AQA A LEVEL BUSINESS YEAR 1(AS) COURSE COMPANION

Edition 1

Essential Topic-by-Topic Study Notes for the AQA A Level Business Year 1 (AS) Specification Content

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Topic: Introduction to Business
3.1 What is Business?

What You Need to Know
What is a business?
Why businesses exist
What businesses do
The role of entrepreneurs
Main types of business

What is a Business?
A business is an organisation that exists to provide **goods** and **services** on a commercial basis to customers.

- **Goods** are **physical or tangible products**: e.g. consumer electronics, industrial components, cars
- **Services** are **intangible products**: e.g. insurance, dental services, cleaning

Customers can be individuals (buying on their own behalf or for households), businesses or other organisations.

Why Businesses Exist
Businesses exist because they are formed by entrepreneurs and are subsequently developed if they manage to get beyond the survival stage.

Most businesses exist in order to earn a return for the business owners, and the potential for profit is a key motive for entrepreneurial activity. However, there are other potential business objectives, which are explored further during your studies.

Businesses play a key role in wider society. In particular they:
- Create and sustain employment & develop the skills of people
- Drive innovation through research & development (R&D) and new products
- Contribute to the infrastructure of the country
- Pay taxes on profits earned & collect taxes on behalf of government
- Create wealth by providing returns on investment

What Businesses Do – the Transformation Process
In different ways, all businesses take resource inputs and transform them into goods and services. This is known as the **transformation process.**

Topic: Introduction to Business

3.1 What is Business?

The transformation process describes what happens inside the business. This is where **value is added** to inputs to create outputs.
Some examples of the transformation process are:

Industry	Key Inputs	Transformation Process
Accountancy	People	Knowledge turned into professional advice
Restaurants	People, Ingredients, Buildings	Value added during cooking and through customer service
House-building	Land, People, Capital	Building process (design, implementation)

Role of Entrepreneurs

Entrepreneurs (and the enterprise that they demonstrate) play a key role in the formation and development of businesses. In particular, entrepreneurs:

- Spot business opportunities
- Take (calculated) risks in order to gain possible future returns
- Act a catalyst for the creation & growth of new business enterprises

Business Sectors

Businesses operate in a wide variety of sectors (and sometimes in more than one). The four broad business sectors are commonly considered to be:

Sector	Description	Examples
Primary	Extraction of natural resources	Mining, farming, energy extraction
Secondary	Production of finished goods and components	Manufacturing, food processing, component assembly, raw material processing
Tertiary	Providing services to consumers and businesses	Personal services (e.g. beauticians), retailing, household franchises
Quaternary	Providing information & ICT	Software development, financial services, data processing

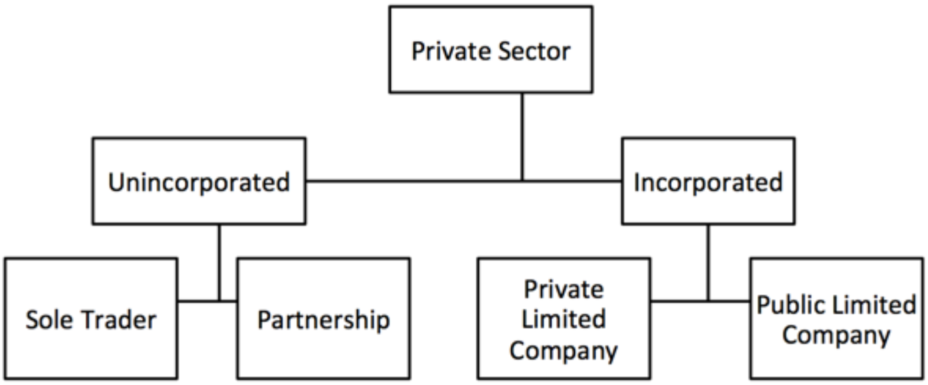
Key Terms

Adding value	The process of creating value by transforming the inputs into business activity so that the value of what is created is greater than the costs involved
Enterprise	A process whereby business opportunities are identified and exploited for commercial gain

Topic: Forms of Business
3.1 What is Business?

What You Need to Know
Unincorporated and incorporated businesses (sole traders & limited companies)
Importance of limited liability
Private & public sector
Public limited companies

Overview of Key Business Forms
We'll look first at the key forms of business in the private sector – which represents the vast majority of businesses in the UK.



Unincorporated and Incorporated Businesses
A key distinction needs to be made between businesses formed as a company (incorporated) and those that are not!

Unincorporated:
- The owner is the business - no legal difference
- Owner has unlimited liability for business actions (including debts)
- Most unincorporated businesses operate as sole traders

Incorporated:
- There is a legal difference between the business (company) and the owners
- The company has a separate legal identity
- Owners (shareholders) have limited liability
- Most incorporated businesses operate as private limited companies

Unlimited Liability
- Unlimited liability is a crucially important characteristic of unincorporated businesses.
- Business owner/s is personally responsible for the debts and liability of the business
- If the unincorporated business fails, the owners are liable for the amounts owed

Sole Traders (Unincorporated)
Operating as a sole trader is the most common type of business form. A sole trader is just an individual owning the business on his/her own. Remember that a sole trader can also employ people – but those employees don't share in the ownership

of the business. The sole trader owns all the business assets personally and is personally responsible for the business debts. **Crucially - a sole trader has unlimited liability.** The main benefits and drawbacks of operating as a sole trader include:

Advantages	**Disadvantages**
Quick & easy to set up – business can always be transferred to a limited company once launched Simple to run – owner has complete control over decision-making Minimal paperwork Easy to close / shut down	Full personal liability – "unlimited liability" Harder to raise finance – sole traders often have limited funds of their own and security against which to raise loans The business is the owner – the business suffers if the owner becomes ill, loses interest etc. Can pay a higher tax rate than a company

Incorporation and the Importance of Limited Liability
The concept of limited liability is an important protection for shareholders in a company. What this means is that shareholders can only lose (are therefore liable for) the value of their investment in the share capital of the company. However limited liability does not protect against wrongful or fraudulent trading or when directors give personal guarantees.

The reason why limited liability arises for shareholders is because the company has a separate legal identity. The shareholders are not the same as the business.

Main Features of a Limited Company

- Limited companies are separate legal entities to the founders. A legal entity can own things itself (assets), can sue and be sued;
- Companies are owned by their shareholders and run by directors. The shareholders appoint the directors (often the same people) who run the company in the interests of the shareholders;
- Shareholders own a share of the company, but they do not own the assets of the company and they are not liable for the debts of the company;
- The company owns the assets and pays the debts. If the company becomes insolvent (i.e. it cannot pay its debts), then the company is closed;
- Shareholders are not liable for any debts owed by the company that cannot be settled. That is the importance of limited liability;
- By far the most common form is a private limited company. Private means that the shares of the company are not traded publicly on a stock exchange
- By contrast, a public limited company ("plc" after its name) tends to have a larger value of share capital invested and its shares may be traded publicly.

The main benefits and drawbacks of operating as a limited company are, therefore:

Advantages	**Disadvantages**
Limited liability – protects the shareholders (the big advantage) Easier to raise finance – both through the sale of shares and also easier to raise debt Stable form of structure – business continues to exist even when shareholders change	Greater administration costs Public disclosure of company information Directors' legal duties

Public Limited Companies

- A public company is simply a more specialist type of limited company
- Shares may be quoted and traded on a public stock market (but don't have to be)
- When traded on a stock market, public companies have substantially more shareholders
- Public companies are subject to significantly greater regulation in terms of public disclosure of financial and other information

Brief Introduction to Public Sector Organisations and Not-for-Profit Businesses

A relatively small number of companies are owned or controlled by the Government Examples include the bank RBS (nationalised during the banking crisis) and Network Rail.

There are many more organisations that provide goods and services that are owned and operated by public bodies. These are funded by central & local government, but may still levy charges for some services. Examples include the NHS, the Highways Agency and TeachFirst (which recruits & trains new teachers)

Not-for-profit organisations:

- Not-for-profit organisations are businesses that trade in order to benefit the community. These businesses have social aims as well as trying to make money
- Examples of social aims are job creation and training, providing community services and fair trade with developing countries
- There are many different types of social enterprise, including community development trusts, housing associations, worker-owned co-operatives and even sports clubs

Key Terms

Limited liability	Where shareholders in a company are only liable for the amount they have invested in the share capital
Unlimited liability	Where the owners of the business are legally inseparable from the business they run, making them liable for the debts of the business

Topic: External Environment (Introduction)

3.1 What is Business?

What You Need to Know
What is the external environment
Effects of changes in the external environment
Overview of: • Market conditions • Incomes • Interest rates • Demographic factors • Environmental issues

Introduction

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

Overview of the External Environment using PESTLE Analysis

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

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

Examples for each element of the PESTLE framework include:

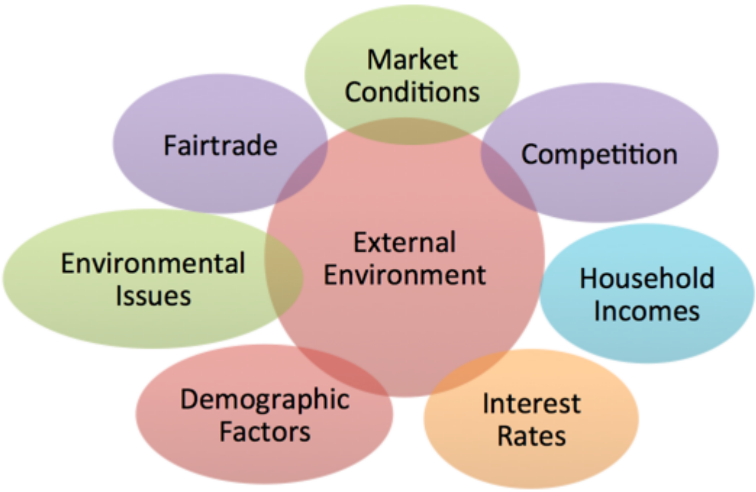
POLITICAL	**ECONOMIC**	**SOCIAL**
Competition policy Industry regulation Govt. spending & tax policies Business policy & incentives	Interest rates Consumer spending & income Exchange rates Economic growth (GDP)	Demographic change Impact of pressure groups Consumer tastes & fashions Changing lifestyles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

Topic: External Environment (Introduction)

3.1 What is Business?

Exploring Specific Aspects of the External Environment

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



Market Conditions

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

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

Competition

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

Topic: External Environment (Introduction)
3.1 What is Business?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Key Terms

External environment	Features of the business environment that are outside of the control of a business

Topic: Shares, Shareholders and Share Prices

3.1 What is Business?

What You Need to Know
What are shares and shareholdings?
Share prices – how determined and why they change
Market capitalisation – the value of a business
Factors that influence share prices
Raising capital through share issues

Introduction: Shareholders and Incorporated Businesses

The most important point to understand about share ownership is that an "incorporated" business (i.e. a company) is a **separate legal entity**. The owners of a company are shareholders.

There are two main kinds of company:

Private Limited Company	**Public Limited Company**
Most popular form of incorporated business Company is privately-owned Shares cannot be traded publicly Usually just 1 or a few shareholders Quick & cheap to set up and administer	Minimum share capital £50,000 Shares may be traded on a public stock market Usually many shareholders More detailed disclosure of information required More costly to administer

Shareholders in both private and public limited companies earn their rewards from two aspects of their business ownership: **dividends** and **capital growth:**

Dividends

- Payments made to shareholders by the company from earned profits
- Amount paid is "per share" – e.g. £1 per share held
- Normally no requirement to pay dividends, but most quoted companies do

Capital Growth (also known as Capital Gain)

- Arises from an increase in the value of the business
- Reflected in an increase in a share price
- Only realised when a share is sold (the price paid)
- No guarantee that a shareholding will increase in value – business value can change both ways

What is a Share?

A share is an individual part of the total **issued share capital** of a company. Most shares that are issued by a company are "ordinary shares". This means:

- Equal voting rights based on number of shares held (shareholding)
- The shareholding % = the number of shares held compared with the total number of shares issues
- Shares qualify for a dividend –but, only if one is paid

To work out what shareholdings are held, you need to look at the composition of the issued share capital by shareholder and then work out the percentages. For example:

Topic: Shares, Shareholders and Share Prices
3.1 What is Business?

Total Number of £1 Ordinary Shares in Issue: 20,000		
Shareholders	**Number of Shares**	**Shareholding**
Ollie	3,000	15.0%
Emma	2,500	12.5%
Jim	11,000	55.0%
Kate	1,000	5.0%
Phoebe	2,500	12.5%
Total	***20,000***	***100%***

Share Prices
A share price is the price paid to acquire ownership of that share. When shares are first issued, the price is the "issue price" (e.g. a £1 share issued for £1). Shares can be issued for more than the issue price (e.g. a £1 share issued for £10) which results in a share premium being established.

Once shares have been issued they are capable of being traded (bought and sold) either privately or using a public stock exchange. This interaction of demand (people who want to buy a share) and supply (existing shareholders who want to sell) results in the determination of a share price.

Key points to remember about share prices:

- Like any other price in a market, a share price is determined by the interaction of **supply** and **demand**
- If demand for a share > supply (more buyers than sellers) then the share price should rise
- A falling share price indicates excess supply (more sellers than buyers)

The determination of share prices for private and public limited companies also varies somewhat. The key differences are:

Share Price of Private Company	**Share Price of Public Company**
Initially set when shareholders "subscribe" for their shares Thereafter only determined when shares are bought or sold No active market in the shares of a private company – so hard to judge current value	Highly transparent – displayed publicly, in real-time All trades are disclosed (how many bought/sold and for what price Share prices widely published and tracked

Share Prices and Market Capitalisation
Market capitalisation represents the **total market value of the issued share capital of the company.** It is calculated using this formula:

Topic: Shares, Shareholders and Share Prices
3.1 What is Business?

Share price (per share)	***x***	***Number of shares in issue***

Factors That Influence the Share Price of a Public (Quoted) Company
The share price (and, therefore the market capitalisation) of a private company does not change regularly. The value of a private company tends only to be determined when the business itself is being bought & sold, or when new shareholders are introduced through a share issue.

By contrast, the share prices of public companies fluctuate every second whilst stock markets are open. Key factors that influence whether a share price rises or falls include:

Factors ***WITHIN*** The Company's Control	Factors ***OUTSIDE*** the Company's Control
Financial performance (e.g. profit growth) Dividend policy (how profits are distributed to shareholders) Relationship with key investors (incl. communication) Management reputation	State of the economy General market sentiment Whether the company is a takeover target Alternative investment's in the company's sector

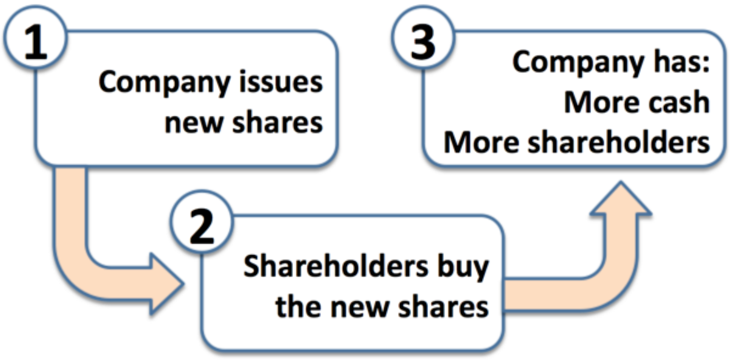
The Importance of Market Expectations for Quoted Companies
- The share price of a quoted public company is significantly influences by market expectations of business performance
- Unexpected warnings indicating that market expectations will not be met almost always result in a significant fall in share price
- Such bad news is known as a "profits warning"

The Role of Share Capital in Business Finance
Share capital is known as **"equity finance"** – it is the finance that is provided by those who share the equity (ownership) of a company. The main alternative to equity finance is **debt finance** – i.e. finance provided by external funders who receive a return (interest) but do not own a share of the company. The key features of equity and debt finance can be summarised as follows:

Equity Finance	**Debt Finance**
Returns: dividends and capital growth Part of the ownership of a company Long-term source of finance Returns tend to be higher given higher risk Can be repaid (share purchase) but this is unusual	Most commonly in the form of loans or overdrafts Return: interest on amount loaned and outstanding Repaid over an agreed period Can be short or long-term No participation in the ownership of the company Often secured against the assets of the company

Topic: Shares, Shareholders and Share Prices
3.1 What is Business?

Raising Finance Through the Issue of New Shares
The issue of new share capital is a key source of finance for companies, particularly public companies whose shares are traded on a stock market.



The two main methods of issuing new shares for a public company are:

Flotation	Share issued on Stock Exchange for the first time Opportunity for existing shareholders to realise profits on their investment Costly + time-consuming process Typically aims to raise at least £25-50 million + of new capital
Rights issue	Fresh issue of new shares to existing shareholders Shareholders have the "right" to subscribe for the new shares, usually at a significant discount to the existing share price Often done to help finance a major expansion (e.g. takeover) or to help refinance a business in difficulty

The main benefits and drawbacks of raising finance through the issue of new shares include:

Benefits	**Drawbacks**
Able to raise substantial funds if the business has good prospects	Can be costly and time-consuming (particularly a flotation)
Broader base of shareholders	Existing shareholders' holdings may be diluted
Equity rather than debt = lower risk finance structure	Equity has a cost of capital that is higher than debt

Key Terms

Market capitalisation	The total market value of the issued share capital of a company based on the latest share price
Flotation	The admission of the shares of a public company to a stock exchange and subsequent trading in those shares

Topic: Stakeholders

3.1 What is Business?

What You Need to Know
What is a stakeholder
What interests and influence stakeholders have in a business
What potential conflicts can arise between stakeholders and how they can be managed

What is a Stakeholder?

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

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

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

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

Main Stakeholders in a Business

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

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

Key Interests of Main Stakeholder Groups

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

STAKEHOLDER	MAIN INTERESTS
Shareholders / owners	Return on investment + profits and dividends Success and growth of the business Proper running of the business
Managers & employees	Rewards, including basic pay and other financial incentives Job security & working conditions Promotion opportunities + job satisfaction & status – motivation, roles and responsibilities
Customers	Value for money Product quality & customer service
Suppliers	Continued, profitable trade with the business Financial stability – can the business pay its bills?

Topic: Stakeholders
3.1 What is Business?

STAKEHOLDER	MAIN INTERESTS
Banks & other finance	Can the business repay amounts loaned or invested? Profitability and cash flows of the business Growth in profits and value of the business
Government	The correct collection and payment of taxes (e.g. VAT) Helping the business to grow – creating jobs Compliance with business legislation
Society	Success of the business – particularly creating and retaining jobs Compliance with local laws and regulations (e.g. noise, pollution)

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

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

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

	High Level of Stakeholder Interest	Low Level of Stakeholder Interest
High Level of Stakeholder Power	Key players Take notice of them Engage directly with them	Keep them satisfied
Low Level of Stakeholder Power	Communicate regularly with them	Communicate only when necessary

Key Terms

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

Topic: Business Objectives
3.1 What is Business?

What You Need to Know
Common business objectives
Business mission, vision & aims

Purpose of Business Objectives
Business objectives are:
- The specific intended outcomes of business strategy
- The anticipated end results of a programme of activities
- Targets that the business adopts in order to achieve its primary aims

The main purposes of business objectives are to:
- Make a clear statement of what needs to be achieved
- Provide a focus for all business activity
- Aid and inform management decision-making
- Help set targets for individual and group achievement
- Provide a means of measuring performance

The Hierarchy of Business Objectives
Objectives are set at various levels in business. A useful way to visualise this is to think of a hierarchy of objectives, as shown in the diagram below:

- The objectives cascade down from the mission getting progressively more specific
- Overall objectives are translated into more specific objectives for different parts of the business
- The hierarchy ensures that at each level the objectives are consistent with the objectives that are above them in the hierarchy

Topic: Business Objectives
3.1 What is Business?

SMART Objectives
It is often thought that for business objectives to be used effectively, they should comply with the acronym SMART – which stands for:

Specific	The objective should state exactly what is to be achieved
Measurable	An objective should be capable of measurement – so that it is possible to determine whether (or how far) it has been achieved
Achievable	The objective should be realistic given the circumstances in which it is set and the resources available to the business
Relevant	Objectives should be relevant to the people responsible for achieving them
Time Bound	Objectives should be set with a time frame in mind. These deadlines also need to be realistic

Mission Statements
The mission of a business is the over-riding goal of the business and the reason for its existence. A mission provides a strategic perspective for the business and a vision for the future. An effective mission statement:
- Differentiates the business from its competitors
- Defines the markets or business in which the business wants to operate
- Is relevant to all major stakeholders - not just shareholders and managers
- Excites, inspires, motivates & guides – particularly important for employees

Mission statements are often criticised because they are:
- Not always supported by actions of the business
- Often too vague and general or merely statements of the obvious
- Viewed as a public relations exercise
- Sometimes regarded cynically by employees
- Not supported wholeheartedly by senior management

The Relationship between Corporate and Functional Objectives

Corporate objectives are what a business as a whole wants to achieve.
Functional objectives are set for the individual functions of a business and are designed to support (and be consistent with) corporate objectives.

Specific corporate objectives are usually set in terms of key performance measures for a business, including:

- Profit (value, margin)
- Return on investment
- Growth (revenues, profit)
- Market share
- Cash flow
- Business value (market capitalisation)

- Corporate image & reputation

Examples of how functional objectives can be set to support corporate objectives are shown in the table below:

Corporate Objective	**Example Functional Objective**
Increase sales	Successfully launch five new products in the next two years (**marketing**)
Reduce costs	Increase factory productivity by 10% by 2018 (**operations**)
Increase cash flow	Reduce the average time taken by customers to pay invoices from 75 to 60 days (**finance**)
Improve customer satisfaction	Achieve a 95% level of high customer service (**people**)

Themes & Direction for Corporate Objectives
The overall direction for a business setting corporate objectives helps determine which specific objectives are set. Common themes for such objectives are summarised below.

Corporate Objective: Survival
- A priority for new businesses since a large proportion of start-ups fail in the first few years
- Survival also a common objective for:
  - Established but loss-making businesses
  - Firms struggling to handle a shock in the external environment (e.g. economic downturn)
  - Business hit by competitive pressures or by loss of a major customer

Corporate Objectives: Revenues
Revenues (or sales) are a crucial indicator of the performance of a business. Common revenue objectives include:

Revenue Objective	**Example**
Revenue growth (percentage or value)	Aiming to grow total revenues by 10% Reach £1million in sales during a year
Sales maximisation	Aim to maximise total sales – regardless of whether those sales are profitable
Market share	Grow market share to 20% (will involve faster revenue growth than market competitors)

Corporate Objective: Cost Efficiency or Cost Minimisation
Cost efficiency aims to achieve the most cost-effective way of delivering goods and services to the required level of quality. The main benefits of achieving cost efficiency are:

- Lower unit costs (competitiveness)
- Higher gross profit margin
- Higher operating profits
- Improved cash flow
- Higher Return on Investment

Corporate Objectives: Profits and Profitability
Revenue and cost objectives are often set in order to support profit objectives. The most common profit objectives are:

Profit Objective	Example
Specific level of profit (in absolute terms)	Achieve an operating profit of £1m
Rate of profitability (as a % of revenues)	Achieve an operating profit margin of 10% of revenues
Profit maximisation	Maximise the total profit for the year
Exceed Industry or Market profit margins	Achieve a higher gross or operating profit margin than key competitors

Corporate Objectives: Employee Welfare
Employee-related objectives tend to be functional in nature (rather than corporate). However, successful services businesses place great emphasis on employee-related corporate objectives, in particular relating to staff retention and the quality of customer service.

Corporate Objectives: Customer Satisfaction
Customer satisfaction is usually at the heart of what successful businesses strive for. But it is rarely a specific corporate objective. Customer satisfaction is loosely linked with functional objectives relating to customer service and quality.

Corporate Objectives: Social
Corporate social responsibility ("CSR") is becoming increasingly important and, as a result, CSR is increasingly integrating into mission statements and vision. However, it is still unusual to see social objectives at the top of the objective hierarchy.

Key Terms

Corporate objective	The specific (SMART) targets that the business as a whole wants to achieve
Functional objectives	The specific objectives set for the individual functional areas of a business, designed to support the achievement of corporate objectives

Topic: Management and Leadership
3.2 Managers, Leadership and Decision-Making

What You Need to Know
What is leadership
How leadership compares with management
Leadership styles
Models of leadership & management • Tannenbaum and Schmidt • Blake Mouton Managerial Grid

What is Leadership?
Leadership is the way in which one person influences the behaviour or actions of other people.

The role of leadership in modern business is changing. Traditionally leadership has been associated with the need to **command and control** a business and to take decisions. However, in modern business the role of leadership is increasingly about:

- Inspiring employees
- Creating a vision – a clear sense of the purpose and direction of the business
- Shaping the core values & culture of the business
- Building effective teams

Why Leadership is Increasingly Important in Business
The need for effective leadership within a business is becoming increasingly vital, particularly because of:

- **Changing organisational structures**
  - Flatter hierarchies + greater use of delegation
  - Increasing emphasis on teamwork + focus on quality assurance
  - Coaching, support & empowerment
- **Rapid Change**
  - Change is becoming a constant feature of business life
  - Soft skills of leadership & management increasingly important

How Leadership Compares with Management
The two concepts of leadership and management are closely linked. However, there is an important distinction between the two. In summary:

Leaders	**Managers**
Set the strategy and objectives	Implement the strategy
Inspire people	Coordinate resources
Build relationships	Use their authority to take decisions
Take risks	Manage risks
Have followers	Have subordinates

Topic: Management and Leadership

3.2 Managers, Leadership and Decision-Making

The Three Key Levels of Management in a Business

The management structure of a business will vary depending on several factors, in particular the scale and complexity of the firm as well as its organisational culture. However, traditionally, management takes place at three core levels in a business:

1. Senior Management
- E.g. Board of Directors
- Set corporate objectives & strategic direction
- Board is responsible to shareholders; led by the CEO

2. Middle Management
- Accountable to senior management
- Run business functions and departments

3. Junior Management
- Supervisory role, accountable to middle management
- Monitor & control day-to-day tasks, and manage teams of workers

Leadership Styles

A leadership style is determined by:
- The way that the functions of leadership are carried out
- How a leader behaves

The leadership styles of successful business people (and others in non business roles) have been scrutinised in great detail by academics – all searching for that precious insight about what makes an effective leadership style.

