is the level of output/quantity (Q) required to earn desired profit. Basically, it means "how many units should organisation produce to achieve desired profit".*

*Target profit = P x Q – (TFC + TVC)*

*Target profit = P x Q – (TFC + AVC x Q)*

*Target profit + TFC = (P – AVC) x Q*

*Q = (target profit + TFC) ÷ (P – AVC)*

*So, **target profit** is the required profit at the target profit output level and **target price** is price that is required to achieve target profit. There are no special formulae for target profit and target price, all you do is just alternate the variables with the desired target profit/price/output and calculate whatever you have to calculate.*

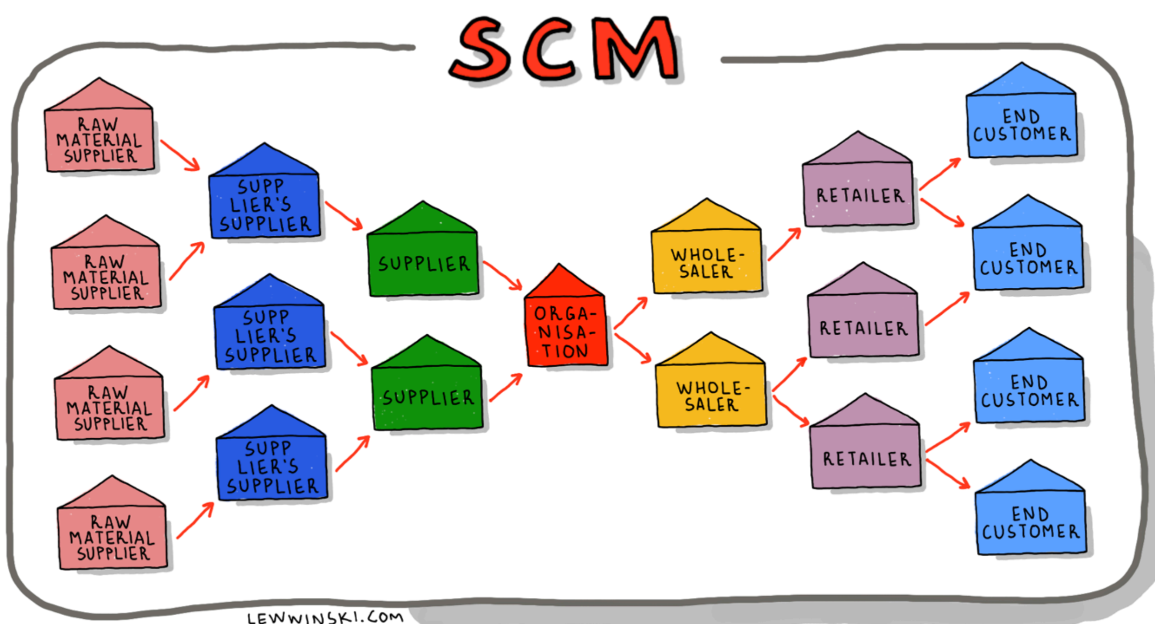
*On the one hand, break-even analysis is a relatively simple tool, that is quite quick to apply. As long as you have data about costs and revenues, you may quickly figure out break-even quantity that will help greatly with decision-making in so many aspects! For example, it helps with determining the price, with production planning (identifying how much output to produce), with cost management.*

*On the other hand, reality is not linear, as in break-even chart. Fixed costs change, prices change, demand changes, etc. So, all these changes are not indicated in a break-even chart which is a static and simplistic indicator of reality with straight lines indicating all the costs and revenues. It's still very helpful for a lot of decisions but it makes it really hard to apply break-even analysis for rapidly changing businesses and environments.*

***Supply chain** is a series of processes involved in production and distribution of goods to the end customer or consumer.*

***Supply chain management (SCM)** refers to dealing with the flow of goods in the supply chain in the most efficient way.*