The four traditional classifications of leadership style are:

Authoritarian	**Paternalistic**
Democratic	**Laissez-faire**

The perceived features of the four traditional leadership styles are:

Authoritarian	Paternalistic
Focus of power is with the manager Communication is top-down & one-way Formal systems of command & control Use of rewards & penalties Very little delegation Consistent with McGregor Theory X approach	Leader decides what is best for employees Links with Mayo (motivation) – addressing employee needs Akin to a parent/child relationship Still little delegation A softer form of authoritarian leadership
Democratic	**Laissez-faire**
Focus of power is more with the group as a whole Leadership functions are shared within the group Employees have greater involvement in decision-making Emphasis on delegation and consultation A trade-off between speed of decision-making and better motivation and morale?	Leader has little input into day-to-day decision-making Conscious decision to delegate power Managers / employees have freedom to do what they think is best Effective when staff are ready and willing to take on responsibility Not the same as abdication – but not far off!

As a general observation, the use of autocratic leadership styles is increasingly viewed as out-dated in the modern business. There will always be circumstances where autocratic leadership may be effective and desirable (e.g. where a business is facing failure and requires painful restructuring). However, the following factors suggest a move away from autocratic leadership:

- Changes in society's values
- Better-educated workforce
- Focus on need for soft HR skills
- Changing workplace organisation
- Greater workplace legislation
- Pressure for greater employee involvement

Tannenbaum and Schmidt – Continuum of Leadership Behaviour
Tannenbaum and Schmidt devised their continuum that illustrates a range of potential leadership and management styles.

The Tannenbaum and Schmidt Continuum recognises that the chosen leadership style depends on a variety of factors, including the leader's personality, the perceived qualities of subordinates. It also allows for "situational" factors such as the need for urgency in leadership and decision-making.

The continuum represents a range of action related to the:

- Degree of authority used by the leader or manager
- Area of freedom available to non-managers

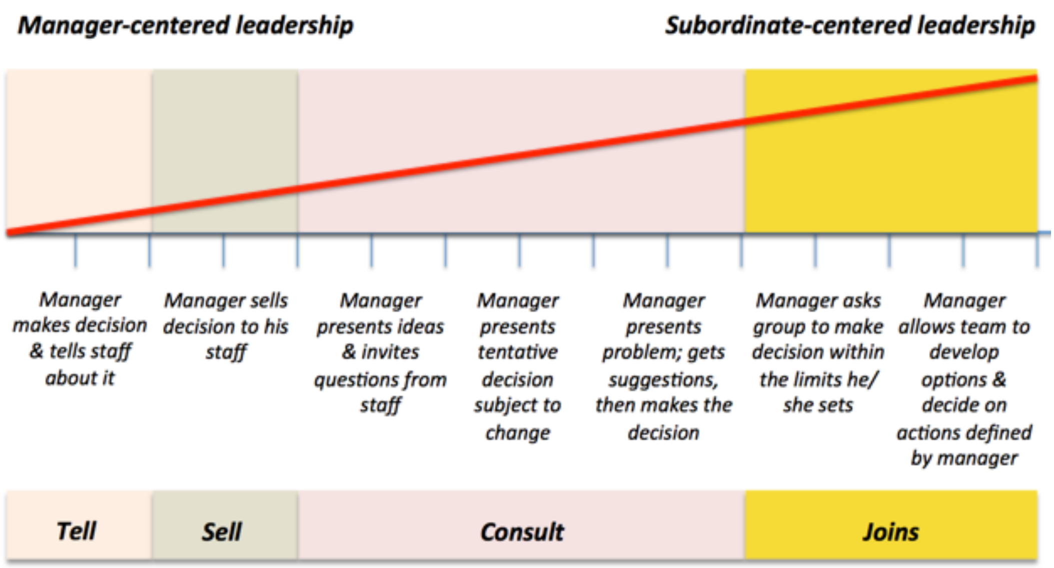
Topic: Management and Leadership

3.2 Managers, Leadership and Decision-Making

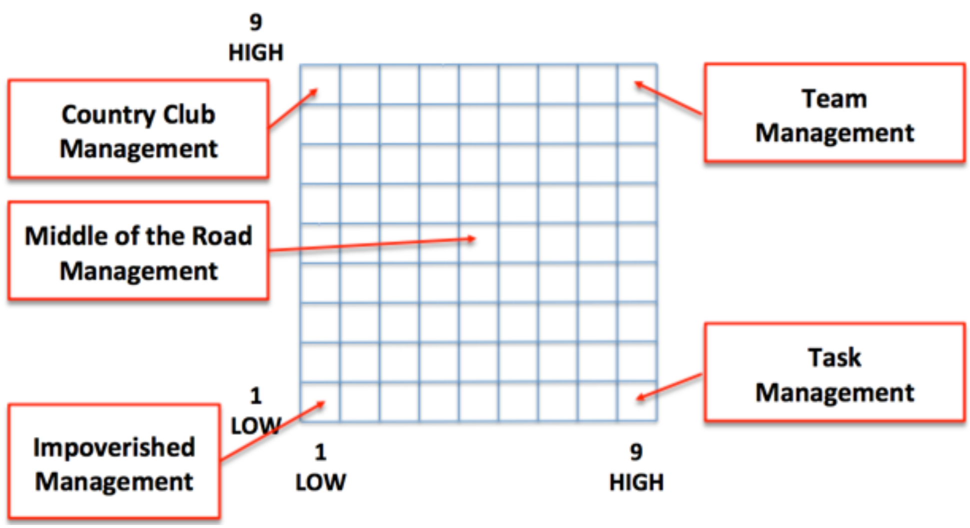
The Tannenbaum and Schmidt Continuum identified four main styles of leadership:

TELLS	Leader identifies problems, makes decision and announces to subordinates; expects implementation
SELLS	Leader still makes decision, but attempts to overcome resistance through discussion & persuasion
CONSULTS	Leader identifies problem and presents it to the group. Listens to advice and suggestions before making a decision
JOINS	Leader defines the problem and passes on the solving & decision-making to the group (which manager is part of)

The continuum is illustrated below:



Blake Mouton Managerial Grid



Topic: Management and Leadership
3.2 Managers, Leadership and Decision-Making

Through a series of questions about their leadership and management style, the position on the Blake Mouton grid is mapped in terms of:

Concern for People (High = 9 Low = 1): this is the degree to which a leader considers the needs of team members, their interests, and areas of personal development when deciding how best to accomplish a task.

Concern for Task (High = 9 Low = 1): this is the degree to which a leader emphasizes concrete objectives, organizational efficiency and high productivity when deciding how best to accomplish a task.

Whilst someone's position could be anywhere on the grid depending on the relative importance he/she attaches to People and Task, the Blake Mouton Grid highlights five extremes on the grid - each of which is given a memorable name:

STYLE	FEATURES	CONCERN FOR PEOPLE	CONCERN FOR TASK
Impoverished Management	Laissez-faire style; minimal effort on management; hoping to avoid blame for errors	**1**	**1**
Country Club Management	Focus on creating safe, comfortable working environment; minimal conflict	**9**	**1**
Task Management	Autocratic style, consistent with McGregor Theory X. Workers have to complete tasks – nothing else	**1**	**9**
Team Management	Staff closely involved in decision-making & feel valued; consistent with McGregor Theory Y	**9**	**9**
Middle of the Road Management	Compromises made to achieve acceptable performance; thought to be the less effective leadership style	**5**	**5**

Key Terms

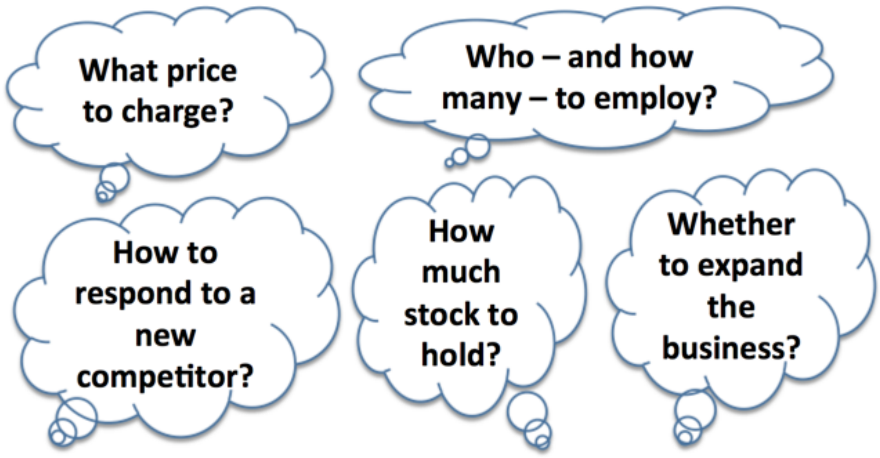
Leadership style	The manner and approach of providing direction, implementing plans, and motivating people
Management	Management is the art of getting things done through people (source: Drucker)

Topic: Decision-Making (Introduction)

3.2 Managers, Leadership and Decision-Making

What You Need to Know
Hunch v scientific decision-making
Key influences on decision-making
Opportunity cost & how it influences decision-making

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



Key Influences on Business Decision-Making
The approach taken to making business decisions is influenced by a variety of factors, the key ones of which are outlined below:

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

- Do the uncertainties in the external environment make scientific approaches less reliable?

Hunch & Scientific: Two Broad Approaches to Decision-Making
There are two main ways in which business decisions are made:

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

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

Opportunity Cost
This is an important concept that is often significant to business decision-making, particularly where resources are limited and choices have to be made.

Opportunity cost is the cost of missing out on the next best alternative. In other words, opportunity cost represents the benefits that could have been gained by taking a different decision.

Opportunity cost is important, and should be taken into account, because:

- For most businesses resources are limited (particularly start-ups)
- When resources are scarce, significant decisions about what to spend and where to focus become more risky
- Entrepreneurs and managers take calculated risks and weigh-up the potential implications of decisions (opportunity costs) before choosing the options they believe are best for their business

Key Terms

Opportunity cost	The benefits foregone of the next best alternative as result of a decision
Scientific decision-making	Decisions taken on the basis of analysis of data and evidence
Big data	Huge, often unstructured data sets that exceed the processing capacity of conventional database systems.

Decision Trees

3.2 Managers, Leadership and Decision-Making

What You Need to Know
What is a decision tree?
Calculating expected values
Assessing the value of decision trees

Introduction

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

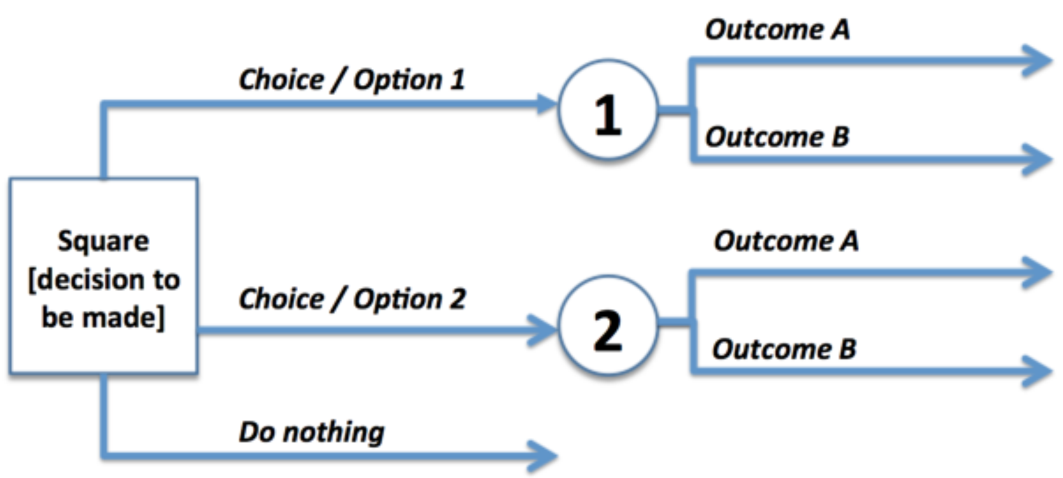
Let's look at an example of how a decision tree is constructed. We'll use the following data:

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

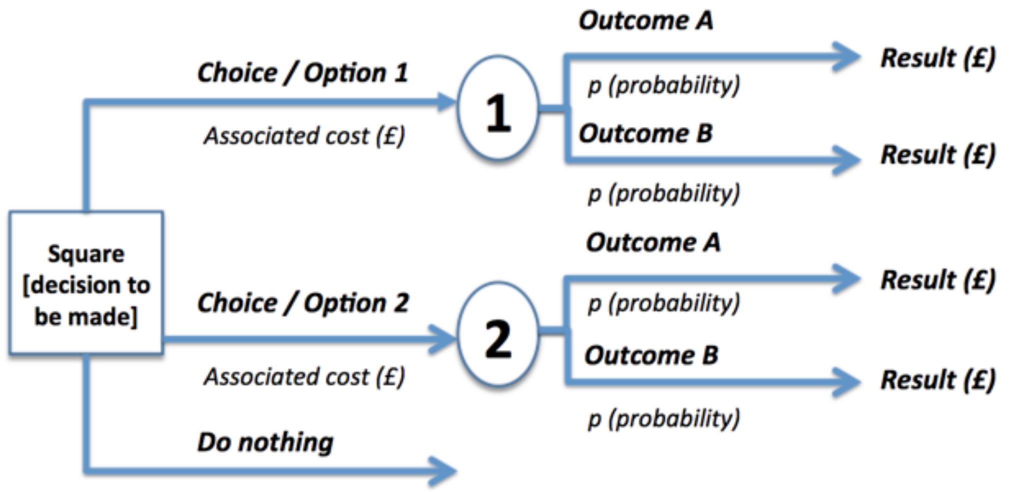
Constructing the Decision Tree

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

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

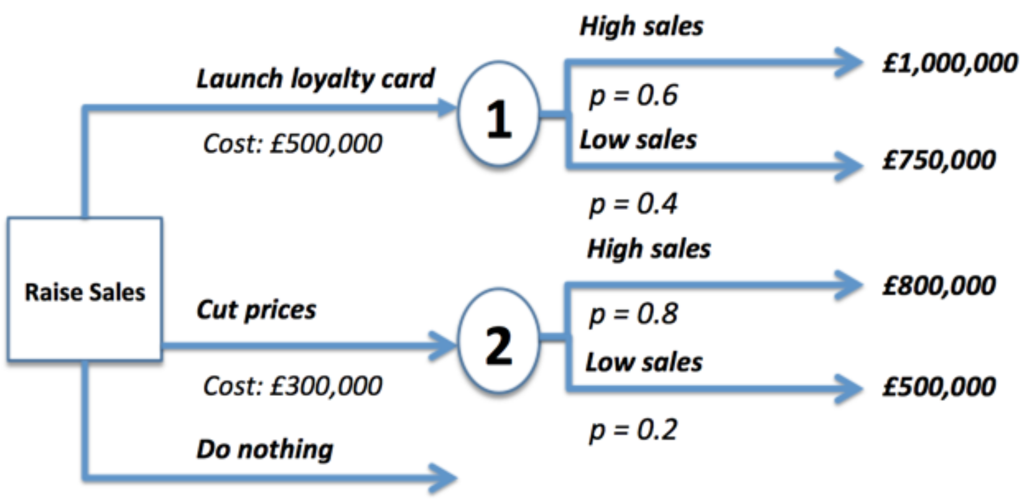


Next we add in the associated costs, outcome probabilities and financial results for each outcome.



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

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



Finally we complete the maths in the model by calculating:

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

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

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

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

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

Benefits and Drawbacks of Using Decision Trees

These can be summarised as follows:

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

Key Terms

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

Topic: Marketing Objectives

3.3 Decision-making to Improve Marketing Performance

What You Need to Know
What are marketing objectives
Examples of marketing objectives
Value of setting marketing objectives
Internal and external influences on marketing objectives and decisions

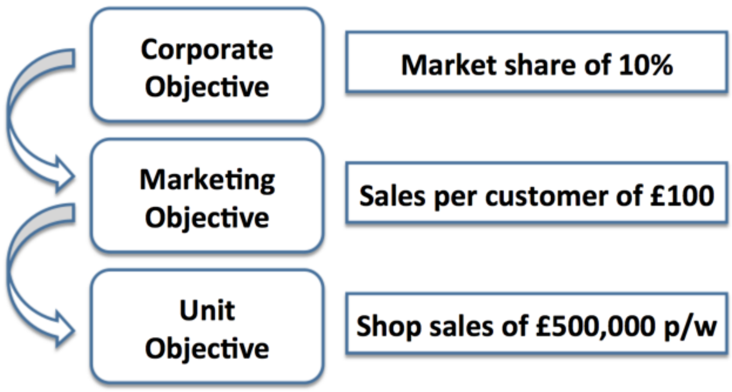
Objectives and the Role of Marketing

To understand the role of marketing objectives, it is important first to remember what marketing is trying to achieve:

Marketing is "the process of identifying, anticipating (predicting) and satisfying customer needs profitably".

Marketing objectives need to be consistent with the purpose of marketing. They also need to be consistent with and support the overall corporate (business) objectives:

An example of how marketing objectives might support corporate objectives could be like this:



Once the marketing objectives have been set, the marketing strategy is determined, which in turn leads to an appropriate marketing mix designed to deliver the strategy. For example:

Topic: Marketing Objectives
3.3 Decision-making to Improve Marketing Performance

	Example
Corporate objectives	Grow revenues by 15% p.a. in each of the next five years
Marketing objectives	Increase UK market share to 17% Grow average customer spend by 5%
Marketing strategies	Refocus product range on high margin items Introduce customer relationship management systems into industrial division
Marketing mix	Improve agreements with key suppliers Launch new distribution channel Attend exhibitions in new territories

Examples of Marketing Objectives Supporting Corporate Objectives
In the table below we have provided some examples of how marketing objectives could be set to support the overall corporate objectives.

Objective	**Example Marketing Objectives**
Maintaining or increasing market share	• Achieve revenue growth of 20% per year for the next four years • Increase our market share in the UK by 5% by 2017 • Add 1,000 new customer accounts generating at least £100,000 per account within four years
Developing new products / innovation	• Launch at least 25 new products into the industrial channel in 2016 and 2017 • Grow average first-year sales of new editions by 25% in the Higher Education sector
Meeting the needs of customers	• Achieve at least an 95% excellent customer service rating each month • Increase the proportion of sales bookings from repeat business to 45% for the summer season
Entering a new market / market positioning	• Supply a minimum of 50,000 trial downloads per month • Increase the number of customer enquiries from the EU by 10,000 per month • Recruit five distribution agents in the four target countries within 12 months
Gaining an advantage over competitors	• Reduce average distribution costs to less than 5% of gross revenue • Reduce the order lead time by 15% • Improve brand recognition amongst the 25-34 age group

Topic: Marketing Objectives

3.3 Decision-making to Improve Marketing Performance

Marketing Objectives and other Functional Areas

The marketing objectives set will inevitably have an impact on the other functional areas of the business. Some examples are show below:

Example Functional Change	How it Supports Marketing
Raising finance	Investment in new products
Introduce quality assurance and lean production	Improve product quality and profitability
Training programme for staff	Improve quality of customer service
Allocate specific production for a new retail customer	Expand product distribution and increase sales

Business Benefits of Setting Marketing Objectives

Provided the marketing objectives are relevant and achievable, there are some important business benefits from setting them and monitoring progress against them. Effective marketing objectives:

- Ensure functional activities consistent with corporate objectives
- Provide a focus for marketing decision-making and effort
- Provide incentives for marketing team and a measure of success / failure
- Establish priorities for marketing resources and effort

Potential Problems with Setting Marketing Objectives

The use of marketing objectives is not without issues. Some of the key ones are:

Problem	Examples
Fast-changing external environment	• Changes in legislation impacting the whole market • New competitor enters the market
Potential conflict between marketing objectives	• Trying to increase market share by cutting prices may damage objectives for brand perception
Easy to be too ambitious with marketing objectives	• Growing market share without putting necessary resources in place to achieve it
Entering a new market / market positioning	• Supply a minimum of 50,000 trial downloads per month • Increase the number of customer enquiries from the EU by 10,000 per month • Recruit five distribution agents in the four target countries within 12 months
Gaining an advantage over competitors	• Reduce average distribution costs to less than 5% of gross revenue • Reduce the order lead time by 15% • Improve brand recognition amongst the 25-34 age group

Topic: Marketing Objectives

3.3 Decision-making to Improve Marketing Performance

Internal Influences on Marketing Objectives

Some of the key internal factors influencing the setting and achievement of marketing objectives are:

Influence	Explanation
Corporate objectives	Corporate objectives are the most important internal influence. A marketing objective should not conflict with a corporate objective
Finance	The financial position of the business (profitability, cash flow, liquidity) directly affects the scope and scale or marketing activities
Human resources	For a services business in particular, the quality and capacity of the workforce is a key factor in affecting marketing objectives. A motivated and well-trained workforce can deliver market-leading customer service and productivity to create a competitive marketing advantage
Operational issues	Operations has a key role to play in enabling the business to compete on cost (efficiency / productivity) and quality. Effective capacity management also plays a part in determining whether a business can achieve its revenue objectives
Business culture	E.g. a marketing-orientated business is constantly looking for ways to meet customer needs. A production-orientated culture may result in management setting unrealistic or irrelevant marketing objectives.

External Influences on Marketing Objectives

Some of the key external factors influencing the setting and achievement of marketing objectives are:

Influence	Description
Economic environment	The key factor in determining demand. E.g. marketing objectives thwarted or changed as a result of the recession. Factors such as exchange rates would also impact objectives concerned with international marketing.
Competitor actions	Marketing objectives have to take account of likely / possible competitor response. E.g. an objective of increasing market share by definition means that competitor response will not be effective.
Market dynamics	The key market dynamics are market size, growth and segmentation. A market whose growth slows is less likely to support an objective of significant revenue growth or new product development.
Technological change	Many markets are affected by rapid technological change, shortening product life cycles and creating great opportunities for innovation.
Social & political change	Changes to legislation may create or prevent marketing opportunities. Change in the structure and attitudes of society also have major implications for many markets.

Topic: Marketing Research
3.3 Decision-making to Improve Marketing Performance

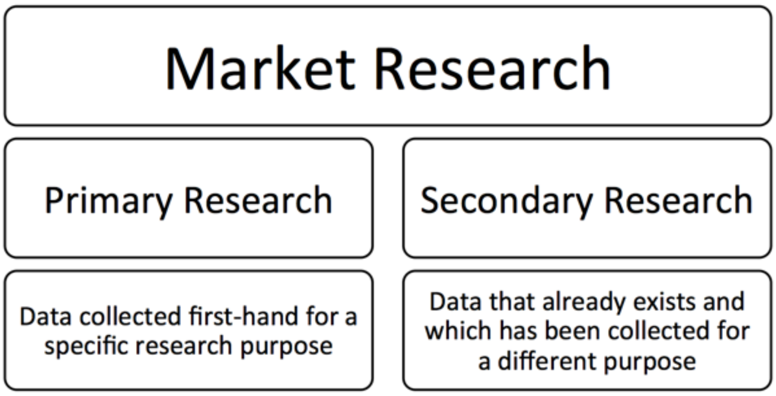
What You Need to Know
Main types of market research
Value of primary and secondary research
Qualitative and quantitative research
Methods and value of sampling

What is Marketing Research?
Marketing research involves the gathering and analysis of research to help support the implementation of marketing strategy.

The right kind of market research can provide important insights that aid marketing strategy and decision-making. For example:

- Dimensions of the market (size, structure, growth, trends etc.)
- Competitor strategies (market share, positioning, USPs)
- Needs, wants and expectations of customers (& how these are changing)
- Market segments – existing and potential opportunities for new segments

Primary and Secondary Research
There are two main types of marketing research – primary and secondary:



The main benefits and drawbacks of primary and secondary research are outlined below:

PRIMARY RESEARCH	SECONDARY RESEARCH
BENEFITS	
Directly focused to research objectives	Often free and easy to obtain
Kept private – not publicly available	Good source of market insights
More detailed insights – particularly into customer views	Quick to access and use
DRAWBACKS	
Time-consuming and costly to obtain	Can quickly become out of date
Risk of survey bias	Not tailored to business needs
Sampling may not be representative	Specialist reports often quite expensive

The main formats of primary and secondary research are:

PRIMARY RESARCH	SECONDARY RESEARCH
Focus groups Observation Surveys Telephone interviews Test marketing Experiments	Published market research reports Internal transactional data Google Official statistics (ONS) Trade associations Media reports Competitor materials

More on the Main Methods of Primary Research

Observation	Watching how consumers behave provides many insights, but can leave questions unanswered. Observation works well in retail markets; sit outside a shop and watch how many people walk by, look at the window display etc.
Postal surveys	Sent to the address of potential customers who complete the form and send back in a pre-paid envelope. Relatively cheap, a postal survey can cover a wide geographical area and avoids the potential for interviewer bias. However, response rates (the proportion of people sending back a completed survey) are often very low and it can take be a long time before enough surveys are returned
Telephone interviews	Not to be confused with "telesales" (which is a method of selling), the telephone interview allows quicker feedback than a postal survey. However, potential customers are often wary of being called and may be reluctant to give anything other than short answers
Online surveys	Increasingly popular and relatively low cost, online surveys are widely used by small businesses as a way of capturing the views of existing and potential customers
Face-to-face surveys	Personal interviews conducted face-to-face. A costly, but good way to get detailed insights from an individual
Focus groups	Groups of potential customers are brought together to discuss their feelings about a product or market. Focus groups are a good way of getting detailed information about customer tastes and preferences
Test marketing	This involves selling a new product in a small section of the market in order to assess customer reaction. For example, a start-up could start by selling to a limited local area in order to iron-out product issues. Software firms often test-market their products by offering "beta" versions for testing by a small group of potential customers. Test marketing can be a good predictor of how a new product or service will be received by the larger market (provided that it can be kept secret from competitors!

Quantitative v Qualitative
Another useful way of categorising market research is to make a distinction between research that is based on hard data, and research that is based on views and opinions. This is what we mean be quantitative & qualitative research.

Key points on quantitative research:

- Concerned with and based on data
- Addresses research questions such as "how many?" "how often", "who?", "when?" and "where?"
- Based on larger samples and is, therefore, more statistically valid
- Main methods of obtaining quantitative data are the various forms of survey – i.e. telephone, postal, face-to-face and online

Key points on qualitative research:

- Based on opinions, attitudes, beliefs and intentions
- Answers research questions such as "Why"? "Would? or "How?"
- Aims to understand why customers behave in a certain way or how they may respond to a new product or service
- Focus groups and interviews are common methods used to collect qualitative data

The main benefits and potential drawbacks of qualitative research include:

BENEFITS	**DRAWBACKS**
Essential for important new product development and launches	Expensive to collect and analyse – requires specialist research skills
Focused on understanding customer needs, wants, expectations = very useful insights for a business	Based around opinions – always a risk that sample is not representative
Can highlight issues that need addressing – e.g. why customers don't buy	
Effective way of testing elements of the marketing mix – e.g. new branding, promotional campaigns	

The main benefits and potential drawbacks of quantitative research include:

BENEFITS	**DRAWBACKS**
Data relatively easy to analyse	Focuses on data rather than explaining why things happen
Numerical data provides insights into relevant trends	Doesn't explain the reasons behind numerical trends
Can be compared with data from other sources (e.g. competitors, history)	May lack reliability if sample size and method is not valid

Sampling in Marketing Research
Sampling involves the **gathering of data from a sample of respondents, the results of which should be representative of the population (e.g. target market) as a whole**.

Sampling is widely used in marketing research and it can provide statistically valid insights into the profile of the overall population (e.g. market) being analysed.

The main benefits and potential drawbacks of sampling are summarised below:

Topic: Marketing Research
3.3 Decision-making to Improve Marketing Performance

BENEFITS	**DRAWBACKS**
Even a relatively small sample size (if representative) can provide useful research insights	Biggest risk = sample is unrepresentative of population – leading to incorrect conclusions
Using sampling before making marketing decisions can reduce risk and costs	Risk of bias in research questions
Sampling is flexible and relatively quick	Less useful in market segments where customer tastes & preferences are changing frequently

Key Terms

Marketing research	Collection of data to obtain insight and knowledge into the needs and wants of customers and the structure and dynamics of a market
Primary data	Research data collected first-hand for a specific purpose
Secondary data	Existing research data that has been collected and analysed for a different purpose
Quantitative research	Research based on numerical data
Qualitative research	Research based on views and opinions

Topic: Interpreting Marketing Data
3.3 Decision-making to Improve Marketing Performance

What You Need to Know
Correlation
Extrapolation
Confidence Intervals and Levels

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

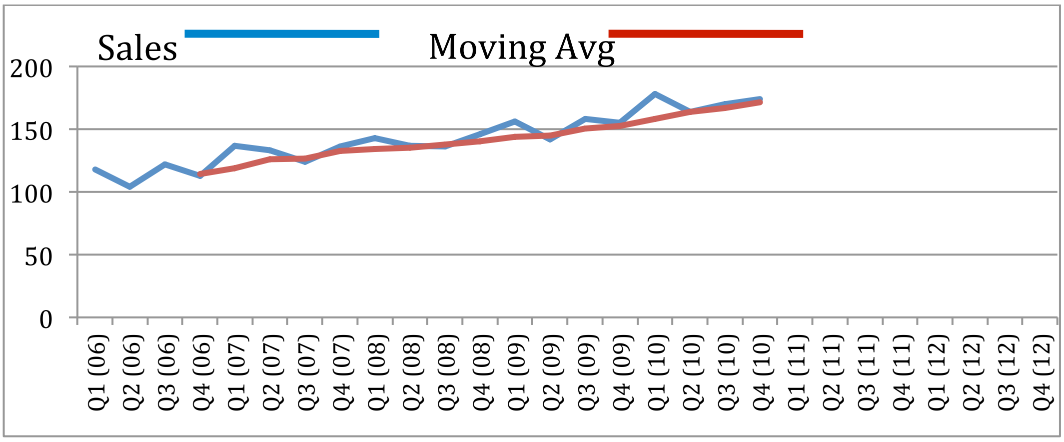
The basic assumption of extrapolation is that the trend / pattern will continue into the future unless evidence suggests otherwise.

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

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

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

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

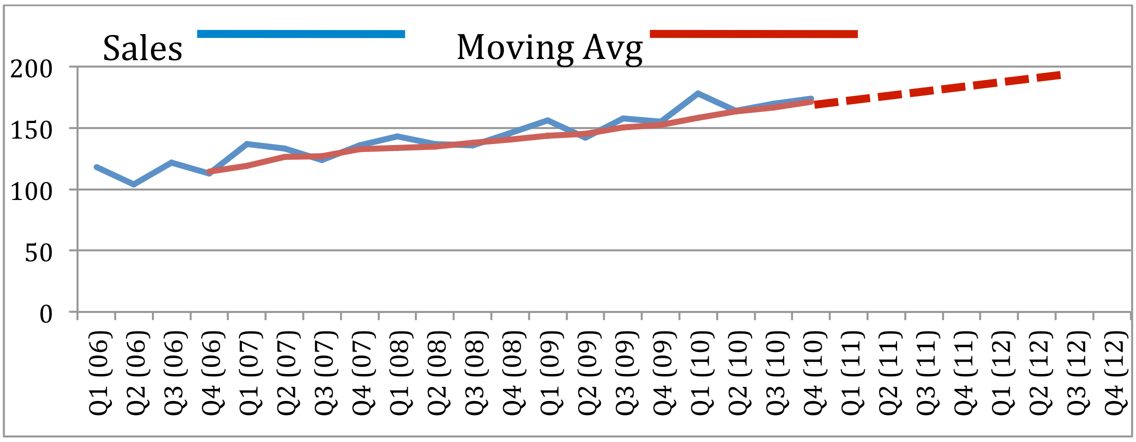


The moving average helps point out the growth trend (expressed as a percentage growth rate), and it is this which extrapolation would use first to predict the path of future sales. This could be done mathematically using a spreadsheet.

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

Topic: Interpreting Marketing Data

3.3 Decision-making to Improve Marketing Performance



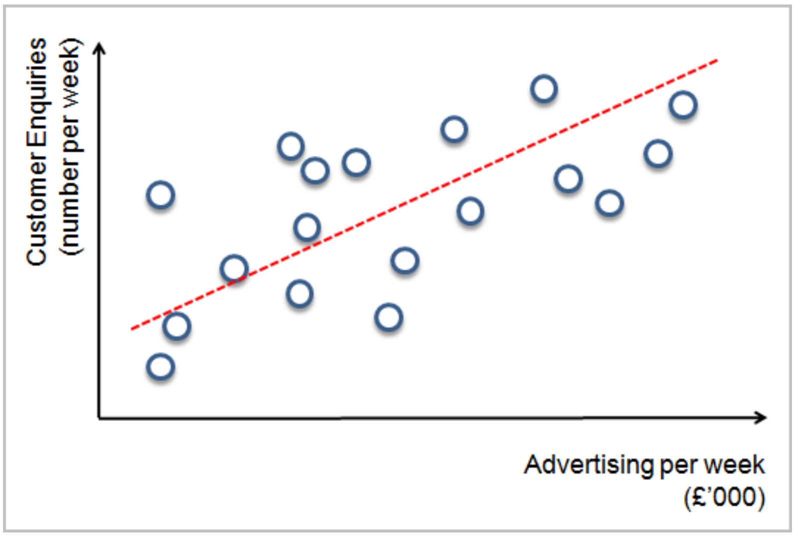
How useful is extrapolation? The main benefits and drawbacks are summarised below:

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

Correlation

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

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



It is normal convention to show the:

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

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

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

There are three kinds of possible correlation:

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

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

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

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

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

Confidence Intervals and Levels
A confidence interval gives the **percentage probability that an estimated range of possible values in fact includes the actual value being estimated**.

Confidence intervals are a useful predictive data tool in business for several reasons:

- Businesses benefit from the use of statistics in estimating or predicting future events

Topic: Interpreting Marketing Data
3.3 Decision-making to Improve Marketing Performance

- A confidence interval helps a business evaluate the reliability of a particular estimate
- Because no estimate can be 100% reliable, businesses need to know how confident they should be in their estimates and whether or not to act on them

Here are some examples of how confidence intervals might be used to support business decision-making:

BUSINESS ACTIVITY	HOW CONFIDENCE INTERVALS ARE USED
Quality management	Percentage reliability of machines Chance that quality control samples will detect issues
Market research	Statistical estimates for sales forecasting Reliability of data from customer surveys
Risk management & contingency planning	Risks of sales forecasts not be achieved Scenario planning for competitor actions
Budgeting & forecasting	Likely range of revenues and costs based on key assumptions Sales forecasts to support new product launches

Key Terms

Extrapolation	The use of trends established by historical data to make predictions about future values.
Correlation	A method of forecasting that looks at the strength of a relationship between two variables
Confidence intervals	The percentage probability that an estimated range of possible values in fact includes the actual value being estimated.

Topic: Marketing Maths
3.3 Decision-making to Improve Marketing Performance

What You Need to Know
How to calculate:
Market size
Market growth
Market share

Introduction
When analysing marketing data and setting marketing objectives, it is important to be able to calculate and interpret these three key marketing measures:

- Market size
- Market growth
- Market share

Let's look at each in turn.

Market Size
As the name implies, market size is a measure of the total available demand for competitors in a market. Key points to remember about market size are:

- It indicates the potential sales for a firm (the "size of the prize")
- Normally measured in terms of annual sales or volume sold per year
- Usually measured in terms of both volume (units) and value (sales)
- Size of individual segments within the overall market can also be measured
- Not normally a marketing objective – since a firm cannot influence it
- Not always easy to measure, since how you define the market determines what you are trying to measure!

Index numbers are a useful way of illustrating how market size changes over time:

Year	Market Size (£)	Index Number (2012 = 100)
2012	5,000,000	100
2013	5,250,000	105
2014	5,600,000	112
2015	6,250,000	125

Market Growth
Market growth measures the rate of change of market size, which might be rising, falling or remaining stable. Key points to remember about market growth are:

- A key indicator for existing and potential market entrants – more businesses might be expected to try to enter fast-growing markets
- Growth rate can be calculated using either value (e.g. market sales) or volume (units sold)
- Market growth is usually expressed as a percentage change on the previous period
- Growth is usually measured on an annual basis

Topic: Marketing Maths

3.3 Decision-making to Improve Marketing Performance

An example of how market growth is calculated is shown in the table below. In this example we've used volume sold as the measure of market size. The same kind of calculation would be applied to a revenue-based measure of market size.

Year	Units Sold [A]	Change (Units) [B]	Growth Rate (%) [B]/[A from previous year] x 100
2012	1,000,000	-	-
2013	1,100,000	100,000	10.0%
2014	1,350,000	250,000	22.7%
2015	1,475,000	125,000	9.3%

Market Share

Market share is a really important measure and in many businesses it forms the basis for a key corporate objective. Key points about market share:

- Expressed as a percentage
- Explains how the overall market is split between the existing competitors
- Tends to be calculated based on market value, but volume can also be used
- Good indicator of competitive advantage: market leaders (with the highest market share) usually have some kind of advantage
- Key is to look for significant +/- changes (for example a business that used to enjoy the largest market share but which has now lost its leadership position).

Here is an example of how the market share is calculated.:

Business	Sales in 2015 (£)	Cumulative Market Sales (£)	Market Share (%) in 2015
A	250,000	250,000	12.5%
B	400,000	650,000	20.0%
C	900,000	1,550,000	45.0%
D	175,000	1,725,000	8.75%
E	275,000	2,000,000	13.75%

Key Terms

Market size	The overall size (value or volume) or demand for a specific market
Market growth	The percentage rate of growth in market size over a period
Market share	The proportion of market size held by each competitor in a market

Topic: Marketing Mix (Introduction)
3.3 Decision-making to Improve Marketing Performance

What You Need to Know
The elements of the extended marketing mix (7P's)
How the marketing mix elements work together
Influences on the marketing mix
Effects of changes in the marketing mix

What is the Marketing Mix?
The marketing mix is the **combination of elements used by a business to enable it to meet the needs and expectations of customers.**

It is called a marketing mix because each element of the marketing mix is related to the others. The challenge for marketing is to ensure that the elements of the mix work together to achieve the marketing objectives.

Traditionally the marketing mix has been taken to comprise four elements:

Element	Description
Product	The good or service that the customer buys
Price	How much the customer pays for the product
Place	How the product is distributed to the customer
Promotion	How the customer is found & persuaded to buy

The Extended Marketing Mix (7P's)

In recent years it has become more common to add three new elements to the traditional marketing mix, making a combined 7p's:

Element	Description
People	The people who make contact with customers in delivering the product
Process	The systems and processes that deliver a product to a customer
Physical	The elements of the physical environment the customer experiences

The extended marketing mix (7P's) therefore comprises:

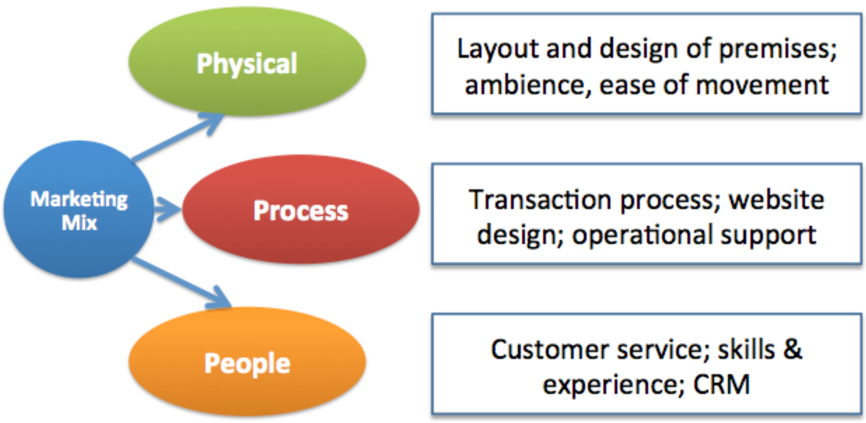
Topic: Marketing Mix (Introduction)

3.3 Decision-making to Improve Marketing Performance

A key implication of an extended marketing mix is that the seven elements need to work even closer together for marketing to be effective.:

- E.g. Customer service, HR (recruitment & training)
    - Technology becomes increasingly important
- E.g. role of IT in e-commerce & customer communication
    - Intangible elements such as branding play an enhanced role

In particular, extending the marketing mix by adding Physical, Process and People to usual 4P's connects the marketing function much closer to both human resource management and operations. Examples are illustrated below:



An Example of the Extended Marketing Mix

To illustrate how the elements of the 7P's work together, consider how budget hotel operator Premier Inn has to make its mix work well:

MIX ELEMENT	HOW USED
PRODUCT	Hotel accommodation & related services Proposition: a "good night's sleep – guaranteed"
PRICE	Dynamic pricing; from approx. £69 per night depending on location & availability
PROMOTION	TV advertising; online & social media
PLACE	Predominantly sold direct; emphasis on online booking
PEOPLE	Hotel reception staff; restaurant & bar staff
PROCESS	Online booking ! Hotel operation
PHYSICAL	Branding | Staff uniforms | Hotel ambience| Facilities, Standardised room layout

What Makes an Effective Marketing Mix?

Every business is different and there is no such thing as a standard or perfect marketing mix. However, businesses with effective marketing mixes tend to find that the chosen mix:

- Achieves marketing objectives
- Meets customer needs
- Is balanced and consistent

Topic: Marketing Mix (Introduction)

3.3 Decision-making to Improve Marketing Performance

- Is focused around creating a competitive advantage (emphasising the value proposition)
- Is consistent with the chosen target market and positioning

Influences on the Marketing Mix

It is important to remember the purpose of the marketing mix. It is there to deliver the chosen marketing strategy, which in turn is determined by the marketing objectives. The most important influence on the marketing mix is, therefore the market segmentation, targeting and positioning strategy adopted.

Segmentation → Targeting → Positioning → Marketing Mix

Other important influences on the marketing mix include:

Business Resources	Particularly finance – impacts what activities can be undertaken (e.g. promotion, new product development)
Technology	Rapid technological change impacting on all aspects of the marketing mix, not just product and promotion
Importance of Customer Relationships	Need to generate repeat business and build customer loyalty increasingly important. Marketing mix needs to reflect this.

Key Terms

Marketing mix	The combination of elements used by a business to enable it to meet the needs and expectations of customers.

Topic: Segmentation, Targeting & Positioning

3.3 Decision-making to Improve Marketing Performance

What You Need to Know
Types and use of market segmentation
Benefits and drawbacks of segmentation
Niche and mass markets
Choosing a target market
Product differentiation
Market positioning

Introduction to Marketing Strategy

Businesses use marketing to create value for customers by making two key decisions:

Decision 1: Choose which customers to serve

This involves two elements:

- **Market segmentation** (analysing the different parts of a market)
- **Targeting** (deciding with market segments to enter)

Decision 2: Choose how to serve those customers

This also involves two important parts of marketing strategy:

- **Product differentiation** (what makes it difference from the competition)
- **Marketing positioning** (how customers perceive the product)

Market Segmentation

Market segmentation involves dividing a market into **parts that reflect different customer needs and wants**.

Segmentation is possible because in almost all markets there are differences in factors such as:

- Customer needs & wants
- How customers buy
- Location of customers
- Knowledge & experience of customers

Recognising and understanding these differences are the first steps in an effective approach to market segmentation.

Four traditional ways (bases) of segmenting a market are:

SEGMENT BASIS	SUMMARY
DEMOGRAPHIC	Dividing a market into segments based on demographic variables such as age, gender, family lifestyle, religion, nationality ethnicity etc.
INCOME	Dividing markets into different income segments, often on the basis of social-economic grouping
BEHAVIOURAL	Dividing a market into segments based on the different ways customers use or respond to a product and the benefits they seek
GEOGRAPHICAL	Dividing a market into different geographical units, such as nations, regions, cities, neighbourhoods or other territories

Benefits and Drawbacks of Market Segmentation

Among the key benefits are that segmentation:

- Focuses resources on parts of a market where the business can succeed
- Allows a business to grow share in markets or to "ride the wave" of fast-growing segments
- Helps with new product development – focused on needs of customers in the segment
- Helps make the marketing mix more effective – e.g. better targeting of promotion

On the other hand:

- Segmentation is an imprecise science – data about each market segment is not always available, up-to-date or reliable
- Just because you can identify a segment doesn't mean you can reach the customers in it!
- Markets are increasingly dynamic – fast-changing; so too are the segments

Niche and Mass Markets

Another way of analysing the differences between markets is to make a distinction between **niche** and **mass** markets. This is a similar idea to market segmentation, although it is based more on the overall characteristics of a market (e.g. size, extent of product differentiation) than other ways in which customer needs and wants are different.

Niche Marketing	Where a business targets a **smaller segment of a larger market,** where customers have specific needs and wants
Mass Marketing	Where a business sells into the **largest part of the market**, where there are many similar products offered by competitors

The key features of a mass market (reverse these to identify key features of a niche) are:

- Customers form the majority in the market
- Customer needs and wants are more "general" & less "specific"
- Associated with higher production output and capacity + potential for economies of scale
- Success usually associated with low-cost (highly efficient) operation or market leading brands

So, given that a mass market is a larger opportunity, why might a business want to target a niche? As with all marketing choices there are potential benefits and drawbacks:

Topic: Segmentation, Targeting & Positioning
3.3 Decision-making to Improve Marketing Performance

Advantages of Targeting a Niche	Disadvantages of Targeting a Niche
Less competition - a "big fish in a small pond" Clear focus - target particular customers Builds up specialist skill and knowledge Can often charge a higher price Profit margins often higher Customers tend to be more loyal	Lack of economies of scale Risk of over dependence on a single product or market Likely to attract competition if successful Vulnerable to market changes – all "eggs in one basket"

Strategies for Choosing the Target Market
A target market is the **set of customers sharing common needs and wants that a business ties to connect with**.

There are three main kinds of approaches to market targeting:

STRATEGY	OVERVIEW
Mass marketing (undifferentiated)	• Business targets the WHOLE market, ignoring segments • Products focus on what customers need and want in common, not how they differ
Segmented (differentiated)	• Business target several market segments within the same market • Products are designed and targeted at each segment • Requires separate marketing plans and often different business units & product portfolios
Concentrated (niche)	• Business focuses narrowly on smaller segments or niches • Aim is to achieve a strong market position (share) within those niches

Market Positioning
Having chosen which segments to target – the next stage of the marketing strategy is to decide how to compete in those segments. Marketing people call this choice the **value proposition**.

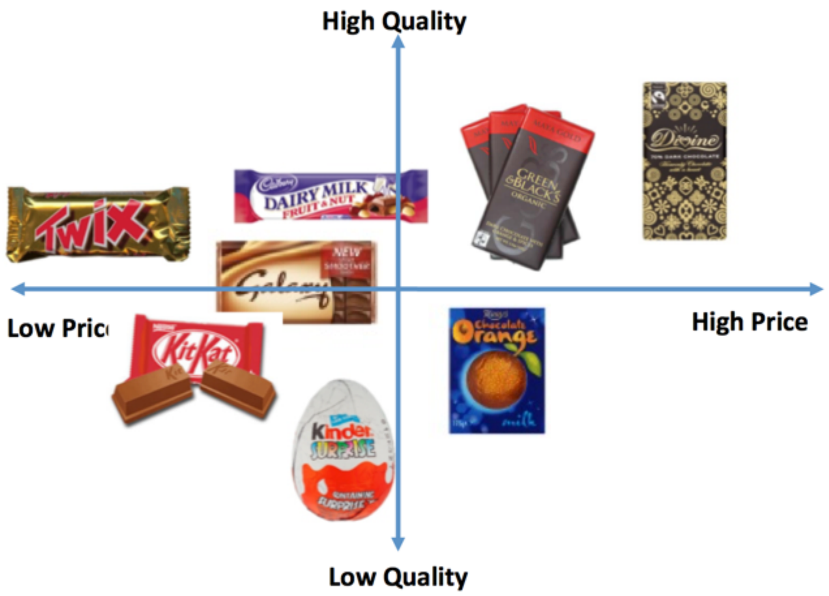
It is important to remember that the market position (or value proposition) is defined by customers – the place a product occupies in customer minds relative to competing products.

A useful framework for analysing market positioning is a **"positioning map".** A market (or positioning) map illustrates the range of "positions" that a product can take in a market based on two dimensions that are important to customers.

Some possible dimensions for the axes of a positioning map include:

Dimensions	
Low price	High price
Basic quality	High quality
Low volume	High volume
Necessity	Luxury
Light	Heavy
Simple	Complex
Unhealthy	Healthy
Low-tech	Hi-tech

An example of a positioning map for chocolate bars might look like this:



Whilst positioning maps are useful conceptual models, care has to be taken when using them in marketing decision-making:

- **Advantages of positioning maps**
  - Helps spot gaps in the market
  - Useful for analysing competitors
  - Encourages use of market research
- **Disadvantages of positioning maps**
  - Just because there is a "gap" doesn't mean there is demand
  - Not a guarantee of success
  - How reliable is the market research?

Market Positioning and Competitive Advantage
Remember that customers choose products based on their perception of a product's value proposition – how they perceive the merits of the product relative to the alternatives (competing products).

Therefore, providing a superior value proposition than the competition is a likely source of competitive advantage – but only if it can be sustained.
There are various possible value differences that have the potential to deliver competitive advantage:

Offer more for less	E.g. Aldi: good quality at low prices
Offer more for more	E.g. high-priced luxury products with prestige value
Offer more for the same	E.g. introduce new features & better performance for the same price
Offer less for much less	E.g. no-frills low cost flying and hotels; good quality, back to basics & low price

Product Differentiation

Product differentiation arises when customers perceive a distinct difference between your product and the alternatives provided by competitors. Effective differentiation allows a business to:

- **Compete effectively**
  - A source of competitive advantage
  - Ideally hard to copy
- **Protect and build a brand**
  - Build intangible value
  - Strengthen customer loyalty
- **Add more value**
  - Strong differentiation should allow a higher price
  - Higher profit margins

The key requirements for effective product differentiation are that the product is:

- Delivers things that are important to customers
- Distinctive – compared with the competition
- Communicated and visible to customers
- Not easily copied by competitors
- Affordable by the target customers
- Profitable

A product that is effectively positioned is often said to have a USP (unique selling point). A USP is something that sets a product apart from its competitors in the eyes of customers, both new and existing.

Key Terms

Market segmentation	Involves dividing a market into **parts that reflect different customer needs and wants.**
Niche market	A **smaller segment of a larger market,** where customers have specific needs and wants & successful products are highly differentiated
Mass market	The **largest part of the market**, where there are many similar (undifferentiated) products offered by competitors
Target market	The set of customers sharing common needs and wants that a business tries to connect with
Product differentiation	Where a product has a value proposition that is sustainably different from the competition

Topic: Price and Income Elasticity of Demand

3.3 Decision-making to Improve Marketing Performance

What You Need to Know
What is price and income elasticity of demand?
Determinants of price elasticity
Value of understanding elasticity to decision-makers
Classifying and interpreting price elasticity

Introduction to elasticity

The demand for goods and services varies depending on a range of factors. Elasticity measures the **responsiveness of demand** to a change in a relevant variable – such as price or income.

Price elasticity of demand

Price elasticity of demand measures the extent to which the quantity of a product demanded is affected by a change in price.