*By the way, it is called "chain" for a reason. The word "chain" emphasises that its elements are interrelated, and failure of one element impacts the entire chain.*



***Local supply chain** is the one that operates on a smaller scale. Distances between suppliers, producers and distributors are relatively short. Local supply chains usually cover a region (province, city, town, county, or even neighbourhood).*

***Global supply chain** is the one that operates on a larger scale. Distances between suppliers, producers and distributors are relatively long. Global supply chains are usually trans-national, which means that they involve several countries.*

***Stock (inventory)** refers to raw materials, components, work-in-progress (semi-finished goods) and finished goods that are held by organisations.*

***Buffer stock** is inventory that is kept "just in case" (for demand fluctuations or for supply chain problems).*

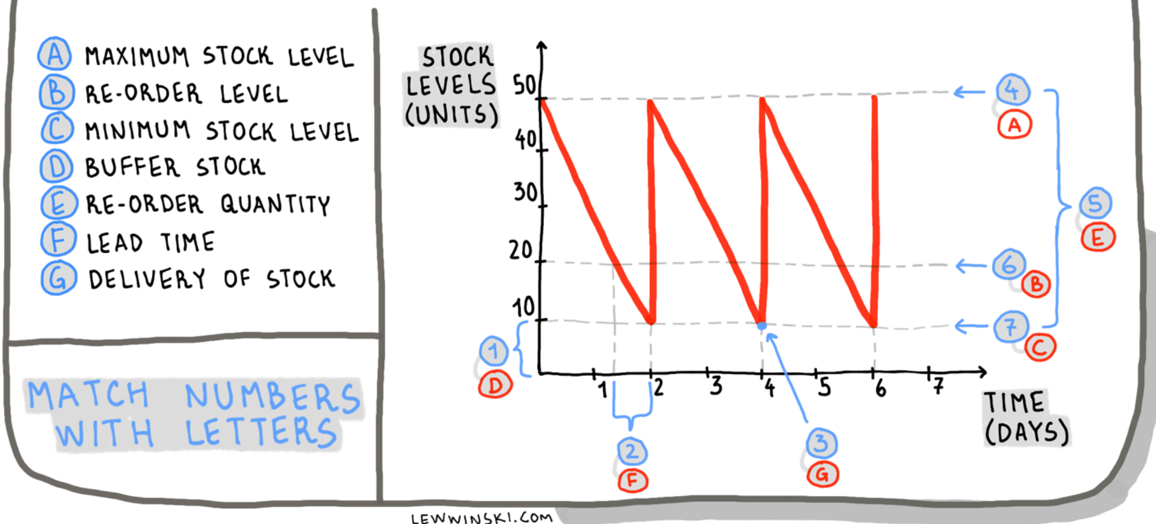
*Stock management is an important element of supply chain management. It helps to minimise costs and to facilitate swift circulation of materials, components, work-in-progress and finished goods.*

***Just-in-case (JIC)** is stock control system that holds buffer stocks. One of the main pros of this approach is the ability to use purchasing economies of scale by negotiating discounts with suppliers in exchange for purchasing higher quantities of goods or materials. However, since more things are held in stock, storage costs (insurance, security, utility bills, rent) are higher as well. JIC stock management allows to minimise the effect on demand fluctuations. If suddenly an organisation gets a special order to produce large quantities of output, there will be materials in stock to cater to this special order.*

***Just-in-time (JIT)** is stock control system that aims at zero buffer stocks.Organisations that use JIT stock management have to rely on and develop close relationships with suppliers because JIT is impossible without swift deliveries from suppliers on short notice. Since there are minimal (or even zero) buffer stocks, storage costs (insurance, security, utility bills, rent) are low. However, if demand fluctuates suddenly, it might have a significant effect on the organisation. If, suddenly, an organisation gets a special order to produce large quantities of output, there might not be enough materials in stock to cater to this special order and suppliers might not deliver enough materials on short notice, so that special order might not be fulfilled.*