Price Elasticity of Demand (usually shortened to PED) is calculated as:

$$\frac{\text{\% Change in Quantity Demanded}}{\text{\% Change in Price}}$$

To interpret the result of the calculation:

	Value of PED	Interpreting the Elasticity
Price elastic	More than 1	Change in demand is more than the change in price
Price inelastic	Less than 1	Change in demand is less than the change in price
Unitary price elasticity	Exactly = 1	Change in demand = change in price

Let's look at two examples of calculating PED – one for a product with elastic demand; one inelastic.

Example of Elastic Demand

	Original Price	New Price
Product B	£1,000	£900
Quantity Demanded	200 units	250 units
Revenue (price x qty)	£200,000	£225,000
Change in Price		- £100
Change in Demand		+ 50 units
% Change in Price		(100/1000) x 100 = 10%
% Change in Demand		(50/200) x 100 = 25%
PED		**25% / 10% = 2.5**

Topic: Price and Income Elasticity of Demand
3.3 Decision-making to Improve Marketing Performance

Example of Inelastic Demand

	Original Price	**New Price**
Product A	£100	£125
Quantity Demanded	500 units	400 units
Change in Price		+ £25
Change in Demand		- 100 units
% Change in Price		(25/100) x 100 = 25%
% Change in Demand		(100/500) x 100 = 20%
PED		**20% / 25% = - 0.8**

Why does price elasticity demand matter?
If PED > 1 (price elastic) then a change in price will cause a larger change in demand

- Overall revenues would increase with a price cut
- Overall revenues would fall with a price increase

Opposite is the case if PED < 1 (price inelastic

A variety of factors will influence what the PED is for a product:

Factor	**Effect on PED**
Brand strength	Products with strong brand loyalty and reputation tend be price inelastic
Necessity	The more necessary a product, the more demand tends to be inelastic
Habit	Products that are demanded and consumed as a matter of habit tend to be price inelastic
Availability of substitutes	Demand for products that have lots of alternatives (substitutes) tends to be price elastic
Time	In the short-run, price changes tend to have less impact on demand than over longer periods

Income elasticity of demand
Income elasticity of demand measures the extent to which the quantity of a product demanded is affected by a change in income.

Income Elasticity of Demand (usually shortened to PED) is calculated as:

$$\frac{\textbf{\% Change in Quantity Demanded}}{\textbf{\% Change in Income}}$$

For most normal products

- A rise in consumer income will result in a rise in demand
- A fall in consumer income will result in a fall in demand

Extent of the change (elasticity)

- This will vary depending on the type of product (e.g. luxury v necessity)

Looking further at this distinction between luxuries and necessities:

Topic: Price and Income Elasticity of Demand

3.3 Decision-making to Improve Marketing Performance

Luxuries	**Necessities**
Income elasticity more than 1	Income elasticity less than 1, but more than 0
As income grows, proportionally more is spent on luxuries	As income grows, proportionally less is spent on necessities
Examples:	***Examples:***
Consumer goods Expensive holidays Branded goods	Staple groceries (e.g. milk) Own-label goods

Watch out too for inferior goods. These have an income elasticity of less than one. For inferior goods, as income rises demand actually falls. Why does demand fall?

- Consumers switch to better alternatives
- Substitute products become affordable

Combining Price and Income Elasticity

It is important to consider the combined impact of price and income elasticity. How might the following price and income elasticity data for two products be interpreted?

	PRODUCT A	**PRODUCT B**
PED	- 1.5	- 0.2
IED	+ 0.5	+ 1.9
	Price elastic Income inelastic Likely to be a necessity	Price inelastic Income elastic Likely to be a luxury good (perhaps branded)

Some limitations of using elasticities

Care needs to be taken interpreting and using elasticity data in marketing. For example:

- It can be difficult to get reliable data on how demand changes in relation to price (although this is getting easier with the emergence of big data)
- Other factors affect demand (e.g. consumer tastes)
- Many markets subject to rapid technological change – make previous data less reliable
- Competitors will react – pricing decisions can't be taken in isolation!

Key Terms

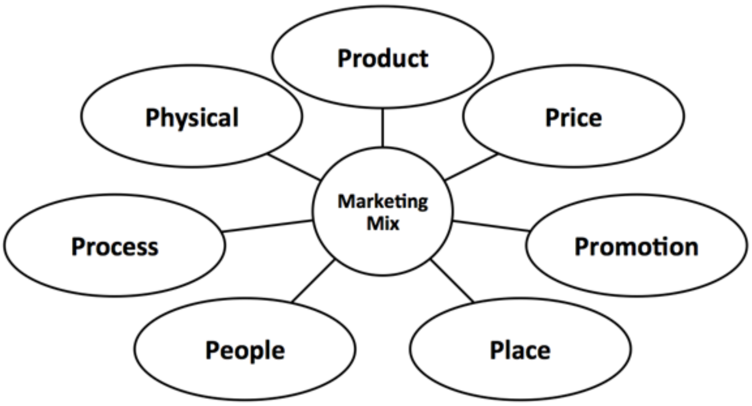
Price elasticity of demand	Measures the extent to which the quantity of a product demanded is affected by a change in price
Income elasticity of demand	Measures the extent to which the quantity of a product demanded is affected by a change in income

Topic: Marketing Products & Product Portfolios
3.3 Decision-making to Improve Marketing Performance

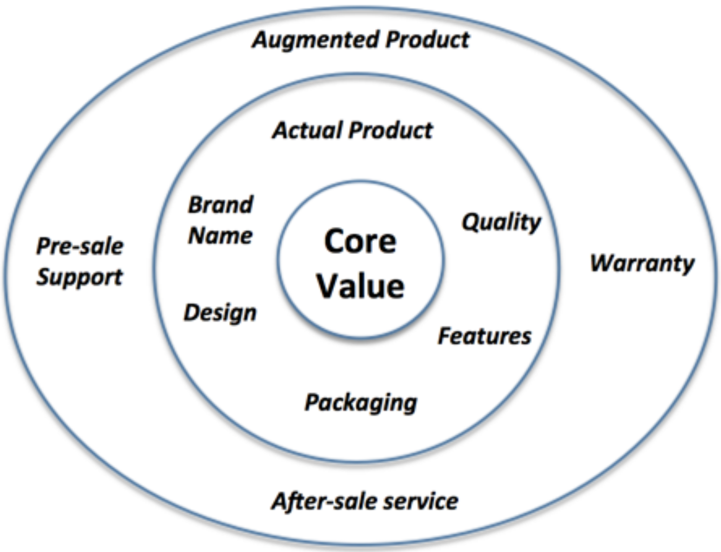
What You Need to Know
What is a product and where it sits within the extended marketing mix
Difference between consumer and industrial products
Value of product portfolio analysis (including Boston Matrix)
Value of product life cycle model and extension strategies
Influences on and the value of new product development

Introduction to Product
A product is **anything that is capable of satisfying customer needs and wants.**

Product is often considered to be the most important part of the extended marketing mix:



A product is more than just the physical elements. As the diagram below shows, a product can be considered to contain a series of layers that offer value to customers beyond the core value.



Consumer & Industrial Products
One way of categorising products is in terms of who the intended consumer or customer is. A broad distinction can be made between goods and services intended

for use by individuals (consumer products) and by other businesses (industrial products).

Consumer Products	Industrial Products
• Bought by final consumers for personal consumption • Differ in they way consumers buy them	• Bought for further processing or for use in conducting a business • Bought by other businesses, not consumers

The three main types of consumer products are summarised below together with the elements of the marketing mix that tends to be emphasised:

Convenience Products	Shopping Products	Speciality Products
• Bought frequently • Little planning or shopping effort • Low customer involvement	• Bought less frequently • Customers careful on suitability, quality, price, brand, style etc.	• Unique characteristics or brand • Buyers make a special effort when buying
Marketing Mix: PRICE Tends to be low PLACE Widespread distribution PROMOTION Mass promotion	***Marketing Mix:*** PRICE Tends to be higher PLACE Selective distribution (fewer outlets PROMOTION Advertising by producer and resellers	***Marketing Mix:*** PRICE High PLACE Exclusive distribution or limited outlets PROMOTION More carefully targeted
Examples: Crisps Toothpaste	***Examples:*** Fashion clothing Home furnishings	***Examples:*** Luxury cars Advanced consumer electronics

Industrial products are perhaps less exciting than consumer products, but they industrial product markets are often significant in terms of market size. For example, all producers of consumer products need themselves to buy industrial products in order to operate!

The three main types of industrial product are:

Materials & Parts	Capital Items	Supplies & Services
• Raw materials, components etc. • Mostly sold to other industrial users • Price and service key issues	• Industrial products used in production or operations • E.g. IT systems, buildings infrastructure	• Operating supplies (e.g. energy) and business services (e.g. maintenance, security)

The marketing mix for industrial products is quite different from that for consumer products:

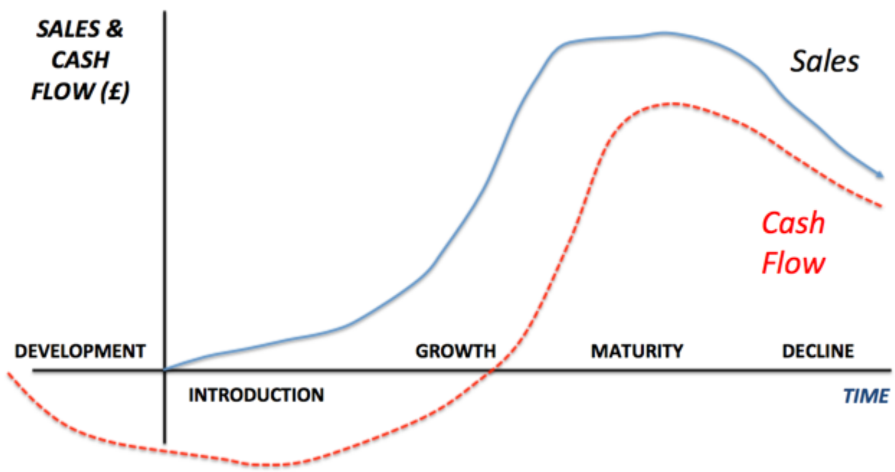
FEATURE	EXPLANATION
Specialist buyers and sellers	Buyers are businesses – will have specialist requirements and more experience. Often dealing with professional "buyers"
Buyer-seller relationship	Strong emphasis on customer relationship management and repeat business
Transaction value	Purchase value often substantial in a single transaction (e.g. bulk purchase contract)
Quality and Price	Greater emphasis on product quality and price (where there are acceptable alternative products). Price is often negotiated by the buyer
Support	Greater requirement for after-sales support

Product Life Cycle Model
The product life cycle is a theoretical model that describes the stages a product goes through over its life. This well-known and popular model can be used to:

- Forecast future sales trends
- Help with market targeting and positioning
- Help analyse & manage the product portfolio

The five stages of the product life cycle are listed below together with a diagrammatical representation of the theoretical model of product sales and cash flow during the life cycle:

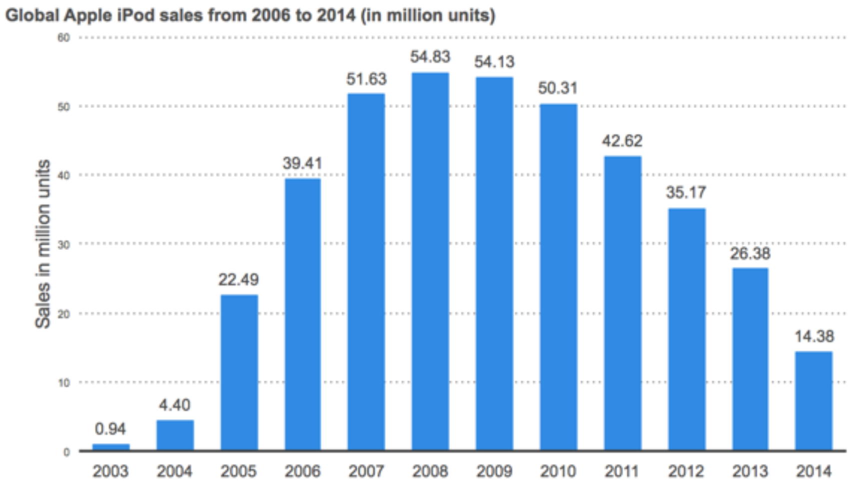
- Development
- Introduction
- Growth
- Maturity
- Decline / End



A classic example of the life cycle in real life is the sales profile of the Apple iPod:

Topic: Marketing Products & Product Portfolios

3.3 Decision-making to Improve Marketing Performance



The key points to remember about each stage are:

Stage	Key Point
Development	• Often complex & time-consuming • Absorbs significant resources • Cost of development often rises as product approaches launch • May not be successful – high failure rate • Test launch may reduce the risk of product failure • Can be a long lead time before sales are achieved
Introduction	• New product launched on the market • Likely to be a low level of sales – penetration pricing may help build customer demand • Low capacity utilisation & high unit costs • Usually negative cash flow • Distributors may be reluctant to take an unproven product • Heavy promotion to make consumers aware of the product
Growth	• Fast growing sales, helped by wider distribution • Rise in capacity utilisation – should lower unit costs • Product gains market acceptance • Cash flow may become positive • The market grows, profits rise but attracts the entry of new competitors
Maturity	• Slower sales growth as rivals enter the market = intense competition + fight for market share • High level of capacity utilisation • High profits for those with high market share • Cash flow should be strongly positive • Weaker competitors start to leave the market • Prices and profits fall
Decline	• Falling sales • Market saturation and/or competition • Decline in profits & weaker cash flows • More competitors leave the market • Decline in capacity utilisation – switch capacity to alternative products

Topic: Marketing Products & Product Portfolios

3.3 Decision-making to Improve Marketing Performance

Extending the Product Life Cycle

There are a number of strategies available to try to extend the life cycle of a product – particularly one that has generated high sales and profits in the growth and maturity stage. Extension strategies might include:

- Lowering the price
- Changing promotion (e.g. new promotional message)
- Changing the product - re-styling and product improvement
- Looking for alternative distribution channels
- Developing a new market segment
- Find new uses for the product
- Repositioning the product

Criticisms of the Product Life Cycle Model

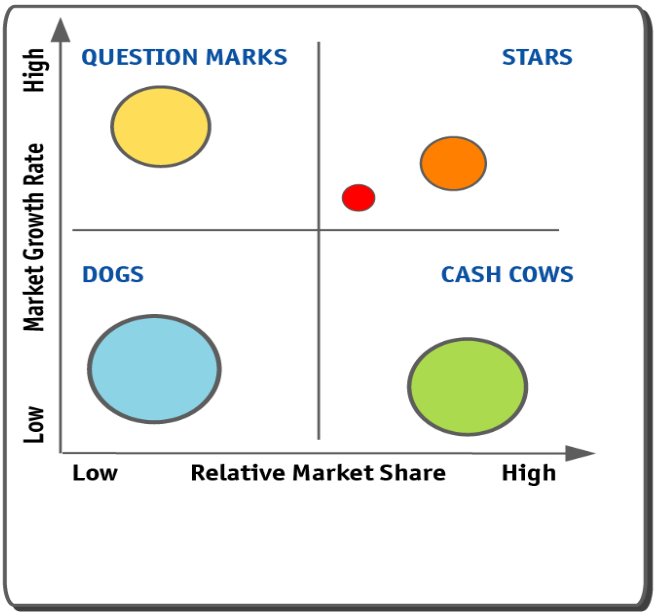
As we have already mentioned, the product life cycle is a theoretical model, although the profiles of many products do exhibit the characteristics predicted by the model. Among the criticisms made of the model are:

- The shape and duration of the cycle varies from product to product
- It is difficult to recognise exactly where a product is in its life cycle
- Length cannot be reliably predicted
- Decline is not inevitable

Product Portfolio Analysis

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

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



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

- **Market share** – does the product being sold have a low or high market share?

- **Market growth** – are the numbers of potential customers in the market growing or not

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

- **Stars** are **high growth products** competing in markets where they are strong compared with the competition.

Often Stars need heavy investment to sustain growth. Eventually growth will slow and, assuming they keep their market share, Stars will become Cash Cows

- **Cash cows** are **low-growth products** with a high market share. These are mature, successful products with relatively little need for investment. They need to be managed for continued profit - so that they continue to generate the strong cash flows that the company needs for its Stars

- **Question marks** are products with low market share operating in high growth markets. This suggests that they have potential, but may need substantial investment to grow market share at the expense of larger competitors. Management have to think hard about "Question Marks" - which ones should they invest in? Which ones should they allow to fail or shrink?

- Unsurprisingly, the term **"dogs"** refers to products that have a low market share in unattractive, low-growth markets. Dogs may generate enough cash to break-even, but they are rarely, if ever, worth investing in. Dogs are usually sold or closed.

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

How valuable is the Boston Matrix?

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

Key Terms

Product	Any good or service that is capable of satisfying customer needs and wants
Product life cycle	A predictive model of the stages a product goes through from development to decline
Boston Matrix	A model use to analyse the strategic position of product and brand portfolios

Topic: Marketing Pricing
3.3 Decision-making to Improve Marketing Performance

What You Need to Know
Pricing tactics and strategies
Factors influencing pricing decisions
Analysing pricing decisions

Introduction – What is Price?
Price is:
- The money charged for a product or service
- Everything that a customer has to give up in order to acquire a product or service
- Usually expressed in terms of £
- The only element of the marketing mix that impacts directly on the value of sales
- Often the hardest part of the marketing mix to get right
- Closely linked to the concept of "value for money" and competitiveness

Price Setting and Corporate & Marketing Objectives
The setting of a price for a product is to a large extent determined by what objectives the business has. Since price directly affects the value of sales (and therefore cash flow) financial as well as marketing objectives are particularly important influences:

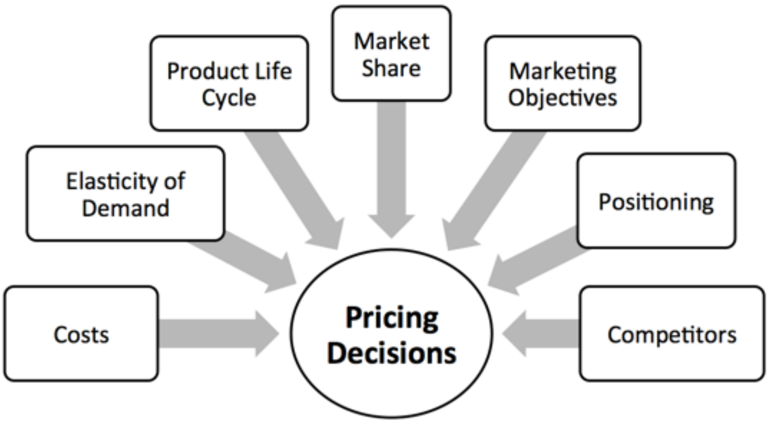
Financial Objectives	**Marketing Objectives**
Maximise profit Achieve a target level of profits Achieve a target rate of return Maximise sales revenue Improve cash flow	Maintain/improve market share Beat/prevent competition Increase sales Build a brand

Pricing Methods, Tactics and Strategies
Pricing works at different levels. The three main levels are:

Pricing Methods	The methods used to calculate the actual price set (e.g. cost-plus)
Pricing Tactics	Adopted in the short run to suit particular situations Limited impact beyond the product itself
Pricing Strategies	Adopted over the medium to long term to achieve marketing objectives Have a significant impact on marketing strategy

Main Influences on Pricing
In addition to corporate and functional objectives, there are a variety of other influences that determine what price is set.

Topic: Marketing Pricing
3.3 Decision-making to Improve Marketing Performance



Competitors are a particularly important influence, the extent of which is largely determined by the relative power of competitors in a market segment. When it comes to setting price a business can be said to be a:

Price taker	Business has no option but to charge the ruling market price
Price maker	Business is able to set its own price without worrying about rivals
Price leader	Market leader whose price changes are followed by rivals
Price follower	Follow the price-changing lead of the market leader

Pricing Based on Costs
If a business wants to operate profitably, then by definition its pricing must take some account of the costs of production or operation.

- Cost is an important influence on pricing
- Over time a price must be more than the related costs in order to make a profit
- Popular method of cost-based pricing is **"mark-up"** – widely used in retailing

An example of basing price using a mark-up approach would be:

Total Costs for producing 10,000 units	£100,000
Cost per Unit	£10
Add mark-up 100% of cost	£10
Selling price = cost + mark-up	£20

The main benefits and drawbacks of basing price on costs are:

BENEFITS	**DRAWBACKS**
Easy to calculate	Ignores price elasticity of demand
Price increases can be justified when costs rise	May not take account of competition
Managers can be confident each product is being sold at a profit	Profit is lost if price is set below the that customers are prepared to pay
	Sales are lost if price is set above the price customers are willing to pay
	Business has less incentive to control costs

Topic: Marketing Pricing

3.3 Decision-making to Improve Marketing Performance

Let's now briefly look at some other specific pricing tactics and strategies:

Price Skimming

- This involves setting a **high price to maximise profit**
- Product is sold to different market segments at different times
- Top segment is skimmed off first with the highest price
- Objective: maximise profit per unit to achieve quick recovery of development costs
- Works well for products that create excitement amongst "early adopters"
- Best used in introduction or early growth stage of product life cycle
- Electronic items provide many great examples

Penetration Pricing

- Penetration pricing is the opposite of price skimming
- Involves offering a product at a low introductory price
- Aim is to
    - Gain market share quickly
    - Build customer usage and loyalty
    - Build sales of higher-priced related items ("hook & bait" approach)
- Price can be increased once target market share is reached

Dynamic Pricing

Dynamic pricing is a pricing strategy in which businesses set **flexible prices** for products or services based on **current market demands.**

A good example is the use of variable pricing by online retailers such as Amazon and the so-called "surge pricing" model of businesses like Uber.

Key Terms

Cost-plus pricing	Price is set by applying a percentage margin based on the unit costs of production or supply
Price skimming	Charging a premium price when a product is first launched in order to maximise revenue per unit
Penetration pricing	Offering a significantly lower price than normal in an attempt to maximise volume sold and to build an installed base of product users
Dynamic pricing	Setting flexible prices for products or services based on current market demands

Topic: Marketing Distribution (Place)

3.3 Decision-making to Improve Marketing Performance

What You Need to Know
Methods of distribution (channels)
Choosing appropriate distribution
Increasing use of multichannel distribution

Introduction to Distribution

Distribution (or place) is one of the four traditional elements of the marketing mix. It involves the ways in which a product reaches the end consumer.

The ultimate aim of effective distribution is to make products available in the **right place** at the **right time** in the **right quantities**

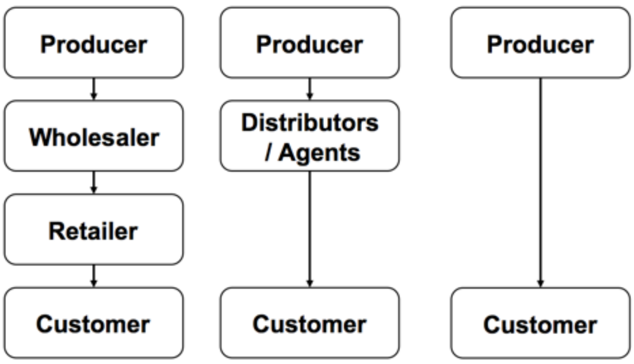
The decisions about what methods of distribution to use are strongly influenced by the choice of target market and product positioning. Key questions for a business to consider include:

- How can the business ensure that its products reach existing and potential customers?
- How and where do customers prefer to buy the product?
- How important are factors such as stock availability, price & speed of delivery?

Distribution Channels

A distribution channel moves a product through the stages from production to final consumption.

Distribution channels can have more than one stage. A distribution channel with more than one stage will involve "intermediaries":



Distribution channels serve a variety of purposes:

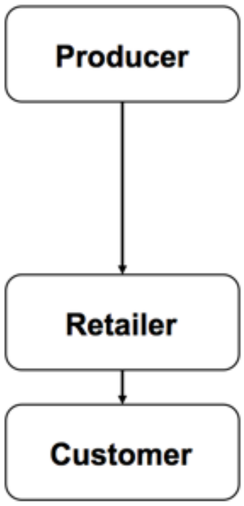
- Provide a link between production and consumption
- Help gather market information
- Communicate promotional offers
- Find and communicate with prospective buyers
- Physical distribution - transporting and storing
- Financing – other parties finance the inventory
- Share risk taking – other parties take some risk by handling inventories

Topic: Marketing Distribution (Place)
3.3 Decision-making to Improve Marketing Performance

Let's look briefly at the four main kinds of distribution channel intermediary:
- Retailers
- Wholesalers
- Distributors
- Agents

Retailers
Key points about retailers:

- Retailer is the final step in the chain – deals directly with the customer
- Focused on consumer markets
- Various kinds of retailer:
    - Multiples – chains of shops owned by a single company (e.g. Sainsbury's or Next)
    - Specialist chains (e.g. fast fashion, perfume)
    - Department stores (e.g. Debenhams, John Lewis)
    - Convenience stores (e.g. Spar, Costcutter)
    - Independents – a shop run by an owner
    - Franchises (retail format operated by franchisee)

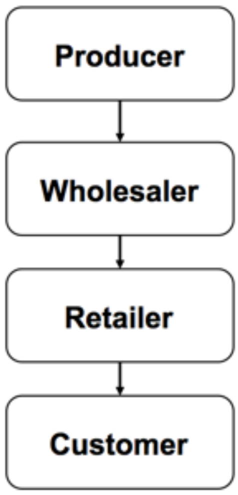


Distributing products via retailers obviously involves a significant loss of margin – since the retailer will add their own "mark-up" to the price charged. However, effective retail distribution offers significant potential advantages:

- Convenience for customers
- Often with a broad geographical coverage
- Retailer chooses the final price
- Retailer handles the financial transaction
- Retailer holds the stock
- Retailer handles after-sales support (e.g. returns)

Wholesalers
Key points about wholesalers:

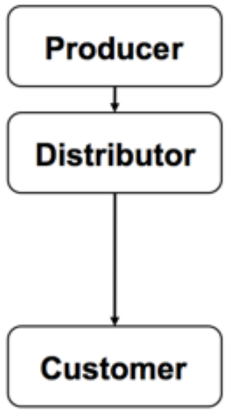
- Wholesalers "break bulk"
    - Buy in large quantities from producers
    - Break into smaller quantities to sell to retailers
- Advantages
    - Reduce the producer's transport costs (fewer journeys to the wholesaler rather than many journeys to retailers)
    - Retailers can order in smaller amounts from wholesalers
- Wholesaler makes money by buying at a lower price from the producer and adding a profit margin onto the price paid by the retailer



Topic: Marketing Distribution (Place)
3.3 Decision-making to Improve Marketing Performance

Distributors

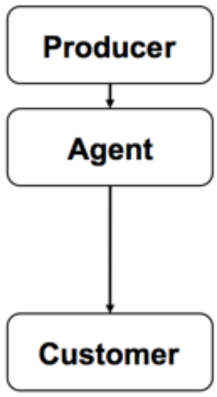
Key points about distributors:



- Distribute (sell on) products and serve as a local sales point
- Usually specialise in a particular industry
- Examples – building supplies, electrical components, industrial clothing
- Offer products from many producers = greater choice
- Different from agents in that a distributor holds stock

Agents

Key points about agents:



- Specialist type of distributor
- Does not hold stock
- Tend to operate in tertiary sector (services); e.g.
    - Travel
    - Insurance
    - Publishing
- Agents normally earn commission based on sales achieved

Making Decisions About Which Distribution Channels to Use

Choosing the most effective approach is not easy. Key decisions to be made include:

- Channel length - direct or indirect?
- Choice of intermediary
- Use just one or several channels?
- How to move the goods through the channel?
- Control over the channel – e.g. who decides price, promotion, packaging?

A key distinction is made between **direct distribution** and **indirect distribution**:

Direct Distribution	Where a producer and consumer deal directly with each other without the involvement of an intermediary
Indirect Distribution	Involves the use of intermediaries between the producer and consumer

Direct distribution is increasingly popular, particularly with advances in the effectiveness of direct marketing methods, growing adoption of e-commerce.

However, there are still some good reasons to use indirect distribution, For example:

- Geography - customers may live too far away to be reached directly or spread widely
- Enables of consolidation of small orders into large ones

- Allows a business to make better use of resources elsewhere (e.g. less capital tied up in inventories)
- Business may lack of retailing expertise
- Segmentation - different segments of the markets can be best reached by different distribution channels. Mass-market products in particular continue to be distributed via retail channels.

Multichannel Distribution

Multichannel distribution involves a business **using more than one type** of distribution channel.

For example, a producer of branded consumer products may distribute via retail stores as well as sell directly to consumers using e-commerce.

Consumer electronics giant Apple is one of the best examples of multichannel distribution.

450+ own retail stores in over 15 countries | *Online stores* | *Multiple Retail Partners*

The benefits and possible drawbacks of multichannel distribution include:

BENEFITS	DRAWBACKS
Allows more target market segments to be reached	Potential for channel "conflict" –e.g. competing with retailers by also selling direct
Customers increasingly expect products to be available via more than one channel	Can be complex to manage
Enables higher revenues – e.g. if retail outlets have no stock, but customer can buy online	Danger that pricing strategy becomes confused (in the eyes of customers)

Key Terms

Distribution channel	The route a product takes from production to final consumption.
Multichannel distribution	Where a business uses more than one channel of distribution

Topic: Marketing Promotion
3.3 Decision-making to Improve Marketing Performance

What You Need to Know
Key methods of promotion
Link between promotion and the rest of the marketing mix
Influences on promotional methods
Analysing promotional decisions

Introduction to Promotion
Promotion in marketing has two key tasks – to i**nform** (communicate) and **persuade**.

The main aim of promotion is to ensure that **customers are aware of the existence and positioning of products.**

Promotion is also used to p**ersuade** customers that the product is better than competing products and to remind customers about why they may want to buy.

The Promotional Mix
The promotional mix describes the promotional methods that a business uses to pursue its marketing objectives: The main elements of the mix are:

- Advertising (offline & online)
- Sales promotion & merchandising
- Personal selling
- Public relations/publicity / sponsorship
- Direct marketing

Most businesses employ a variety of these elements rather than relying on just one. The important thing is that the elements must be integrated in a cohesive, consistent and logical manner.

Key influences on which promotional elements are used (and how) include:

Stage in the product's life cycle	Position in the life cycle will require different promotional methods
Nature of the product	What information do customers require before they buy?
Competition	What are rivals doing? What promotional methods are traditionally effective in a market?
Marketing objectives & budget	What does promotion need to achieve? How much can the firm afford?
Target market	Appropriate ways to reach the target market segments

Let's look at the key points to remember for each main promotional method.

Advertising

Key points:
- Paid-for communication

- Many different advertising media (e.g. mobile devices, TV & radio, newspapers & magazines, online, social media, cinema, billboards)
- Consumers subjected to many advertising messages each day = hard to get through
- Mass-market advertising is very expensive
- Niche market advertising now much more cost effective due to growth of online & mobile)

Benefits of Advertising	Drawbacks of Advertising
Wide coverage Control of message Repetition means that the message can be communicated effectively Effective for building brand awareness and loyalty	Often expensive Most methods are impersonal (although less so for mobile & online) One way communication Lacks flexibility Limited ability to close a sale

Personal Selling

Key points:

- Promotion on a person-to-person basis
- Uses two-way communication
- Usually involves meeting with potential customers to close a sale
- Many methods: by telephone, at meetings, in retail outlets, knocking on doors
- Highly priced, low volume and highly technical products rely heavily on personal selling

Benefits of Personal Selling	Drawbacks of Personal Selling
High customer attention Message is customised Interactivity Persuasive impact Potential for development of relationship Adaptable Opportunity to close the sale	High cost Labour intensive Expensive Can only reach a limited number of customers

Sales Promotion

Key points:

- Tactical, point of sale material or other incentives designed to stimulate purchases
- Examples include free samples, coupons, BOGOF-style offers
- Short-term incentives designed to increase sales, for example through impulse purchase
- Some promotions aimed at consumers; others at intermediaries or to help the direct sales force

Topic: Marketing Promotion

3.3 Decision-making to Improve Marketing Performance

Benefits of Sales Promotion	Drawbacks of Sales Promotion
Effective at achieving a quick boost to sales Encourages customers to trial a product or switch brands	Sales effect may only be short-term Customers may come to expect or anticipate further promotions May damage brand image

Public Relations (PR)

Public relations activities are those that create goodwill toward an individual, business, cause or product.

Key points:

The main aims of PR are to:

Achieve favourable publicity about the business

Build the image and reputation of the business and its products, particularly amongst customers

Communicate effectively with customers and other stakeholders

Typical PR activities:

- Promoting new products
- Enhancing public awareness
- Projecting a business image
- Promote corporate social responsibility
- Projecting business as a good employer
- Obtain favourable product reviews / recommendations

Direct Marketing

Direct marketing involves the sending of promotional material directed through mail, email, social media or phone to individuals or businesses. The ultimate aim of direct marketing is to trigger a "response" – e.g. a purchase or an enquiry.

Key points:

- Allows a business to generate a specific response from targeted groups of customers
- Allows a business to focus on several marketing objectives at the same time:
    - Increasing sales to existing customers
    - Building customer loyalty
    - Re-establishing lapsed customer relationships
    - Generating new business

Key Terms

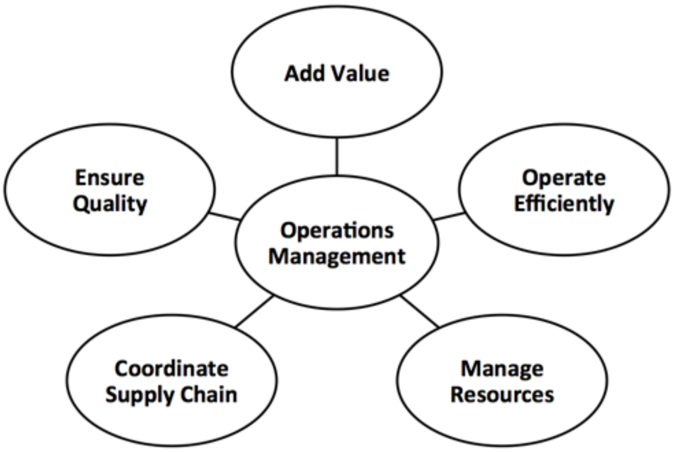
Sales promotion	Tactical, point of sale material or other incentives designed to stimulate purchases
Advertising	Paid-for communication, aimed at informing or persuading
Direct marketing	Sending promotional materials and messages directly to the target audience
Promotional mix	The mix of activities and approaches taken to promoting a product

Topic: Setting Operational Objectives
3.4 Decision-making to Improve Operational Performance

What You Need to Know
Key features of operations management
Key operational objectives
Importance of innovation
Influences on operational objectives

Introduction – What is Operations Management?
Operations management is all about **the management of processes, activities and decisions relating to the way goods and services are produced and delivered.**

The five key tasks of operations management are to:



Main Operational Objectives
The functional objectives set for operations management can be grouped into four main categories:
- Cost and volume objectives
- Quality objectives
- Efficiency and flexibility objectives
- Environmental objectives

Cost and Volume Objectives
- A business needs to ensure that operations are cost-effective
- The traditional measure of cost-effectiveness is "unit cost" (total costs divided by total units)
- Businesses in the same industry face similar cost structures, but each varies in terms of productivity, efficiency and scale of production
- The business with the lowest unit cost is in a strong position to be able to compete by being able to:
  - Offer the lowest price, or
  - Make the highest profit margin at the average industry price

Examples of cost & volume objectives include:
- **Productivity & efficiency** (e.g. units per week or employee)
- **Unit costs per item**

- **Contribution per unit**
- **Number of items to produce** (per time period, or per machine etc.)

Quality Objectives
- Quality is one of the most important challenges facing a business
- Markets are more competitive: customers are more
    - Knowledgeable
    - Demanding
    - Prepared to complain about poor quality
    - Able to share information about poor quality (e.g. via email & social networking)
- If a business can develop a reputation for high quality, then it may be able to create an advantage over its competitors

Depending on the nature of production / operations, examples of quality objectives could include:
- **Scrap / defect rates:** a measure of poor quality
- **Reliability** – how often something goes wrong; average lifetime use etc
- **Customer satisfaction** – measured by customer research
- Number / incidence of **customer complaints**
- **Customer loyalty** – e.g. percentage of repeat business
- Percentage of **on-time delivery**

Efficiency and Flexibility Objectives
- These are closely linked to cost targets
- Look at how effectively the assets of the business are being utilised
- Also measure how responsive the business can be to short-term or unexpected changes in demand
- Efficiency and flexibility are key determinants of unit costs

Examples of efficiency and flexibility objectives might include:
- **Labour productivity**: e.g. output per employee, units produced per production line; sales per shop
- **Output per time period:** e.g. potential output per week on a normal shift basis; potential output assuming certain levels of capacity utilisation
- **Capacity utilisation:** the proportion of potential output actually being achieved
- **Order lead times:** e.g. the time taken between receiving and processing an order

Environmental Objectives
- An increasingly important focus of operational objectives
- Businesses face more stringent environmental legislation
- Customers increasingly base their buying decisions on firms that take environmental responsibility seriously

Examples of environmental objectives include:
- Rate of **energy efficiency**
- **Proportion of recycled** production or packaging materials

- **Compliance** with waste disposal regulations / proportion of waste to landfill
- Percentage of supplies of raw materials from **sustainable sources**

The Importance of Innovation
Innovation is about putting a new idea or approach into action. Innovation is commonly described as **'the commercially successful exploitation of ideas'.**

There are two key types of innovation:
Product innovation: launching new or improved products (or services) on to the market
Process innovation: finding better or more efficient ways of producing existing products, or delivering existing services

The key business benefits of successful innovation include:

Benefits of Product Innovation	Benefits of Process Innovation
Higher prices and profitability Greater added value Opportunity to build early customer loyalty Enhanced reputation as an innovative company Public Relations – e.g. news coverage Increased market share	Reduced costs Improved quality More responsive customer service Greater flexibility Higher profits

Key Influences on Operations Objectives
These can be split between internal (within the firm's control) and external (outside of the firm's control):

Internal Influences:

Corporate objectives	As with all the functional areas, corporate objectives are the most important internal influence. An operations objective (e.g. higher production capacity) should not conflict with a corporate objective (e.g. lowest unit costs)
Finance	Operations decisions often involve significant investment and cost The financial position of the business (profitability, cash flow, liquidity) directly affects the choices available
Human resources	For a services business in particular, the quality and capacity of the workforce is a key factor in affecting operational objectives. Targets for productivity, for example, will be affected by the investment in training and the effectiveness of workforce planning
Marketing issues	The nature of the product determines the operational set-up. Regular changes to the marketing mix – particularly product – may place strains on operations, particularly if production is relatively inflexible

Topic: Setting Operational Objectives
3.4 Decision-making to Improve Operational Performance

External Influences

Economic environment	Crucial for operations. Sudden or short-term changes in demand impact on capacity utilisation, productivity etc. Changes in interest rates impact on the cost of financing capital investment in operations.
Competitor efficiency flexibility	Quicker, more efficient or better quality competitors will place pressure on operations to deliver at least comparable performance
Technological change	Also very significant – especially in markets where product life cycles are short, innovation is rife and production processes are costly.
Legal & environmental change	Greater regulation and legislation of the environment places new challenges for operations objectives.

Key Terms

Innovation	Practical application of new inventions into marketable products or services

Topic: Capacity Management

3.4 Decision Making to Improve Operational Performance

What You Need to Know
Meaning & importance of capacity
Calculation and interpretation of capacity utilisation
How to use capacity efficiently

Introduction to Capacity

The **capacity** of a business is a measure of how much **output** it can achieve in a given period. For example:

- A fast-food outlet may be able to **serve 1,000 customers per hour**
- A call-centre may be able to **handle 10,000 calls per day**
- A football stadium could seat no more than **45,000 fans at each match**
- A car production line may be able to complete **50,000 cars per year**

Capacity is therefore a measure of "potential" output. Of course, not every business will be able to operate to full potential; and sometimes a business will find demand so high that it does not have sufficient capacity.

Why Capacity is Important

How capacity is managed has a direct effect on the performance of a business. In order for a business to be able to meet **demand** from customers, it needs to have the **capacity** to do so. Having capacity enables orders to be met and revenues generated. However, a lack of capacity can have a damaging effect on business performance. For example, a restaurant will lose sales if customers turn away seeing all the tables full; a factory may lose an order if it is not able to produce the volume required for a possible order.

The Costs of Capacity

Since capacity is all about the **output a business can achieve**, it is easy to see what costs are involved in making that capacity available. The key costs of capacity are:

Equipment: e.g. production line
Facilities: e.g. building rent, insurance
Labour: wages and salaries of employees involved in production or delivering a service

There is an important link between capacity and unit costs, since unit costs are calculated using the actual output during a period. This link is a key concept called **capacity utilisation**.

Capacity Utilisation

Capacity utilisation measures the extent to which capacity is used during a specific period. For example:

- A frozen pizza production line might make 75,000 pizzas in a week compared with its capacity of 100,000 per week
- A beauty salon could complete 300 appointments in a month compared with a potential of 500 appointments per month.

Where both actual and potential output can be measured, capacity utilisation can be calculated and it is **expressed as a simple percentage** using this formula:
Capacity utilisation = the percentage of total capacity that is actually being achieved in a given period

Topic: Capacity Management

3.4 Decision Making to Improve Operational Performance

(Actual output / potential output) x100

Example of Capacity Utilisation Calculation
Kaur Components manufactures printed circuit boards for use in remote monitoring devices. Working a normal two-shift rota, the Kaur factory is capable of producing 150,000 circuit boards per month. In the latest month, actual output was 127,500 units. What was the capacity utilisation for that month? Actual Output: 127,500 units Potential Output (Capacity): 150,000 units **Capacity Utilisation = 127,5000 / 150,000 = 85%**

Capacity utilisation is an important concept because:

- It is a useful measure of productive efficiency since it measures whether there are idle (unused) resources in the business;
- Average production costs tend to fall as output rises – so higher utilisation can reduce unit costs, making a business more competitive
- Businesses usually aim to produce as close to full capacity (100% utilisation) as possible in order to minimise unit costs
- A high level of capacity utilisation is required if a business has a high break-even output due to significant fixed costs of production

Reasons Why Businesses Operate Below Full Capacity

Most businesses have some **spare capacity** – i.e. they operate at below their capacity (i.e. less than100% capacity utilisation). This happens for a variety of reasons:

Reason	**Example**
Lower than expected market demand	A change in customer tastes
A loss of market share	Competitors gain customers
Seasonal variations in demand	Weather changes lead to lower demand
Recent increase in capacity	A new production line has been added
Maintenance and repair programmes	Capacity is temporarily unavailable

If a business operates **consistently at a low level of capacity utilisation,** this is likely to indicate potentially serious issues, particularly if production costs are mainly fixed and the business has a high break-even output. Persistently low levels of capacity utilisation are likely to result in the business having higher unit costs than other competitors that may therefore result in the business being less competitive.

Drawbacks of High Capacity Utilisation

Although there are benefits of operating at a high level of capacity utilisation, there are also possible drawbacks. Possible issues include:

- There is less time for productive equipment and facilities to be maintained and repaired, which may increase the likelihood that they break-down in the future;
- Employees involved in production are out under greater stress and pressure which can be counter-productive if, for example, they become demotivated or it contributes to an increase in absenteeism;

- Customer service may deteriorate if, for example, customers have to wait longer to be served or to receive their product
- A business is less likely to be able to respond to sudden or unexpected increases in demand

Options to Increase Capacity

What happens if a business finds itself with **excess demand** (i.e. it does not have enough capacity to meet demand). In such circumstances, what can it do to operate at higher than 100% normal capacity? Possible options might include:

- Increase workforce hours (e.g. extra shifts; encourage overtime; employ temporary staff)
- Sub-contract some production activities (e.g. assembly of components)
- Reduce time spent maintaining production equipment

Key Terms

Capacity	The potential output of a business measured in terms of units of output over a specific period
Capacity utilisation	The proportion (percentage) of a business' capacity that is actually being used over a specific period
Spare (excess) capacity	Where actual output is less than capacity
Excess demand	Where demand for a business' products or services is greater than the business capacity

Topic: Labour Productivity
3.4 Decision-making to Improve Operational Performance

What You Need to Know
How is labour productivity measured?
The effects of higher or lower labour productivity
Ways of improving labour productivity
Challenges of improving labour productivity

What is Labour Productivity and Why Does it Matter?
Labour productivity measures the amount or value of output per employee.
Labour productivity is an important concept for many businesses because:

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

The key point to remember is that achieving a higher labour productivity results in lower labour unit costs, which in turn should lower overall unit costs.

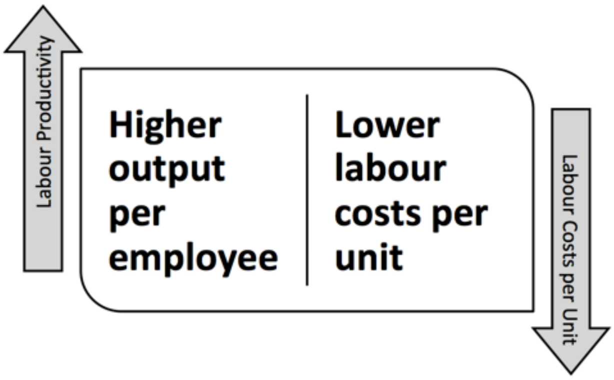


Illustration of How Labour Productivity is Calculated
The table below shows how a business might calculate output per employee and the related labour cost per unit:

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

Topic: Labour Productivity
3.4 Decision-making to Improve Operational Performance

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

Calculating Labour Productivity
As we have seen in the table above, the classic measure of labour productivity is output per worker, calculated using the formula:

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

If you are asked to calculate this, remember to ensure that the answer is expressed in terms of **output per employee** (e.g. 1,000 units per employee per month)

An example of the calculation is shown below:

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

Labour productivity =

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

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

Ways a Business Can Improve Labour Productivity
- Measure performance and set targets
- Streamline production processes
- Invest in capital equipment (automation + computerisation)
- Invest in employee training
- Improve working conditions

Topic: Labour Productivity

3.4 Decision-making to Improve Operational Performance

Some Potential Issues With Trying to Improve Labour Productivity

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

Key Terms

Labour productivity	A measure of output per employee
Unit Labour Costs	Average labour cost per unit of output produced

Topic: Unit Costs and Efficiency
3.4 Decision-making to Improve Operational Performance

What You Need to Know
Calculation of unit costs
Interpretation of unit costs
Relationship between unit costs and scale of production and nature of operations

Introduction to Unit Costs
Unit costs are a key indicator of the efficiency and productivity of a business. They are also critical to the profitability and competitiveness of many businesses.

The unit cost measures the **average cost per unit produced,** as measured over a particular time period (e.g. month, year).

Unit costs will vary over time and as the scale of a business' operation changes. Unit costs are particularly sensitive to the effect of significant operational scale and to the relationship between fixed and variable costs for a business.

Calculating Unit Costs
Average (or unit cost) is calculated using this formula:

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

Looking at an example of this calculation, the table below illustrates how unit costs (cost per unit) change as output increases. In the data used, it is assumed that fixed costs are £10,000 and variable costs are £100 per unit:

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

Understanding how unit costs change as output changes – and over time – is very useful for a business.

So too is understanding how unit costs compare with the competition, since we know that unit costs are an important component of competitiveness.

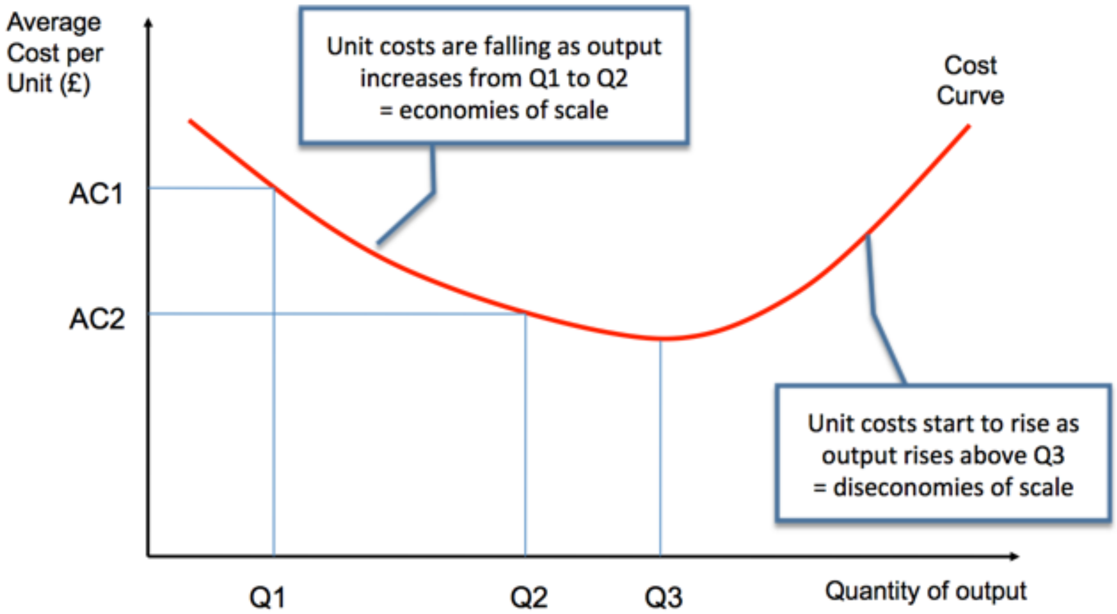
In the exam table below, the unit costs of different businesses are shown. Business D has the lowest unit costs, perhaps because it operates at higher output – potentially benefitting from economies of scale.

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

Economies of Scale

How you every wondered how IKEA can profitably sell flat-pack furniture at what seem impossibly low prices? The answer is – **economies of scale.** Scale economies have brought down the unit costs of production and have fed through to lower prices for consumers.

Most firms find that, as their production output increases, they can achieve lower costs per unit. This can be illustrated as follows:



In the diagram above, you can see that unit costs fall from AC1 to AC2 when output increases from Q1 to Q2. That illustrates the effect of economies of scale – so what are they?

Economies of scale are the **cost advantages** that a business can exploit by expanding their scale of production. The effect of economies of scale is to reduce the average (unit) costs of production. There are many different types of economy of scale and depending on the particular characteristics of an industry, some are more important than others.

Internal economies of scale

Internal economies of scale arise from the growth of the business itself. Examples include:

Technical economies of scale

Large-scale businesses can afford to invest in expensive and specialist capital machinery. For example, a supermarket chain such as Tesco or Sainsbury's can invest in technology that improves stock control. It might not, however, be viable or cost-efficient for a small corner shop to buy this technology.

Specialisation of the workforce

Larger businesses split complex production processes into separate tasks to boost productivity. By specialising in certain tasks or processes, the workforce is able to produce more output in the same time.

Marketing economies of scale

A large business can spread its advertising and marketing budget over a large output and it can purchase its inputs in bulk at negotiated discounted prices if it has sufficient negotiation power in the market. A good example is the major grocery retailers who use their buying power when purchasing supplies from farmers and other suppliers.

Managerial economies of scale

Large-scale manufacturers employ specialists to supervise production systems, manage marketing systems and oversee human resources.

External economies of scale

External economies of scale occur within an industry. Examples of external economies of scale include:

- Development of research and development facilities in local universities that several businesses in an area can benefit from
- Spending by a local authority on improving the transport network for a local town or city
- Relocation of component suppliers and other support businesses close to the main centre of manufacturing are also an external cost saving

Unit Costs and Resource Intensity

Unit costs are closely linked to the relationship between labour and capital in operations.