***Stock** (or **inventory**) refers to raw materials, components, **WIP** (work-in-progress, i.e. semi-finished goods) and finished goods that are held by organisations. **Stock control** is the process of ensuring that appropriate amounts of stock are held. The two aims of stock control are:*

- *Meet customer demand without delay — make sure that customers always have an opportunity to purchase products at any time.*
- *Keep costs associated with stocks low — make sure that all the costs that are related to keeping stocks (insurance, utility bills, wages, etc) are minimised in order to maintain higher profitability.*




*Given the two aims above, organisations try to balance and keep appropriate stock levels that are not too expensive to keep and at the same time big enough to make sure there are always things in stock to keep up with demand. Basically, the two aims of stock control correspond to avoiding high levels of* ***stockpiling*** *(keeping excessive levels of stock that are expensive to maintain) and avoiding* ***stockout*** *(the situation when stocks are insufficient to meet customers' demand).*

*The diagram that shows how stock control is managed is called (surprise-surprise!)* ***stock control chart****.*

***Lead time*** *is period between ordering new stock and receiving it. As you can see on the stock control chart, it is the interval between the actual delivery of stock and the time when the order was placed*

***Buffer stock*** *is minimum amount of stock. If stocks are at a level lower than the buffer stock, then production is compromised.*

***Reorder level*** *is the level of stock at which the new order is placed. As you can see on the stock control chart, when stocks reach reorder level, order is placed and, ideally, supplies should be delivered before the stocks go lower than buffer stock level.*

***Reorder quantity*** *is the amount of ordered stock. As you can see on the stock control chart, it is the difference between maximum stock level and buffer stocks.*

*The 6 rates that we are going to learn in this part of class are:*

1. *Capacity utilisation rate*
2. *Defect rate*
3. *Productivity rate*

4. *Labour productivity rate*
5. *Capital productivity rate*
6. *Operating leverage*

***Capacity utilisation*** *is a measure of existing output relative to productive capacity.*

***Productive capacity*** *is the maximum possible level of output. So, capacity utilisation rate expresses how much of productive capacity is used. The formula is:*

*Capacity utilisation rate = actual output ÷ productive capacity × 100*

***Defect*** *is a characteristic/fault/problem of a product that hinders its usability. For example, if you buy a new smartphone and its screen does not work, it is clearly a defect.*

***Productivity*** *is a measure of efficiency of production. It is always relative to internal or external (competitors') benchmarks, which means that simply knowing productivity rates of a certain organisation does not provide many insights unless it is compared to standards (benchmarks) and competitors.The formula of productivity rate is:*

*Productivity rate = total output ÷ total input*

***Labour productivity*** *is a measure of worker's efficiency. It can be applied to calculate a single worker's productivity, or a group, or the entire workforce. Again, it all depends on the context and on organisational needs. Regardless, the formula is:*

*Labour productivity = total output ÷ hours worked*

***Capital productivity*** *is a measure of efficiency of organisation's capital, especially working capital. Working capitl is cash that is used to sustain daily operations of the business. Its formula is:*

*Working capital = current assets — current liabilities*

***Operating leverage*** *is a measure of the effect of fixed costs on profit given different sales levels. This rate uses the same data as break-even analysis: fixed costs, variable costs, contribution.*

*Unit contribution = P – AVC*

*Total contribution = (P – AVC) × Q*

*Operating leverage = total contribution ÷ profit*

# OPERATING LEVERAGE

BESTDRINKS LTD.
PRODUCT: APPLE JUICE
PRICE: $10 PER LITRE
SALES: 100 LITRES PER MONTH

| HIGH O.L. | LOW O.L. |
|---|---|
| TFC: $500 PER MONTH<br>AVC: $3 PER LITRE | TFC: $300 PER MONTH<br>AVC: $5 PER LITRE |
| UNIT CONTRIBUTION =<br>= $10 - $3 = $7 | UNIT CONTRIBUTION =<br>= $10 - $5 = $5 |
| TOTAL CONTRIBUTION =<br>= $7 × 100 L = $700 | TOTAL CONTRIBUTION =<br>= $5 × 100 L = $500 |
| PROFIT = $700 -<br>- $500 = $200 | PROFIT = $500 -<br>- $300 = $200 |
| O.L. = $700 ÷ $200 = 3.5 | O.L. = $500 ÷ $200 = 2.5 |