A **labour–intensive business** has a relatively high proportion of it costs related to the employment of people. By contrast, a **capital-intensive business** has relatively low labour costs, but high costs arising from the extensive use of equipment (e.g. machinery). Some examples of labour and capital intensive operations are:

Topic: Unit Costs and Efficiency
3.4 Decision-making to Improve Operational Performance

Labour intensive	**Capital intensive**
Food processing	Oil extraction & refining
Hotels & restaurants	Car manufacturing
Fruit farming	Web hosting
Hairdressing	Intensive arable farming
Coal mining	Transport infrastructure

The key implications for unit costs of labour and capital intensity can be summarised as follows:

Labour Intensive	**Capital Intensive**
Labour costs higher than capital costs	Capital costs higher than labour costs
Costs are mainly variable = lower breakeven output	Costs are mainly fixed = higher breakeven output
Firms benefit from access to sources of low-cost labour	Firms benefit from access to low-cost, long-term financing

The respective benefits and drawbacks of labour and capital intensity include:

Benefits of Labour Intensity	**Drawbacks of Labour Intensity**
Unit costs may still be low in low-wage locations	Greater risk of problems with employee/employer relationship
Labour is a flexible resource – through multi-skilling and training	Potentially high costs of labour turnover (recruitment etc.)
Labour at the heart of the production process – can help continuous improvement	Need for continuous investment in training

Benefits of Capital Intensity	**Drawbacks of Capital Intensity**
Greater opportunities for economies of scale	Significant investment
Potential for significantly better productivity	Potential for loss competitiveness due to obsolescence
Better quality & speed (depending on product)	May generate resistance to change from labour force
Lower labour costs	

Key Terms

Unit cost	The average cost per unit produced, as measured over a particular time period
Economy of scale	The effect of unit costs falling as output rises

Topic: Quality Management
3.4 Decision-making to Improve Operational Performance

What You Need to Know
What is meant by quality
Why quality is increasingly important
The costs of poor quality
Business benefits of improving quality
Approaches to monitoring, assuring and improving quality

What is Quality?
"Quality is about meeting the needs and expectations of customers"
Customers want quality that is appropriate to the price that they are prepared to pay and the level of competition in the market. Key aspects of quality for the customer include:

- Good design – looks and style
- Good functionality – it does the job well
- Reliable – acceptable level of breakdowns or failure
- Consistency
- Durable – lasts as long as it should
- Good after sales service
- Value for money

'Value for money' is especially important, because in most markets there is room for products of different overall levels of quality, and the customer must be satisfied that the price fairly reflects the quality.

For many businesses, good product design is also fundamental, so that the product can be produced efficiently, reliably and at the lowest possible cost.

Why Quality Is important
Quality can determine business success in several ways:

- Customer loyalty: customers return, make repeat purchases and recommend the product or service to others.
- Strong brand reputation for quality
- Retailers and other distributors want to stock the product
- As the product is perceived to be better value for money, it may command a premium price and will become more price inelastic
- Fewer returns and replacements lead to reduced costs
- Attracting and retaining good staff

These points can each help support the *marketing function* in a business. However, businesses have to work hard to maintain and improve their reputation for quality, which can easily be damaged by a news story about a quality failure.

Costs of Poor Quality
You can probably come up with several examples from your own experience of when you have come across poor quality: e.g.

- Product fails – e.g. a breakdown or unexpected wear and tear
- Product does not perform as promised (or what the customer thought was promised!)

- Product is delivered late
- Poor instructions/directions for use make using the product difficult or frustrating
- Unresponsive customer service

Poor quality results in additional business **costs:**

- Lost customers (expensive to replace – and they may tell others about their bad experience)
- Cost of reworking or remaking product
- Costs of replacements or refunds
- Wasted materials

Some recent examples of how costly poor quality can be for a business are listed below:

When	What	Cost
2006	Dell recalls 4 million laptops due to faulty over-heating batteries	$400m
2007	Mattel recalls 19 million toys supplied from China	$30m
2010	Toyota recalls 10 million cars due to a faulty accelerator pedal	$1.2bn
2011 -	UK banks required to pay compensation for mis-selling of PPI (Payment Protection Insurance)	£40bn+
2013	Horsemeat scandal results in slide in sales of red meat in UK	Industry sales down 5%
2015	Alton Towers rollercoaster crash results in compensation claims & lower customer visits	£40m+

Business Benefits from Good Quality
You can see from the list above that poor quality is a likely **source of competitive disadvantage.** If competitors are achieving higher quality, then a business will suffer. The flip side of the above is that a business can benefit by improving its quality.

The key benefits of improved quality are:

- Improved image & reputation, which should result in
- Higher demand, which may in turn mean
- Greater production volumes (possibly providing better economies of scale)
- Lower unit costs because of less waste and rejected output
- Fewer customer complaints (& more satisfied customers)
- Potentially higher selling prices (less need to discount)

Indeed, quality is now seen as a key component of competitiveness:

- Fewer businesses are competing solely on price
- At a similar price, the higher-quality product is likely to win
- Quality can enable a business to differentiate its product from the competition

Topic: Quality Management
3.4 Decision-making to Improve Operational Performance

Measuring Quality

There are several tangible and intangible measures of quality:

Tangible	Intangible
Reliability	Brand image
Functions & features	Exclusiveness
Support levels & standards	Market reputation
Cost of ownership (e.g. repairs)	

However, it is important to remember that:

- Quality is **subjective**, it is a matter of personal opinion and what constitutes an acceptable level of quality will vary from one individual to another
- Not all aspects of quality are tangible – for example the degree of assurance given by a firm's name or reputation can be very important even though it is hard to measure.
- Quality is always evolving because of things like improved technology, better materials, new manufacturing techniques and fresh competitors. No business can afford to stand still as far as quality is concerned
- Whilst controlling quality has benefits to the firm, it can also be costly to do, so it is important that the benefits outweigh the costs in the long term

Approaches to Managing Quality
Achieving high quality does not happen by accident. The production process must be properly managed to achieve quality standards.
Quality management is concerned with controlling activities with the aim of ensuring that products and services are fit for their purpose and meet the specifications. There are two alternative approaches to managing quality

Quality Control
Quality control is **the process of inspecting products to ensure that they meet the required quality standards**

This method checks the quality of completed products for faults. Quality inspectors measure or test every product, samples from each batch, or random samples – as appropriate to the kind of product produced.

The **main objective of quality control** is to ensure that the business is achieving the standards it sets for itself.

In almost every business operation, it is not possible to achieve perfection. For example there will always be some variation in terms of materials used, production skills applied, reliability of the finished product etc.

Quality control involves setting standards about how much variation is acceptable. The aim is to ensure that a product is manufactured, or a service is provided, to meet the specifications that ensure customer needs are met.

Topic: Quality Management

3.4 Decision-making to Improve Operational Performance

There are several methods of quality control. At its simplest, quality control is achieved through inspection. For example, in a manufacturing business, trained inspectors examine samples of work-in-progress and finished goods to ensure standards are being met.

For businesses that rely on a continuous process, the use of **statistical process control ("SPC")** is common. SPC is the continuous monitoring and charting of a process while it is operating. Data collected is analysed to warn when the process is exceeding predetermined limits

Advantages of Quality Control

- With quality control, inspection is intended to prevent faulty products reaching the customer. This approach means having specially trained inspectors, rather than every individual being responsible for his or her own work. Furthermore, it is thought that inspectors may be better placed to find widespread problems across an organisation.

Disadvantages of Quality Control

- A major problem is that individuals are not necessarily encouraged to take responsibility for the quality of their own work.
- Rejected product is expensive for a firm as it has incurred the full costs of production but cannot be sold as the manufacturer does not want its name associated with substandard product. Some rejected product can be re-worked, but in many industries it has to be scrapped – either way rejects incur more costs,
- A quality control approach can be highly effective at preventing defective products from reaching the customer. However, if defect levels are very high, the company's profitability will suffer unless steps are taken to tackle the root causes of the failures.

Quality Assurance

Quality assurance is about **the processes that ensure production quality meets the requirements of customers.**

This is an approach that aims to achieve quality by organising every process to get the product '**right first time'** and prevent mistakes ever happening. This is also known as a '**zero defect'** approach.

In quality assurance, there is more emphasis on '**self-checking'**, rather than checking by inspectors.

Advantages of quality assurance include:

- Costs are reduced because there is less wastage and re-working of faulty products as the product is checked at every stage
- It can help improve worker motivation as workers have more ownership and recognition for their work (see Herzberg)
- It can help break down 'us and them' barriers between workers and managers as it eliminates the feeling of being checked up on

- With all staff responsible for quality, this can help the firm gain marketing advantages arising from its consistent level of quality

Total Quality Management ("TQM")

This is a specific approach to quality assurance that aims to develop a quality culture throughout the firm. In TQM, organisations consist of 'quality chains' in which each person or team treats the receiver of their work as if they were an external customer and adopts a target of 'right first time' or zero defects.

Which is Best: Quality Control or Quality Assurance?

Which approach to managing quality is best? Here is a summary of the main considerations:

Quality Assurance	Quality Control
A medium to long-term process; cannot be implemented quickly	Can be implemented at short-notice
Focus on processes – how things are made or delivered	Focus on outputs – work-in-progress and finished goods
Achieved by improving production processes	Achieved by sampling & checking (inspection)
Targeted at the whole organisation	Targeted at production activities
Emphasises the customer	Emphasises required standards
Quality is built into the product	Defect products are inspected out

Key Terms

Quality control	An approach to managing quality by inspecting production output before it is delivered to the customer
Quality assurance	A series of processes that aim to build quality into the production process

Topic: Inventory Management

3.4 Decision-making to Improve Operational Performance

What You Need to Know
The types of inventory held by businesses
The need for inventory holding and management
Factors influencing how much inventory is held
Inventory control charts

Introduction to Inventory (Stocks)

Inventories are the raw materials, work-in-progress and finished goods held by a firm to enable production and meet customer demand.

There are three main categories of inventory:

Type of Inventory	Description
Raw materials & components	Bought from suppliers Used in production process E.g. parts for assembly or ingredients
Work in progress	Semi or part-finished production E.g. construction projects
Finished goods	Completed products ready for sale or distribution E.g. products on supermarket shelves; goods in the ASOS and Amazon warehouses

Why Businesses Hold Inventory

Depending on the nature of the business, there are several reasons why a business will want to hold inventory:

What Inventory Management and Control is Important

Inventory management & control is a key part of a business operating efficiently:

- The business damage from stock-outs or having the wrong inventory can be significant
- However, it is crucial to manage inventory carefully as it often ties up a significant value of capital (cash) that could be used elsewhere in the business
- These days, inventory management is much easier due to widely available IT systems

Topic: Inventory Management

3.4 Decision-making to Improve Operational Performance

Main Influences on the Quantity of Inventory Held

How much inventory should a business hold? The answer of course is – it depends. Key factors a business needs to consider are:

- **Need to satisfy demand**
    - Failure to have goods available for sale is very costly
    - Demand may be seasonal or unpredictable
- **Need to manage working capital**
    - Holding inventories ties up cash in working capital
    - There is an opportunity cost associated with inventory holding
- **Risk of inventory losing value**
    - Longer stocks are held, the greater risk that they cannot be used or sold

Costs of Holding Inventory

A decision to hold inventory involves more than just the cost of the inventory itself. The overall cost of inventory needs to take account of:

Cost	**Explanation**
Cost of storage	More inventories require large storage space and possibly extra employees and equipment to control and handle them
Interest costs	Holding inventories means tying up capital (cash) on which the business may be paying interest
Obsolescence risk	The longer inventories are held, the greater is the risk that they will become obsolete (i.e. unusable or not capable of being sold)
Stock out costs	A stock out happens if a business runs out of inventory. This can result in: Lost sales & customer goodwill Cost of production stoppages or delays Extra costs of urgent, replacement orders

Stock-out costs can be particularly significant as it results in lost sales that may instead go to a competitor as well as the potential loss of customer goodwill and loyalty.

Inventory Control Charts

The overall objective of inventory control is to maintain inventory levels to that the total costs of holding inventories is minimised. Inventory control charts are a popular method of automating this process.

An example of an inventory control chart is shown below:

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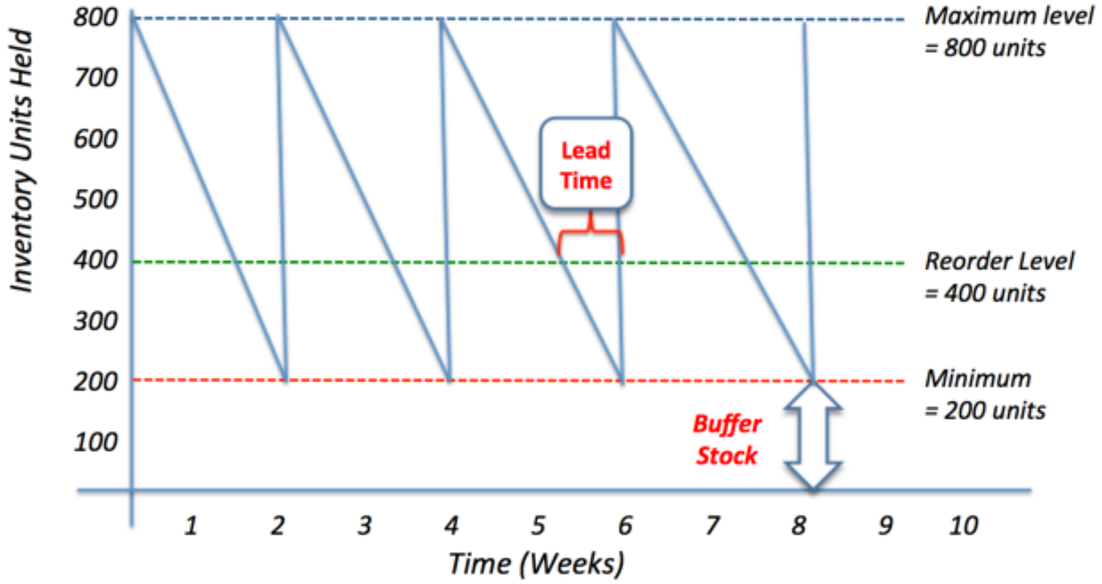
3.4 Decision-making to Improve Operational Performance



The key elements of an inventory control chart are as follows:

Element	Description
Maximum level	Max level of inventory a business can or wants to hold Example chart: 800 units
Re-order level	Acts as a trigger point, so that when inventory falls to this level, the next supplier order should be placed Example chart: 400 units
Lead time	Amount of time between placing the order and receiving the inventory Example chart: just under a week
Minimum inventory level	Minimum amount of product the business would want to hold in stock. Assuming the minimum stock level is more than zero, this is known as buffer stock
Buffer stock	An amount of inventory held as a contingency in case of unexpected orders so that such orders can be met and in case of any delays from suppliers

Careful consideration is required in deciding when and how much inventory to re-order. Key factors to take into account are:

- **Lead-time from the supplier**
  - How long it takes for the supplier to deliver the order
  - Higher lead times may require a higher re-order level
- **Implications of running out (stock-outs)**
  - If stock-outs are very damaging, then have a high re-order level & quantity
- **Demand for the product**
  - Higher demand normally means higher re-order levels

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Benefits and Drawbacks of Holding Low or High Inventory Levels
These can be summarised as follows:

LOW INVENTORY LEVELS	HIGH INVENTORY LEVELS
Lower inventory holding costs (e.g. storage)	Production fully supplied – no delays
Lower risk of inventory obsolescence	Potential for lower unit costs by ordering in bulk / high quantities
Less capital (cash) tied up in working capital – can be used elsewhere in the business	Better able to handle unexpected changes in demand or need for higher output
Consistent with operating "lean"	Less likelihood of "stock-outs"

Key Terms

Stock-out	Where a business is unable to satisfy customer demand due to inventory being unavailable
Re-order level	The inventory quantity at which a replacement order is triggered
Lead time	The period between placing an order and the receipt of inventory
Buffer stock	Inventory held as a contingency in case of unexpected orders so that such orders can be met and in case of any delays from suppliers

Topic: Lean Production
3.4 Decision-making to Improve Operational Performance

What You Need to Know
What is lean production?
Business benefits of operating "lean" & potential drawbacks
Key approaches to lean production

Introduction to Lean Production
Lean production is an approach to operations management that focuses on **cutting out waste**, whilst still **ensuring quality**. Lean production aims to cut costs by making the business **more efficient** and **responsive** to market needs.

It achieves this by **cutting out or minimising activities that do not add** value to the production process, such as holding of stock, repairing faulty product and unnecessary movement of people and product around the business.

The lean approach to managing operations is really about:

- Doing the simple things well
- Doing things better
- Involving employees in the continuous process of improvement
- ...and as a result, avoiding waste

The Importance of Reducing Waste (Cost)
Less waste means lower costs, which is an essential part of any business being competitive.

Type of Waste	Description
Over-production	Making more than is needed – leads to excess stocks
Waiting time	Equipment and people standing idle waiting for a production process to be completed or resources to arrive
Transport	Moving resources (people, materials) around unnecessarily
Stocks	Often held as an acceptable buffer, but should not be excessive
Motion	A worker who appears busy but is not actually adding any value
Defects	Output that does not reach the required quality standard – often a significant cost to an uncompetitive business

The key aspects of lean production that you should be aware of are:
- Time based management
- Simultaneous engineering
- Just in time production (JIT)
- Cell production

Time-based Management
Time-based management is a general approach that recognises the importance of time and seeks to reduce the level of wasted time in the production processes of a business. Benefits include:

- Quicker response times (reduced lead times) to meet changing market and customer needs
- Faster new product development
- Reduction in waste, therefore greater efficiency

For a business to operate time-based management effectively, it needs to have flexible production facilities that enable it to make changes easily. For example, it may need to be able to switch production quickly between different products and to alter the length of production runs as needed.

As with other aspects of lean production, time-based management also calls for flexible, multi-skilled staff, and a culture of mutual trust between workers and managers.

Simultaneous Engineering

Simultaneous Engineering is a **project management approach** that helps businesses develop and launch new products more quickly. All of the areas involved in a project are planned together. Everything is considered **simultaneously** (together, in parallel) rather than separately.

The main benefits of successful simultaneous engineering are:

- New product is brought to the market much more quickly
- Business may be able to charge a premium price that will give a better profit margin and help recoup R&D costs
- A greater sense of involvement across business functions improves staff commitment to the project
- Can be a source of competitive advantage ('first mover advantage') for the firm if it can get a reliable new product into the market and build brand loyalty before its competitors

Cell Production

Cell production is a form of team working where production processes are split into cells. Each cell is responsible for a complete unit of work

Amongst the potential benefits of cell production are:

- Closeness of cell members should improve communication, avoiding confusion arising from misunderstood or non-received messages
- Workers become multi-skilled and more adaptable to the future needs of a business
- Greater worker motivation, arising from variety of work, team working and more responsibility
- Quality improvements as each cell has 'ownership' for quality on its area

Some of the downsides of using cell production include:

- The business culture has to encourage trust and participation, or workers can feel that they are being constantly pushed for more and more output with no respite
- The business may have to invest in new materials handling and ordering systems suitable for cell production

- Cell production may not allow a business to use its machinery as intensively as in traditional flow production
- Some small scale production lines may not yield enough savings to make a switch cell production economically worthwhile
- The allocation of work to cells has to be efficient so that they have enough work, but not so much that they are unable to cope
- Recruitment and training of staff must support this approach to production

Just-in-time ("JIT")
JIT aims to ensure that inputs into the production process only arrive when they are needed. Implemented successfully, stock levels of raw materials, components, work in progress and finished goods can be kept to a minimum.

The key features of JIT are:
- Based on a "pull" system of production - customer orders determine what is produced
- Requires complex production scheduling - achieved using specialist software to connect production department with suppliers
- Supplies delivered to production line only when needed
- Requires close cooperation with high-quality suppliers

The main benefits and potential drawbacks of using JIT are:

Advantages	Disadvantages
Lower stock holding means a reduction in storage space which saves rent and insurance costs	There is little room for mistakes as minimal stock is kept for re-working faulty product
As stock is only obtained when it is needed, less working capital is tied up in stock	Production is highly reliant on suppliers and if stock is not delivered on time, the whole production schedule can be delayed
Less likelihood of stock perishing, becoming obsolete or out of date	There is no spare finished product available to meet unexpected orders, because all product is made to meet actual orders
Less time spent on checking and re-working production as the emphasis is on getting the work right first time	A need for complex, specialist stock systems

Key Terms

Lean production	Organising production and operations to minimise waste
Cell production	A form of team working that helps ensure worker commitment, as each cell is responsible for a complete unit of work
Just-in-time (JIT)	A manufacturing system in which materials or components are delivered immediately before they are required in production

Topic: Supply Chains
3.4 Decision-making to Improve Operational Performance

What You Need to Know
What are suppliers and the "supply chain"?
Factors influencing the choice of suppliers
How to manage a suppliers effectively

Role of Suppliers in Business
A supplier is a business or individual that provides goods and services to another business. Examples of suppliers include:

Example Business	**Typical Suppliers**
Food manufacturer	Raw materials Energy (electricity, gas, light)
Fashion retailer	Suppliers of garments (wholesalers) Landlord (shop lease)
Online publisher	Authors Web host & website designers

Suppliers are usually involved at each stage of the transformation process. The resources and services provided by suppliers to a business are known as the supply chain. A simple example might be a restaurant business, as illustrated below:

Importance of Suppliers to a Business
Suppliers are usually a crucial part of managing a successful business:
- For a business to meet the needs and wants of customers, it needs an effective "supply chain"
- Suppliers determine many of the costs of a business (e.g. raw materials, distribution)
- Suppliers are closely linked to product quality
- Suppliers can be an important source of finance to a business (trade credit)
- For businesses that use lean production techniques, effective relationships with key suppliers are essential

Examples of the ways in which suppliers can help improve business performance include:

Topic: Supply Chains
3.4 Decision-making to Improve Operational Performance

Lower purchase costs	Better prices from a supplier lower the costs of a business
Better quality	Crucial for a business to satisfy customers
Improved customer service	E.g. fewer late deliveries
Increased productivity	E.g. fewer production delays, less wastage (lean production)
More flexible capacity	E.g. ability of a business to work with suppliers to meet sudden increase in demand

Characteristics of Effective Suppliers
The price at which a supplier provides goods and services is just one important consideration. A range of factors determine the effectiveness of a supplier:

Factor	**Characteristics of an Effective Supplier**
Price	Often considered the most important; value for money is crucial But, lowest price not necessarily the best value – depends on quality
Quality	Consistently high quality; the right product at the right time
Reliability	Delivers the correct product on time Goods and services work as described
Communication	Easy to communicate with supplier – e.g. place orders, develop trading relationship
Financially secure	Long-term trading relationship requires supplier to stay in business! Also more likely to offer better payment terms
Capacity	Ability to handle increased volumes of supply, perhaps at short notice

Whilst non-price factors such as reliability, quality, location etc. are important, suppliers must also offer a competitive price (value for money). This is particularly important if a business has an objective of cost efficiency or cost minimisation. Two ways in which supplier prices can be pushed lower by are by:

- Grouping purchases with fewer suppliers (use bargaining power to get lower price)
- Ensuring suppliers compete against each other for regular orders

Key Terms

Supplier	A person or business that is the source of goods and services
Supply chain	The network of all the resources and suppliers involved in the creation and sale of a product

Topic: Setting Financial Objectives

3.4 Decision-making to Improve Financial Performance

What You Need to Know
Value of setting financial objectives
Distinction between cash flow and profit
Objectives for: • Revenue, cost and profit • Cash flow • Investment levels and returns • Capital structure
Influences on financial objectives

Introduction to Financial Objective

A financial objective is a specific goal or target of relating to the financial performance, resources and structure of a business.

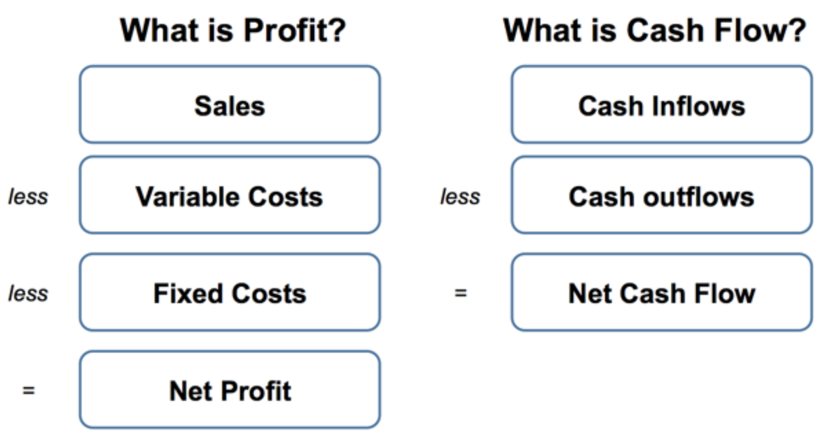
When set appropriately, financial objectives provide many benefits to business management:

- A focus for the entire business
- Important measure of success of failure for the business
- Reduce the risk of business failure
- Provide transparency for shareholders about their investment
- Help coordinate the different business functions
- Key context for making investment decisions

The Difference between Profit and Cash Flow

An important distinction needs to be made between profit and cash flow. They are similar concepts – but not quite the same!