IF SALES GROW BY 10%
(100 L → 110 L), THEN:

| HIGH O.L. | LOW O.L. |
|---|---|
| CHANGE IN PROFIT (%) =<br>= 10% × 3.5 = 35% | CHANGE IN PROFIT (%) =<br>= 10% × 2.5 = 25% |
| 35% OF OLD PROFIT =<br>= $200 × 35% = $70 | 25% OF OLD PROFIT =<br>= $200 × 25% = $50 |
| NEW PROFIT = $200 +<br>+ $70 = $270 | NEW PROFIT = $200 +<br>+ $50 = $250 |
| IF SALES GROW BY 10%,<br>PROFIT GROWS BY 35% | IF SALES GROW BY 10%,<br>PROFIT GROWS BY 25% |

LEWWINSKI.COM

*High operating leverage is common for businesses with high levels of fixed costs. Usually, these are capital-intensive businesses that rely on machinery in production. On the one hand, high operating leverage means that more sales would lead to more profit. That is because fixed costs do not change with the increase in output, so the more output is sold, the higher the profits are.*

*Low operating leverage is common for businesses with low level of fixed costs. Usually, these are labour-intensive businesses that rely on workers in production. On the one hand, low operating leverage implies low risk if sales are low. That is because most of the costs the organisation bears are variable. And, as you hopefully remember, if sales revenue is low, then variable costs are also low because they are proportional to the level of output*

***Make-or-buy decision*** *is a choice between purchasing from supplier and manufacturing on one's own. For example, a pizza restaurant might face a make-or-buy decision if its managers are thinking whether to buy tomato sauce from a supplier or producing their own.*

***Cost to buy (CTB)*** *is the cost of purchasing from supplier. It is calculated by simply multiplying price per item bought from supplier by quantity:*

$CTB = P \times Q$

***Cost to make (CTM)*** *is the cost of manufacturing on one's own. It is calculated by adding all costs (fixed and variable) together.*

$CTM = (AVC \times Q) + TFC$

***Crisis*** *is a period of extreme difficulty or danger.* ***Crisis management*** *is the process of dealing with a crisis or an emergency. As you can see from the definition, crisis management is something that happens after the crisis. So, you let crisis happen and then you try to minimise its effects.*

***Contingency*** *is a future event that is possible but not 100% likely to occur.* ***Contingency planning*** *is preparing an action plan for potential crisis. As you can see from the definition, contingency planning is something that happens before the crisis. So, you try to prevent the crisis before it happens.*

*How successfully an organisation manages crisis depends on these factors:*

1. *Transparency*
2. *Communication*
3. *Speed*
4. *Control*

***Transparency*** *is the extent to which information regarding costs, damage, consequences, etc is made available to relevant stakeholders. If crisis management is not transparent enough, then stakeholders are kept in the dark, they panic and do not trust managers. If managers are too transparent and disclose every single bit of information about how crisis is managed, then managers are perceived as incompetent and not being able to take situation under control.*

***Communication*** *in crisis management refers to establishing reliable official channels for spreading up-to-date information.. If there is no communication, then stakeholders will eventually get information from alternative unreliable sources (such as rumours) and will not have a clear and up-to-date information regarding crisis management. However, if there is too much back-and-forth communication, then crisis management is prolonged.*

***Speed*** *in crisis management is the rate at which crisis management decisions are made and executed. If crisis management is too long, then the effects of crisis are too harmful. However, fast decisions are often careless, which might only worsen the effects of the crisis.*