Profit	The difference between total revenues and total costs over a period
Cash Flow	The difference between total cash inflows and total cash outflows over a period



Profit and cash flow are linked as follows

- Profits are the main source of funds for an established business

- Revenues eventually turn into cash inflows
- Costs eventually turn into cash outflows

However, cash flow differs from profit in the following ways:

- **Timing differences**
  - Sales to customers made on credit
  - Payments to suppliers
- **The way fixed assets are accounted for**
  - Payment for fixed asset = cash outflow
  - Cost of fixed asset = treated as an asset not a cost
  - Depreciation is charged as cost when the value of fixed assets is reduced
- **Cash flows arising from the way the business is financed**
  - Inflows from shareholders, bank loans, factoring etc.
  - Repayments of amounts loaned
  - Payment of dividends

The table below provides some more detailed examples of how business transactions have different effects on profit and cash flow:

Transaction Example	What happens to Profit?	What happens to Cash Flow?
Customer buys goods for £50,000 on 60 days credit	Sales of £50,000 are recognised immediately	Cash inflow of £50,000 when the customer actually pays
Marketing campaign costing £10,000 ordered from marketing agency	Cost of £10,000 included in marketing costs	Cash outflow of £10,000 when the marketing agency is paid
New factory machinery bought for £150,000	No effect. £150,000 added to the value of fixed assets	Cash outflow of £150,000 paid to supplier of machinery
Depreciation charge of £100,000 to reflect use of factory fixed assets	Depreciation of £100,000 included as a cost	No effect on cash flow

Introduction to Revenue, Cost and Profit Objectives
Before looking at revenue, cost and profit objectives, it is worth highlighting how the achievement of these objectives might be recorded in the financial statements of a business.

The relevant financial statement is the Income Statement – a historical record of the trading performance of a business over time. An example Income Statement is shown below.

All figures in £'000	2016	2015
Revenue	**3,500**	**2,750**
Cost of Sales	(1,700)	(1,300)
Gross Profit	**1,800**	**1,450**
Administrative Expenses	(650)	(550)
Operating Profit	**1,150**	**900**
Net Finance Costs	(75)	(80)
Taxation	(250)	(150)
Profit for the Year	**825**	**670**

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

Category	Explanation
Revenue	Revenues (sales) during the period.
Cost of sales	Direct costs of generating revenues go into "cost of sales". Includes the cost of raw materials, components, goods bought for resale and the direct labour costs of production
Gross profit	The difference between revenue and cost of sales. A simple but very useful measure of how much profit is generated from every £1 of revenue before overheads and other expenses are taken into account. Is used to calculate the gross profit margin (%)
Administration expenses	Operating costs and expenses that are not directly related to producing the goods or services are recorded here. Includes distribution costs (e.g. marketing, transport) and the wide range of administrative expenses or overheads that a business incurs
Operating profit	A key measure of profit. Operating profit records how much profit has been made in total from the trading activities of the business before account is taken of how the business is financed.
Finance expenses	Interest paid on bank and other borrowings, less interest income received on cash balances. A useful figure for shareholders to assess how much profit is being used up by the funding structure of the business.
Taxation	An estimate of the amount of corporation tax that is likely to be payable on the profits for the period.
Profit for the year	The amount of profit that is left after the tax has been accounted for. Shareholders then decide how much of this is paid out to them in dividends and how much is left in the business ("retained profits").

Topic: Setting Financial Objectives

3.4 Decision-making to Improve Financial Performance

Revenue Objectives

Most businesses set revenue objectives. The most common are:

Revenue Objective	Example
Revenue growth (percentage or value)	Aiming to grow total revenues by 10% Reach £1million in sales during a year
Sales maximisation	Aim to maximise total sales – regardless of whether those sales are profitable
Market share	Grow market share to 20% (will involve faster revenue growth than market competitors)

Cost Minimisation Objectives

Cost minimisation is a strategy that aims to achieve the **most cost-effective way of delivering goods and services to the required level of quality**.

If successful, the key business benefits of cost minimisation would likely be:

- Lower unit costs (competitiveness)
- Higher gross profit margin
- Higher operating profits
- Improved cash flow
- Higher return on investment

Profit Objectives

Revenue and cost objectives are often set in order to support profit objectives. The most common profit objectives are:

Profit Objective	Example
Specific level of profit (in absolute terms)	Achieve an operating profit of £1m
Rate of profitability (as a % of revenues)	Achieve an operating profit margin of 10% of revenues
Profit maximisation	Maximise the total profit for the year
Exceed industry or market profit margins	Achieve a higher gross or operating profit margin than key competitors

Cash Flow Objectives

It is rare for businesses to set cash flow objectives (certainly compared with revenue and profit objectives). However, strong cash flow helps business achieve other financial objectives by providing extra financial resources.

Depending on the financial position of the business, some possible cash flow objectives might be:

- Reduce borrowings to target level
- Minimise interest costs
- Reduce amounts held in inventories or owed by customers
- Reduce seasonal swings in cash flows
- Net cash flow as a percentage of net profit (e.g. 90% of operating profit)

Topic: Setting Financial Objectives
3.4 Decision-making to Improve Financial Performance

Investment Objectives
Most businesses make investments to a greater or lesser degree. Like any investment, the aim is usually to earn at least an acceptable return on those investments.

Business investment includes:

- Capital expenditure on items such as product machinery, IT systems, buildings etc.
- Can also be the purchase of other businesses (takeovers) or brands
- Investment is intended to help generate a return (profit) over more than one year

Two common investment objectives are:

Level of Capital Expenditure	Set at either an absolute amount (e.g. invest £5m per year) or as a percentage of revenues (e.g. 5% of revenues)
Return on Investment	Usually set as a target % return, calculated by dividing operating profit by the amount of capital invested

Capital Structure of a Business
The final area to look at in terms of financial objectives relates to the way that a business is financed. In particular this is about – the long-term finance which forms the foundations for the business.

An important distinction can be made between the two main types of capital in a business – **equity** and **debt.**

Equity	Represents amounts invested by the owners of the business: it comprises: **SHARE CAPITAL** **RETAINED PROFITS**
Debt	Represents long-term finance provided to the business by external parties: it comprises **LONG-TERM BANK LOANS** **OTHER LONG-TERM DEBT** (E.G. DEBENTURES)

An example of a balance sheet which two different capital structures is shown below:

Extract from the Balance Sheet on 31/12/XX	**BUSINESS A £'000**	**BUSINESS B £'000**
Share capital [A]	500	300
Retained profits [B]	300	100
Bank loan [C]	200	500
Other loan capital [D]	0	100
Total Capital	**1,000**	**1,000**
Made up of…		
Total Equity [A + B]	800	400
Total Debt [C + D]	200	600

Looking at the information in the balance sheet extract, it is possible to calculate what is known as a the debt/equity ratio:

The debt/equity ratio is the proportion (percentage) of a business' capital made up from DEBT and EQUITY

BUSINESS A £'000	**BUSINESS B £'000**
$\dfrac{\textit{Debt} \quad 200}{\textit{Equity} \quad 800}$	$\dfrac{\textit{Debt} \quad 600}{\textit{Equity} \quad 400}$
= 25%	***= 150%***

Business A has a much lower debt/equity ratio (25%) compared with Business B. That means that a much larger proportion of the capital of the business is in the form of equity than Business B. That might be a good thing – depending on the nature of the business and also what financial objective the business has for its capital structure.

- **Reasons for higher equity in the capital structure**
  - Where there is greater business risk (e.g. a startup)
  - Where more flexibility required (e.g. don't have to pay dividends)
- **Reasons why high levels of debt can be an objective**
  - Where interest rates are very low = debt is cheap to finance
  - Where profits and cash flows are strong; so debt can be repaid easily

Topic: Setting Financial Objectives

3.4 Decision-making to Improve Financial Performance

Internal and External Influences on Financial Objectives

The key internal influences on financial objectives include:

Business ownership	The nature of business ownership has a significant impact on financial objectives. A venture capital investor would have quite a different approach to a long-standing family ownership.
Size and status of the business	E.g. start-ups and smaller businesses tend to focus on survival, breakeven and cash flow objectives. Quoted multinational businesses are much more focused on growing shareholder value
Other functional objectives	Almost every other functional objective in a business has a financial dimension – which often brings the finance department into conflict with other functions.

Some important external influences on financial objectives include:

Economic conditions	The economic downturn forced many businesses to reappraise their financial objectives in favour of cost minimisation and maximising cash inflows and balances. Significant changes in interest rates and exchange rates also have the potential to threaten the achievement of financial targets like return on investment.
Competitors	Competitive environment directly affects the achievability of financial objectives. E.g. cost minimisation may become essential if a competitor is able to grow market share because it is more efficient
Social and political change	Often an indirect impact. E.g. legislation on environmental emissions or waste disposal may force an business to increase investment in some areas, and cut costs in others

Key Terms

Capital structure	The long-term financial base of a business split between equity sources and long-term debt
Debt/equity ratio	The proportion of business capital provided by long-term debt
Cost minimisation	Strategy that aims to achieve the most cost-effective way of delivering goods and services to the required level of quality.

Topic: Measurement & Importance of Profit
3.4 Decision-making to Improve Financial Performance

What You Need to Know
What are revenues?
What are costs and how do they relate to output?
How is profit measured?
Why profit is important in business

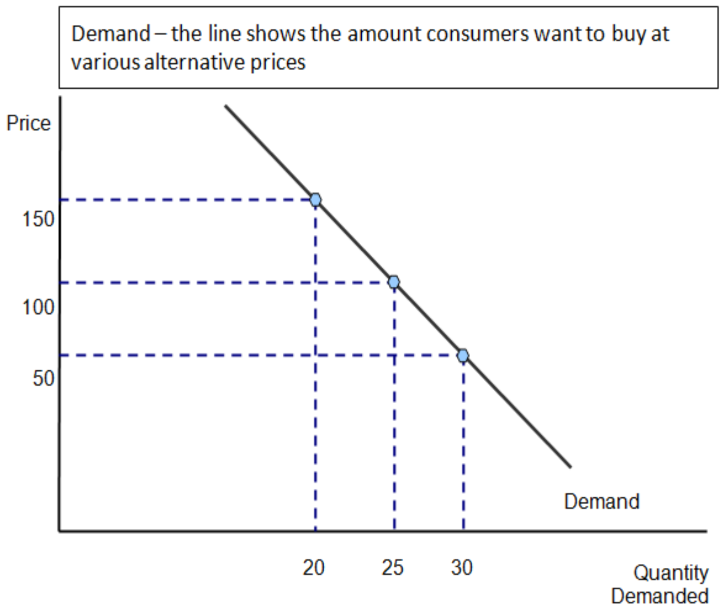
Introduction to Revenues and Demand
A business generates revenues by satisfying demand from customers. In other words, revenues flow from customer demand – but only if a business has a product that meets the customer needs and expectations:

Revenues	• The amount (value) of a product that customers actually buy from a business
Demand	• The amount of a product that customers are prepared to buy • Can be measured in terms of **volume** (quantity bought) and/or **value** (£ value of sales)

Various factors will affect the level of demand:

- Prices & Incomes (you look at this in more detail when considering **elasticity of demand**)
- Tastes & fashions
- Competitor actions
- Social & demographic change
- Seasonal changes
- Changing technology
- Government decisions

The relationship between quantity demanded and price can be shown graphically by drawing a demand curve, as illustrated below:



Topic: Measurement & Importance of Profit
3.4 Decision-making to Improve Financial Performance

Revenue
There are various different names for the same thing – the value of what a business sells!

- Sales
- Revenues
- Income
- Turnover
- Takings

They all mean the same thing - revenue arises through the trading activities of a business.

The value of revenue achieved in a given period is a function of the quantity of product sold multiplied by the price that customers paid. So revenues can be calculated using the following important formula:

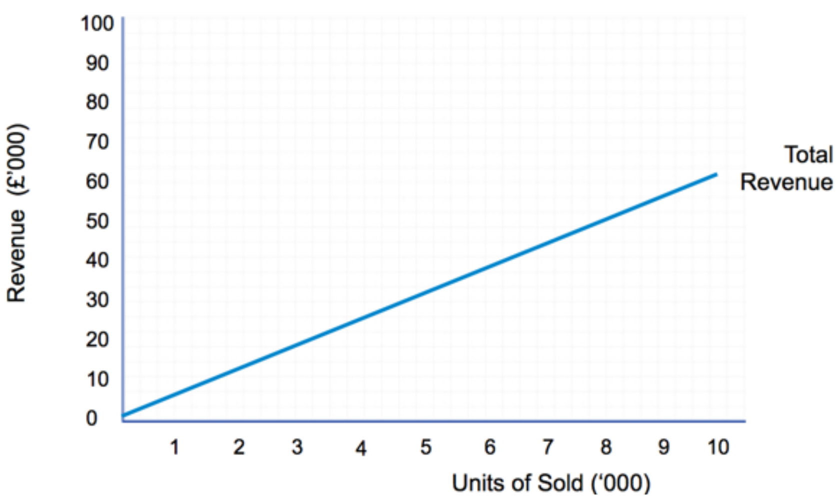
Total revenue = volume sold x average selling price

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

Product	Quantity (Q)	Price (P)	Revenue (P x Q)
		£ / unit	£
Blue	5,000	£10	£50,000
Red	2,500	£12	£30,000
Pink	8,000	£11	£88,000
Purple	4,000	£10	£40,000
Total	19,500		£208,000

Using the revenue formula, you can chart the value of total revenue. Revenues rise as higher quantities are sold.

In the chart below, we assume that each unit of product is sold for the same price (£6). E.g. 10,000 units sold at £6 per unit = total revenues of £60,000



Using the revenue calculation formula, you can see that there are two main ways of increasing revenues:

Increase quantity (amount) sold

- Perhaps by cutting the price or offering volume-related incentives (e.g. 2 for price of 1)
- Key issues - is demand sensitive to price?

Achieve a higher selling price

- Best to add value rather than simply increase price
- Does market research suggest that prices are high enough or too low?

Introduction to Costs

Costs are amounts that a business incurs in order to make goods and/or provide services.

Costs are important to business because they:

- Are the thing that **drains away the profits** made by a business
- Are the difference between making a good and a poor **profit margin**
- Are the **main cause of cash flow problems** in business
- **Change as the output or activity of a business changes**

Variable and Fixed Costs

An important distinction needs to be made between variable and fixed costs. This is summarised below:

VARIABLE COSTS	FIXED COSTS
• Costs which change as output varies • Lower risk for a start-up: no sales = no variable costs	• Costs which do not change when output varies • Fixed costs increase the breakeven output
Examples: • Raw materials • Bought-in stocks • Wages based on hours worked or amount produced • Marketing costs based on sales (e.g. % commission)	***Examples:*** • Rent & rates • Salaries • Advertising • Insurance, banking & legal fees • Software • Research and development

Calculating Total Costs

The total costs of a business can be calculated using this formula:

Total costs (TC) = Fixed costs (FC) + Variable costs (VC)

Let's look at a simple example of how total costs can be calculated using the following example data:

Topic: Measurement & Importance of Profit
3.4 Decision-making to Improve Financial Performance

Graham's Van Repairs Business *Forecasts for March*	
Variable costs per job	£75
Garage rent & rates	£500
Wages	£1,500
Advertising	£100
Other fixed costs	£400
Expected number of jobs for month	100

What would Graham's costs be in March if his forecasts prove correct?

Stage 1: calculate variable costs: = £75 x 100 = £7,500
Stage 2: add together the fixed costs = £2,500 (i.e. £500 + £1,500 + £100 + £400)
Stage 3: add variable to fixed costs: total costs are £10,000 (£7,500 + £2,500)

The costs incurred by a business are often relatively easy to estimate. You know how much salary someone is paid or what price your supplier is charging. However, this is not always the case – some costs are uncertain:

- Raw materials – affected by wastage
- Product returns or refunds – affected by quality
- Where a business or entrepreneur does not have detailed experience of a market

How Costs Change with Output
As output rises, total costs can be expected to increase. However, as output rises, fixed costs are spread over more units produced, which usually results in lower unit costs. The table below illustrates how unit costs (cost per unit) change as output increases:

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

[note: in the above example it is assumed that fixed costs are £10,000 & variable costs are £100 per unit]

Introduction to Profit
Profit is perhaps the most important concept in business. Profit is:

- A return on investment
- A reward for taking risks
- A key source of finance

Topic: Measurement & Importance of Profit

3.4 Decision-making to Improve Financial Performance

- A measure of business success
- A motivating factor & incentive

The calculation is profit is straightforward.

Profit = Total Sales less Total Costs

A simple example of this profit calculation formula is shown below:

Sales	Costs	Profit or Loss?
£100,000	£75,000	£25,000 (profit)
£100,000	£125,000	£25,000 (loss)
Total sales > total costs Total costs > total sales Total sales = total costs		= Profit = Loss = Breakeven

Profit can be measured in both absolute terms (how much) and relative terms (profit as a percentage):

- **Profit in <u>absolute</u> terms**
  - The £ value of profits earned
  - E.g. £50,000 profit made in the year
- **Profit in <u>relative</u> terms**
  - The profit earned as a proportion of sales achieved or investment made
  - E.g. £50,000 profit from £500,000 of sales is a profit margin of 10%
  - E.g. £50,000 profit from an investment of £1 million = a 5% return on investment

Putting it Together: Revenues, Costs and Profit

Using the calculations we have introduced in this topic, here is how the three concepts of revenues, costs and profit come together:

Output	Total Revenues	Total Costs	Profit or (Loss)
Units	**£**	**£**	**£**
50	10,000	15,000	(5,000)
100	20,000	20,000	Nil
150	30,000	25,000	5,000
200	40,000	30,000	10,000
250	50,000	35,000	15,000

Key Formulae

Revenues (Sales)	Selling price per unit x Quantity sold
Costs	Fixed costs + variable costs
Profit	Total revenues less total costs

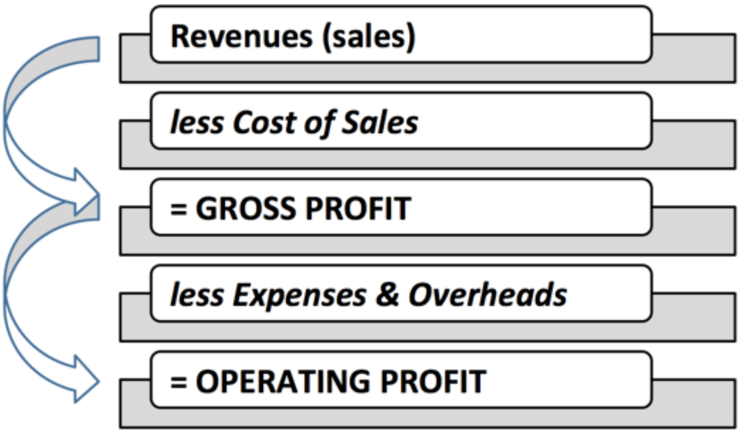
Topic: Improving Profit
3.4 Decision-making to Improve Financial Performance

What You Need to Know
Gross profit and gross profit margin
Operating profit and operating profit margin
Methods of improving profits & profitability

The Components of Profit
Remember that the simple formula for calculating profit it:

Total Profit = Total Revenues less Total Costs

The profit that arises from the operations of a business can be analysed in more detail as illustrated in diagram below. We'll explore this breakdown in more detail below.



Introduction to Ratio Analysis
Ratio analysis involves looking at the relationships between financial data to assess the performance of a business. Ratio analysis is particularly useful when it comes to understanding how profitable a business is and how profit might be improved.

Profitability ratios provide some really useful insights into business performance:

- Is the business making a profit? Is profit growing?
- How efficient is the business at turning revenues into profit?
- Is the profit enough to justify investment in the business?
- How does the profit achieved compare with the rest of the industry?

We'll look in more detail at two key profitability ratios:

- Gross profit margin
- Operating profit margin

Topic: Improving Profit

3.4 Decision-making to Improve Financial Performance

Gross Profit Margin

The table below illustrates an example of how to calculate gross profit margin:

£'000	**2014**	**2015**	**2016**
Revenue	250	325	400
Cost of Sales	150	186	225
Gross Profit	**100**	**139**	**175**
Gross margin	40.0%	42.8%	43.8%

In the calculations above we use two important formulae:

Gross profit = revenue less cost of sales

Gross margin (%) = gross profit / revenue

Operating Profit

Operating profit is what is left after all the costs of a business have been taken from its revenues.

The operating profit margin expresses operating profit as a percentage of revenues using the formula:

Operating profit margin (%) = Operating Profit (£) / Total Revenues (£)

An example of this is shown in the table below:

	£'000
Revenues	**150**
Wages	(50)
Energy costs	(25)
Marketing	(15)
Other overheads	(30)
OPERATING PROFIT	**30**
Operating profit margin	*20%*

The operating profit margin (%) is a very useful ratio. It helps tell us:

- How effectively a business turns its sales into profit
- How efficiently a business is run
- Whether a business is able to "add value" during the production process (a high margin business must be doing something right!)

Comparing Operating Profitability with Other Businesses

The operating profit margin of a business can be compared with other competitors in the same market, and over time, to provide useful insights.

Take the following data as an example:

Topic: Improving Profit

3.4 Decision-making to Improve Financial Performance

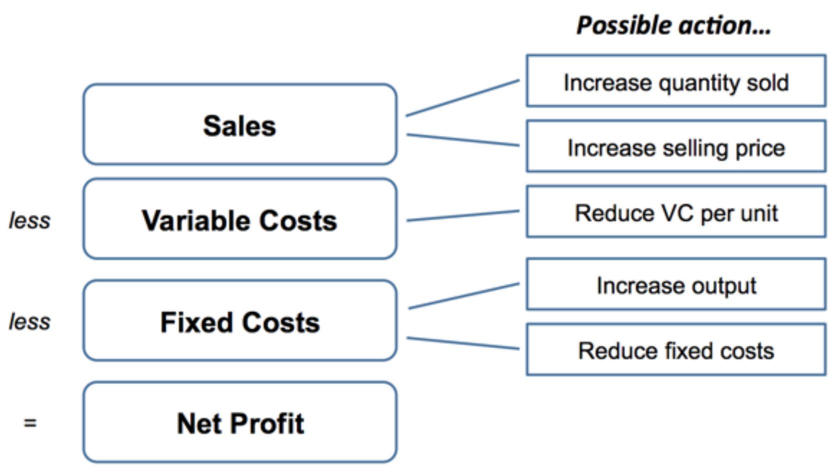
	Company A £'000	Company B £'000	Company C £'000
Sales	150	250	500
Operating profit	50	25	125
Operating profit margin	20%	10%	25%

In the table above:

- Company A makes a higher operating profit than Company B even though its sales are lower – because it has a higher operating profit margin
- Company C makes the highest operating profit margin of these three & also the highest sales. So it makes the largest operating profit too!

How to Improve Profit

A useful way of thinking about the ways a business can improve its profit is by returning to the components of profit. The diagram below illustrates the simple ways profit might be increased:



Let's look at each of these possible actions in turn:

Increase the Quantity Sold (Higher Sales)

Why?	Higher sales volumes = higher sales, assuming that the selling price is not lowered Makes better use of production capacity (i.e. fixed costs should not rise) May result in higher market share
Will it work?	Depends on elasticity of demand Sales value may actually fall if price has to be reduced to achieve higher sales volumes Does business have capacity to sell more?
Why it might not work	Competitors are likely to respond Marketing efforts may fail – e.g. promotional campaign does not generate results Fixed costs might actually rise – e.g. higher marketing

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Increase Selling Prices (Higher Sales)

Why?	Higher selling price = higher sales (assuming quantity sold does not fall in response) Maximises value extracted from customers Customers may perceive product as higher quality No need for extra production capacity
Will it work?	Depends on price elasticity of demand Sales value may actually fall price rise is matched by an even bigger fall in quantity sold It will work if customers remain loyal and still perceive product to be good value
Why it might not work	Competitors are likely to respond (e.g. prices lower) Customers may decide to switch to competitors

Reduce Variable Costs per Unit (Lower Cost of Sales = Higher Gross Margin %)

Why?	Increase the value added per unit sold Higher profit margin on each item produced and sold Customers do not notice a change in price
Will it work?	Yes, if suppliers can be persuaded to offer better prices Yes, if quality can be improved through lower wastage Yes, if operations can be organised more efficiently
Why it might not work	Lower input costs might mean lower quality inputs – which can lead to greater wastage Customers may notice a decrease in product quality

Increase Production Output (Spread Fixed Costs over Higher Output)

Why?	Provides greater quantity of product to be sold Enables business to maximise share of market demand Spreads fixed costs over a greater number of units
Will it work?	Yes, if the extra output can be sold (e.g. finding a new market, offering a lower price for a more basic product) Yes, if the business has spare capacity
Why it might not work	A dangerous option – what if the demand is not there? Fixed costs might actually rise (e.g. stepped fixed costs) Production quality might be compromised (lowered) in the rush to produce more

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Reduce Fixed Costs (Lower Costs = Higher Profit)

Why?	A drop in fixed costs translates directly into higher profits Reduces the break-even output Often substantial savings to be made by cutting unnecessary overheads
Will it work?	Yes, provided costs cut don't affect quality, customer service or output A business can nearly always find savings in overheads
Why it might not work	Might reduce ability of business to increase sales Intangible costs – e.g. lower morale after making redundancies

More Complex Approaches to Increasing Profit

Two other ways a business might look to improve profit could be:

Reduce product range

- Business often has too many products = complex operations & inefficiency
- Some products may be very low-margin or even loss-making

Outsource non-essential functions

- A way of reducing fixed costs
- Focus the business on what it is good at
- Areas to outsource: e.g. IT, call handling, finance

Key Terms

Gross profit	Calculated as total sales less total cost of sales
Operating profit	Calculated as gross profit less fixed costs and other overheads

Topic: Breakeven Analysis

3.4 Decision-making to Improve Financial Performance

What You Need to Know
What is breakeven and contribution?
Methods of calculating breakeven
Using breakeven analysis
Value & limitations of breakeven analysis

Introduction

Understanding the breakeven position is key to understanding what a business needs to do to operate profitably.

Calculating contribution and breakeven output is an important analytical method that is used in every type of business – large and small

However, breakeven analysis makes certain assumptions, so be aware of its limitations!

Contribution

Contribution is one of the most important concepts in business and it is essential that you understand it!