***Control** in crisis management refers to the extent to which organisation has power to influence the course of events and people's behaviour. If there is lack of control, then, obviously, crisis goes out of control. If there is too much control, it might result in demotivated staff that resists change, which might only worsen the effects of crisis.*

*Impact of contingency planning is discussed in terms of these factors:*

1. *Costs*
2. *Time*
3. *Risks*
4. *Safety*

*With regards to costs, they are saved in the long term. However, in the short term, costs are higher. For example, purchasing fire extinguishers increases short-term costs but reduces costs in case of fire because damage caused by fire is minimised thanks to fire extinguishers.*

*With regards to time, less time is needed to react to an emergency because there is a plan in place, so stakeholders know what to do in case of crisis. However, more time is needed to develop a contingency plan. For example, fire drills are time-consuming and disrupt the working process but reaction time is minimised in case of real fire.*

*With regards to risk, it is lowered if crisis actually happens. However, maybe, contingency plan will never be used, so it is a waste of time, in a way… For example, most people who practice fire drills never end up in a real fire (luckily), so from a certain (weird) perspective, they wasted their time preparing to something that never happened (thank God).*

*With regards to safety, safety regulations minimise risks. However, it is impossible to guarantee 100% safety anyways…For example, practicing fire drills still does not mean that everyone will survive in case of real fire (sadly)*

***Research and development (R&D)** refers to activities directed at innovation, launch and improvement of products (goods and services). Let's break down this definition. Innovation refers to creating something new and commercialising it,*

*Please be mindful of two important facts about R&D:*

1. *It applies to all industries, not only high-tech and pharmaceuticals. For some reason, it is a common misconception among students that in order to do R&D you have to be a multinational tech company like Apple or a multinational pharmaceutical company like Pfizer. No, you can be a cupcake bakery startup and have R&D as well.*
2. *R&D is about products, i.e. goods and services, not just goods. R&D about how to improve a service, such as call centre, customer care or sales is as common as R&D of goods.*

*On the one hand, successful R&D may result in **first mover advantage** — that is when an organisation is doing something before others, thus enjoying temporary monopoly before competitors enter the market*

*Other than that, successful R&D can help organisations reach a competitive advantage and develop a USP. Besides, if R&D targets improvement of existing products, it may extend product life cycle, letting products "stay afloat" in the market longer . Lastly, R&D results in cost reduction in the long term because it can lead to improvement of efficiency in production or provision of services*

*On the other hand, R&D takes a long time, especially in the pharmaceutical industry where it takes 10-15 years on average to develop new medicine. Additionally, R&D results in increased costs in the short term, because researchers need equipment and salaries and whatever is being researched, does not result in sales until it's launched. For this reason, R&D department is usually a cost centre. Besides, R&D does not guarantee any success. It may result in failure, for example Apple Newton was an extremely innovative product for its time but it did not have a commercial success. So, failures of R&D are quite common. And lastly, R&D often comes with ethical implications which might delay the launch of the products*

*Customers do not always know what they need. For example, before iPhone was released, people were not in urgent need of a phone with big touch screen and no buttons. You, students, were not born back then, but let me assure you that my friends and I (back when we were teenagers) were perfectly happy with our Nokia smartphones that had traditional old school buttons under the screen. And then iPhone was released and it was a complete game changer. Everyone realised that this is what phone looks like now: customers' needs were met, even though those needs were unknown and customers were not aware of them.*

*The iPhone example above when people do not really know what they need refers to **product-oriented approach** to marketing: organisations take the risk to develop something that will meet customers' needs even when these needs are unclear.*

*Another way to satisfy unmet needs is **market-oriented approach**: conducting **market research** in order to find out what customers need.*

*Both approaches have the same goal (to sell products successfully) but ways to achieve it are different. Product-oriented approach refers to satisfying unmet needs that customers are unaware of and market-oriented approach refers to satisfying unmet needs that customers are aware of.*

*Implications and pros and cons of developing products that address unmet needs are similar to those of R&D, product-oriented and market-oriented approaches. On the one hand, if you (organisation) hit the spot, then market is all yours: either because you met the needs that customers were not aware of (product-oriented approach) or because you are very good at market research and at understanding what customers want (market-oriented approach). On the other hand, if you don't hit the spot, it's a waste of time and money.*

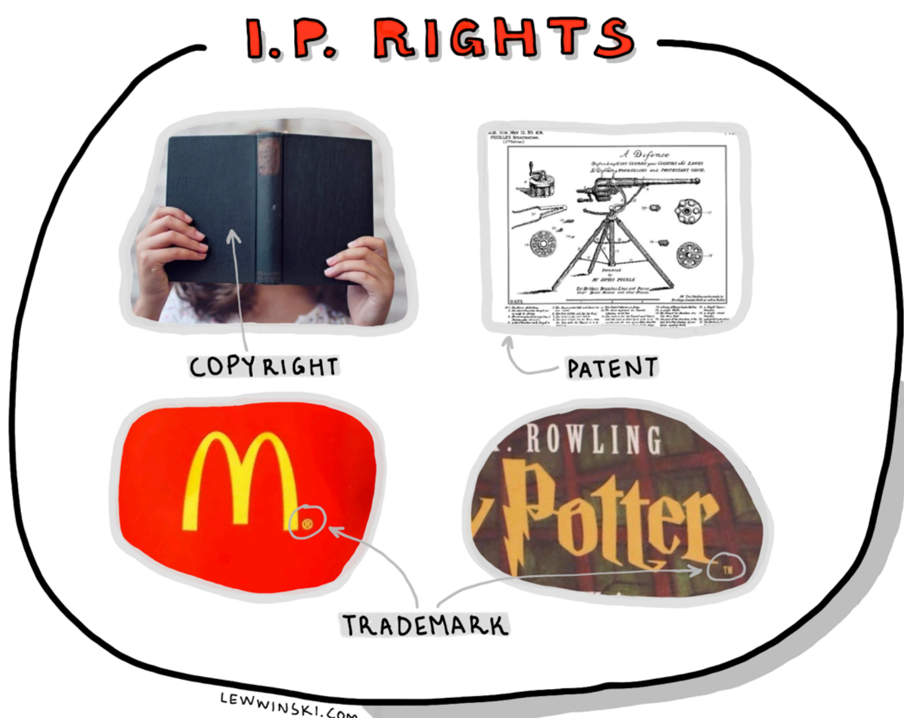
***Intellectual property (IP)** is intangible property that is the result of creativity. According to WTO, IP rights are the rights given to people or organisations over the creations of their minds.*

Piracy better :) https://dl.ibdocs.re https://repo.pirateib.xyz

***Copyright** (symbol: "©") is an exclusive right for the creator to copy, publish, distribute or perform a creative work. Basically, anything that is written or can be explained using text symbols (art, music, literature) is protected by copyright.*

***Patent** is the right to prohibit others from producing, using or selling an invention. In exchange for being granted this right for a limited period of time, patent holders disclose the details of the claimed invention.*

***Trademark** (symbols: "™" for unregistered trademark or "®" for registered trademark) is a recognised symbol, style, or phrase that defines and sets apart a product from others.*



***Innovation*** *is the process of commercialising a creative idea and giving it a practical use. From the business perspective, creating something new is not innovation unless it can have a real-life application, satisfy needs and wants and have a commercial value.*

***Incremental innovation*** *is the improvement of existing products based on the established needs of customers. It may also be called adaptive innovation or sustaining innovation. For example, every new modification of iPhone is incremental innovation. Apple does not create an entirely new smartphone twice a year, they just improve and add new features to every new version.*

***Disruptive innovation*** *refers to creation of completely new products that change existing industry or create a new industry. For example, the very first iPhone may be considered a disruptive innovation because it changed the industry entirely and it was a complete game changer.*