- Contribution looks at the profit made on individual products
- It is used in calculating how many items need to be sold to cover all the business' total costs (variable and fixed)
- Contribution is the difference between sales and variable costs of production

In terms of calculating contribution, there are several different formulae:

Contribution = total sales less total variable costs

Contribution per unit = selling price per unit less variable costs per unit

Total contribution can also be calculated as:

Contribution per unit x number of units sold

Finally,

Profit = Contribution less Fixed Costs

Example Calculation of Contribution

Using the following data, let's calculate contribution:

Data

Quantity sold: 5,000 units
Selling price per unit: £10
Variable cost per unit: £5
Fixed costs: £10,000

Contribution per unit = £10 less £5 = £5
Total Sales = 5,000 x £10 = £50,000
Total Variable Costs = 5,000 x £5 = £25,000
Total Contribution = £50,000 - £25,000 = £25,000

Introduction to Breakeven
A business is said to "breakeven" when it is earning enough sales to cover all its costs.

The breakeven point (breakeven output) happens when total sales = total costs.

In other words, at the break-even point, the business isn't making a profit, but it isn't making a loss either!

When we look at breakeven, we are concerned with the following key issues:

- At what level of production (output) does break-even take place?
- What is the effect on break-even of changes in the business?
- What business decisions can be taken which affect break-even and which will help improve profits?

There are three alternative ways of calculating the breakeven point:

- A table (or spreadsheet) showing sales and costs over different levels of output
- A formula which you can use to calculate break-even output
- A graph which charts sales and costs

For each approach, we have to make some important assumptions:

- Selling price per unit stays the same, regardless of the amount produced
- Variable costs vary in direct proportion to output – i.e. variable cost per unit is the same
- All output is sold
- Fixed costs do not vary with output – they stay the same

Using a table to calculate break-even output

Here is a table showing the sales, variable costs, fixed costs and profits from various levels of output for a one-product business:

The product is sold for £10 per unit. The variable cost per unit is £4. Fixed costs are £40,000 (the same at each level of output).

Topic: Breakeven Analysis

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Output	Sales	Variable Costs	Fixed Costs	Total Costs	Profit
'000	£'000	£'000	£'000	£'000	£'000
0	0	0	40	40	-40
1	10	4	40	44	-34
2	20	8	40	48	-28
3	30	12	40	52	-22
4	40	16	40	56	-16
5	50	20	40	60	-10
6	**60**	**24**	**40**	**64**	**-4**
7	**70**	**28**	**40**	**68**	**2**
8	80	32	40	72	8
9	90	36	40	76	14
10	100	40	40	80	20

Using the table, you can see that the break-even output is somewhere between 6,000 and 7,000 units. At 6,000 units, the business makes a loss of £4,000. At 7,000 units, the business makes a profit of £2,000.

Using a formula to calculate break-even output

Let's use the same information as above to show how a formula can be used to quickly calculate the break-even output.

Remember contribution per unit? Here is a reminder of this crucial and really useful formula:

Contribution per unit = selling price per unit less variable cost per unit

In our example, contribution per unit = **£10 less £4 = £6 per unit**

Here comes the clever bit – the formula

Break-even output (units) = Fixed costs (£) / Contribution per unit (£)

So, break-even output = £40,000 divided by £6 = 6,666

Note: break-even output is always expressed in terms of units

So break-even output = 6,666 units

If the information is available, it is always quicker and easier to use this formula rather than use a table or draw a chart.

Using a chart to calculate break-even output

Using graph paper, it is possible to chart the financial data that allows the break-even output to be measured. We'll use the same example data one last time!

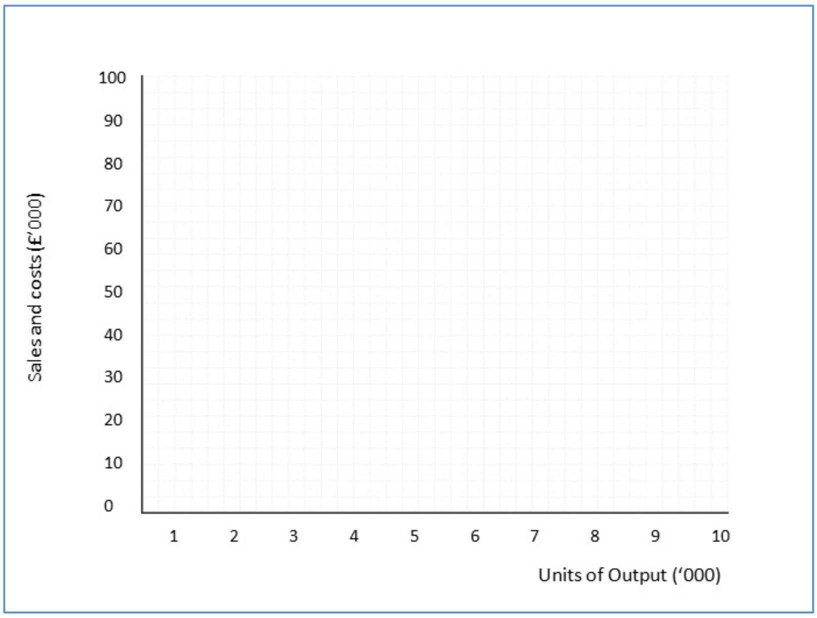
Topic: Breakeven Analysis
3.4 Decision-making to Improve Financial Performance

Step 1

The first step is to produce two axes:

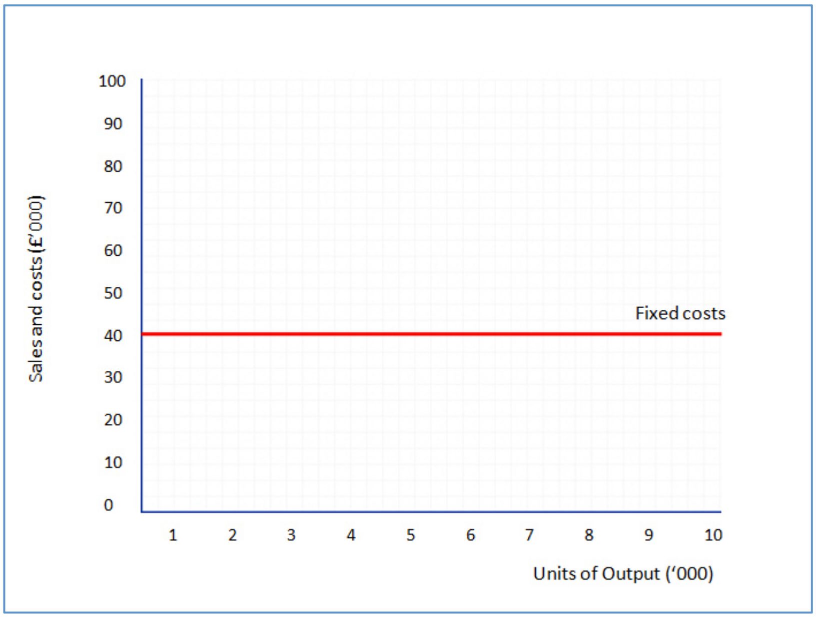
- The vertical axis shows the value of sales & costs
- The horizontal axis shows the output

So here is what the blank chart would look like:



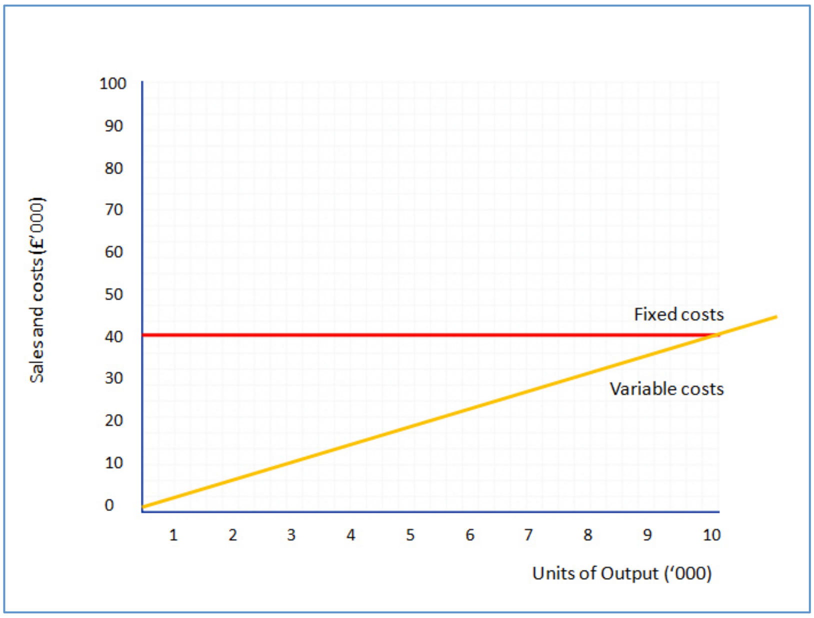
Step 2

The next step is to add the fixed cost line. Remember that we assume fixed costs don't change with the level of output. So the fixed cost line (in red below) is a horizontal line, showing £40,000.



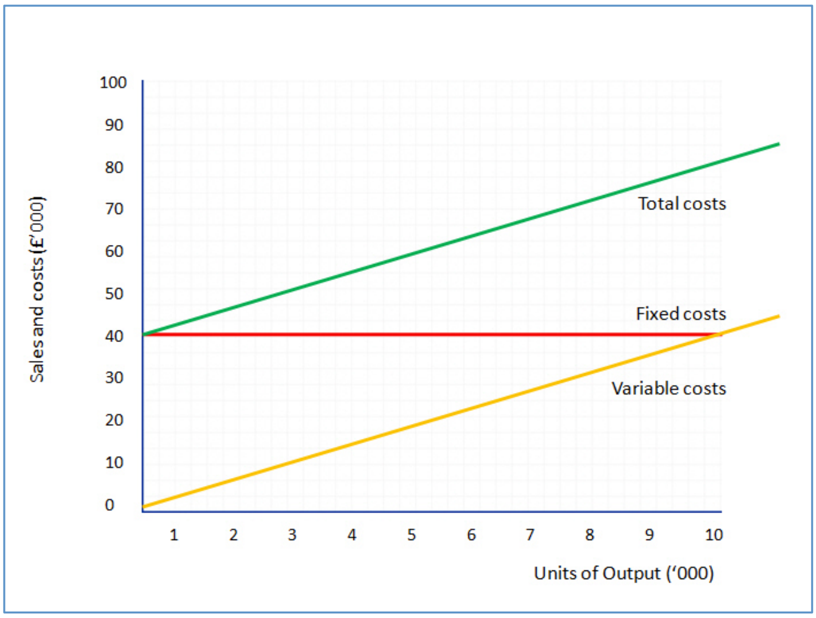
Step 3

Next we add the variable costs. We assume that variable costs vary directly with output. In our example, the variable cost per unit is £4. So variable costs for 1,000 units will be £4,000, and at 5,000 units they will be £20,000. Remember that you only need to plot a couple of points to be able to draw the straight line (in yellow below).



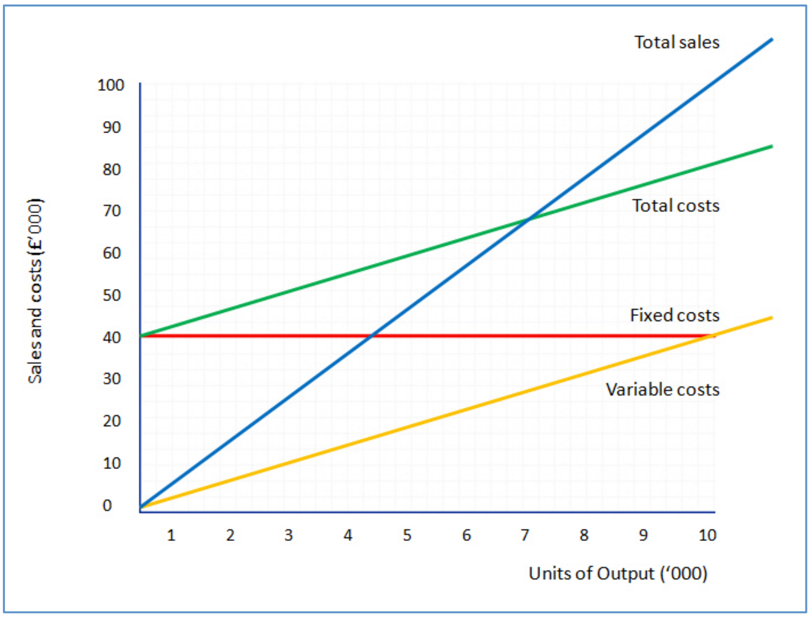
Step 4

Next step is to add the variable costs to the fixed costs for each level of output. This is important. Remember that to calculate break-even we need to know total costs. The total cost line is shown in green on the chart.



Step 5

Having dealt with costs, we can now draw the line for total sales. Remember that we assume that all output is sold for the same selling price (in this case - £10 per unit). So total sales for 2,000 units will be £20,000; 10,000 units will make £100,000 of sales. The total sales line is drawn in blue below.



Step 6

Almost there! The last step is to use these lines to identify certain information from the chart.

First, the break-even output. Remember this is the point where total sales = total costs. So the output is the point where the total sales line crosses the total costs line (e.g. where the blue line crosses the green line). Find this point on the chart and then follow a vertical line down to the output (horizontal) axis. You can see this brings us to 6,666 (approximately, since our chart isn't drawn perfectly to scale!).

Another thing you can notice from the chart is the over a range of output, total costs are higher than total sales (green line higher than the blue line). That means that in this range, the business is making losses. This is the **loss-making range of output**.

If the actual output is more than the break-even output, the business will be making a profit. In our example, any output more than 6,666 units will mean profits are earned.

The difference between the actual output and the break-even output is known as the **"margin of safety".** For example, if actual output were 8,000 units, then the margin of safety = 8,000 units less 6,666 units = 1,334 units.

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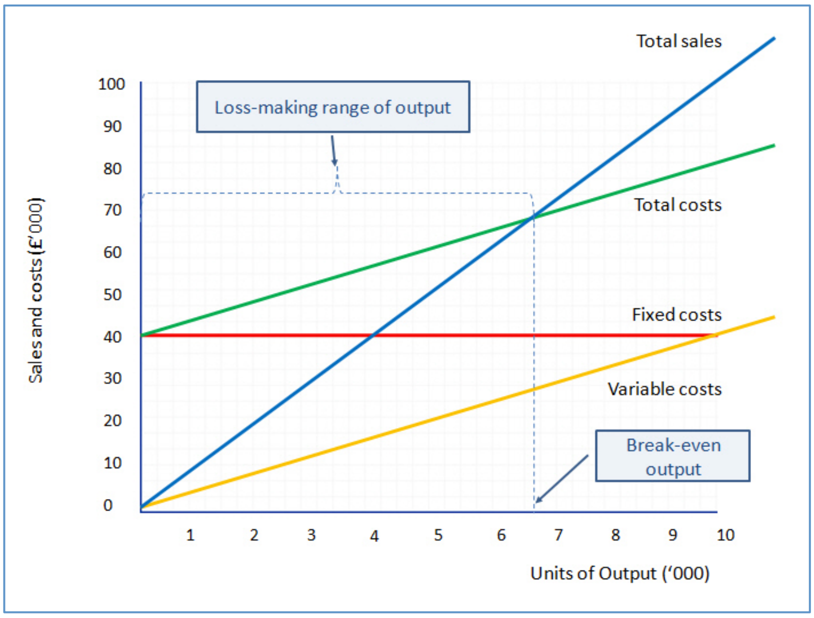

More on the Margin of Safety

The margin of safety is an important concept in breakeven analysis. The margin of safety is the difference between actual output and the breakeven output. A worked example of how it is calculated is shown below.

	DATA
Selling price per unit	£10
Variable cost per unit	£4
Contribution per unit	**£6**
Fixed costs per period	£12,000
Actual output	3,500 units
Breakeven output	**2,000 units**
MARGIN OF SAFETY	**1,500 units**

Changes to Breakeven

We have looked at three approaches to calculating break-even output using the same information. The next stage is to consider what happens to break-even if the data changes. The best way to see the effect of these changes is to work through some calculations. However, here is a simple summary you might find helpful:

Change	Effect on Contribution per Unit	Effect on Breakeven Output
Higher selling price	Higher	Lower
Lower selling price	Lower	Higher
Higher variable cost per unit	Lower	Higher
Lower variable cost per unit	Higher	Lower
Increase in fixed costs	No change	Higher
Decrease in fixed costs	No change	Lower

Strengths and Limitations of Breakeven Analysis

These can be summarised as follows:

Strengths	Limitations
Focuses on what output is required before a business reaches profitability	Unrealistic assumptions – products are not sold at the same price at different levels of output; fixed costs do vary when output changes
Helps management & finance-providers better understand the viability and risk of a business or business idea	Sales are unlikely to be the same as output – there may be some build up of stocks or wasted output too
Margin of safety calculation shows how much a sales forecast can prove over-optimistic before losses are incurred	Variable costs do not always stay the same. For example, as output rises, the business may benefit from being able to buy inputs at lower prices (buying power)
Illustrates the importance of keeping fixed costs down to a minimum	Most businesses sell more than one product
Calculations are quick and (relatively) easy	A planning aid rather than a decision-making tool

Key Terms

Contribution	The difference between total revenues and total variable costs
Contribution per unit	The difference between selling price per unit and variable cost per unit
Margin of safety	The difference between actual output and breakeven output
Breakeven output	The output at which total revenues = total costs

Topic: Budgeting

3.4 Decision-making to Improve Financial Performance

What You Need to Know
What a budget is
Business benefits of budgeting
The budgeting process
Meaning & interpretation of budget variances

Introduction

A budget is **financial plan for the future concerning the revenues and costs of a business.**

The preparation of budgets is an important business process:

- The process by which financial control is exercised in a business
- Budgets for revenues and costs are prepared in advance and then compared with actual performance to establish any variances
- Managers are responsible for controllable costs within their budgets
- Managers take remedial action if the adverse variances are regarded as excessive

Budgets of various kinds have many uses in business, particularly as the business grows, becomes more complex and the organisational structure becomes more complicated. Some key uses of budgets in business include:

Establish priorities & set targets	Delegate without loss of control
Turn objectives into practical reality	Motivate staff
Provide direction and co-ordination	Improve efficiency
Assign responsibilities	Forecast outcomes
Allocate resources	Monitor performance
Communicate targets	Control income and expenditure

Principles of Effective Budgeting

For budgeting to work effectively as a management process, the following principles need to apply:

- Managerial responsibilities are clearly defined
- Managers have a responsibility to adhere to their budgets
- Performance is monitored against the budget
- Corrective action is taken if results differ significantly from the budget
- Unaccounted for variances are investigated
- Departures from budgets are permitted only after approval from senior management

Two Main Approaches to Budgeting

There are traditionally two main approaches to budgeting – historical and zero-based. These are summarised below.

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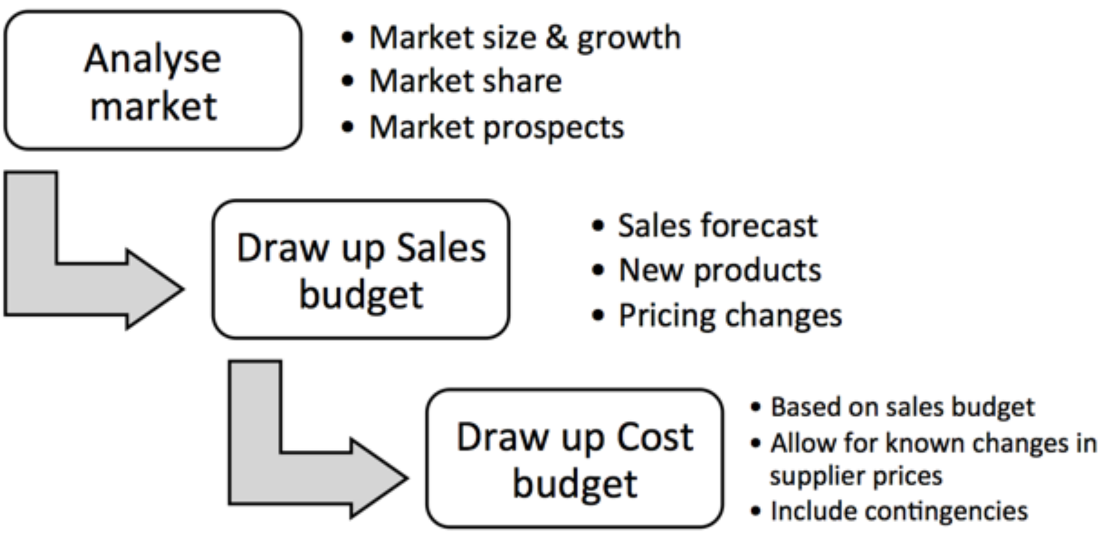
HISTORICAL BUDGETING	ZERO BUDGETING
• Use last year's figures as the basis for the budget • Realistic in that it is based on actual results • However, circumstances may have changed (e.g. new products, lost customers, credit crunch) • Does not encourage efficiency	• Budgeted costs & revenues are set to zero • Budget is based on new proposals for sales and costs – i.e. built from the bottom-up • Makes budgeting more complicated and time-consuming, but potentially more realistic

Three Main Types of Budget

The three most common types of budget in business are the revenue, cost and profit budgets. These are summarised below:

Type of Budget	What is Included
Revenue (or income) budget	Expected revenues & sales Broken down into more detail (products, locations, etc.)
Cost (or expenditure) budget	Expected costs based on sales budget Overheads and other fixed costs
Profit budget	Based on the combined sales and cost budgets Of great interest to stakeholders May form basis for performance bonuses

The diagram below illustrates how the profit budget is produced. Importantly it needs to be based on an informed analysis of the competitive (market) position of the business. The profit budget then flows from the revenue and cost budgets.



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Budgetary Accuracy
A budget is only as accurate and useful as the quality of the information used to produce it!

Various sources of information are typically used to inform the budgeting process: for example;

- **Financial performance in previous periods**
    - Particularly for established businesses
    - Lots of relevant data likely to be available
- **Market research**
    - Trends in market size, growth, segmentation, product life cycles
    - Competitor activity
    - Customer feedback

The main difficulties in budgeting accurately usually arise because of the challenges of forecasting revenues and costs:

Sales Forecasting	Costs
• Harder when market experiences rapid change (e.g. new technology) • Start-up firms find it hard to estimate likely sales and revenues • Competitor actions difficult to predict	• Always likely to be unexpected costs • Will vary depending on the sales budget • Changes in external environment will impact costs (e.g. taxes, exchange rates

Variance Analysis
Variance analysis involves calculating and investigating the differences between actual results and the budget.

Variances can be either:

- **Positive/favourable** (better than expected) or
- **Adverse/unfavourable** (worse than expected)

A **favourable variance** might mean that:

- Costs were lower than expected in the budget, or
- Revenue/profits were higher than expected

By contrast, an **adverse variance** might arise because:

- Costs were higher than expected
- Revenue/profits were lower than expected

Should variances be a matter of concern to management? After all, a budget is just an estimate of what is going to happen rather than reality. The answer is – it depends. The significance of a variance will depend on factors such as:

- Whether it is positive or negative – adverse variances (negative) should be of more concern

- Was it foreseen?
- Was it foreseeable?
- How big was the variance - absolute size (in money terms) and relative size (in percentage terms)?
- The cause
- Whether it is a temporary problem or the result of a long term trend

Example of Variance Analysis
Consider the following budget statement:

	Budget	**Actual**	**Variance**	**Favourable**
	£'000	**£'000**	**£'000**	**or Adverse**
SALES REVENUE				
Standard product	75	90	15	F
Premium product	30	25	-5	A
Total sales revenue	**105**	**115**	**10**	**F**
COSTS				
Wages	35	38	3	A
Rent	15	17	2	A
Marketing	20	14	-6	F
Other overheads	27	35	8	A
Total costs	**97**	**104**	**7**	**A**
Profit	**8**	**11**	**3**	**F**

What do the numbers in the budget statement tell us?

- Looking at the sales revenue section, you can see that actual sales of standard product were £15k higher than budget – this is a positive (favourable) variance.
- Turning to the costs section, actual wages were £3k higher than budget – i.e. an adverse (negative) variance.
- Overall, the profit variance was positive (favourable) – i.e. better than budget

Problems and Limitations of Using Budgets
Whilst budgets are widely used to in business, you should appreciate that they have some important limitations. In particular, budgets

- Are only as good as the data being used to create them. Inaccurate or unreasonable assumptions can quickly make a budget unrealistic
- Can lead to inflexibility in decision-making
- Need to be changed as circumstances change
- Can take significant time to prepare – in large businesses, whole departments are sometimes dedicated to budget setting and control
- Can result in short term decisions to keep within the budget rather than the right long term decision which exceeds the budget

- Managers can become too preoccupied with setting and reviewing budgets and forgetting to focus on the real issues of winning customers

Budgets can also create some behavioural challenges in a business

- Budgeting has behavioural implications for the motivation employees
- Budgets are de-motivating if they are imposed rather than negotiated
- Setting unrealistic targets adds to de-motivation
- Budgets contribute to departmental rivalry - battles over budget allocation
- Spending up to budget: it can result in a "use it or lose it" mentality - spend up to the budget to preserve it for next year
- Budgetary slack occurs if targets are set too low
- A "name, blame and shame" culture can develop - but managers should be answerable only for variations that were under their control

Key Terms

Budget	Financial plan for the future concerning the revenues and costs of a business
Variance analysis	Calculating and investigating the differences between actual results and the budget
Positive variance	Actual result is better than budget
Adverse variance	Actual result is worse than budget

Topic: Sources of Finance

3.4 Decision-making to Improve Financial Performance

What You Need to Know
Internal and external sources of finance
Benefits and drawbacks of different sources of finance
Criteria in choosing a source of finance

Introduction

There are a wide variety of potential sources of finance for a business. The key sources are summarised in the table below:

Long-term	**Medium-term**	**Short-term**
Finances the whole business over many years	*Finances major projects or assets with a long-life*	*Finances day-to-day trading of the business*
Examples:	***Examples:***	***Examples:***
Share capital Retained profits Venture capital Mortgages Long-term bank loans	Bank loans Leasing Hire purchase Government grants	Bank overdraft Trade creditors Short-term bank loans Factoring

Factors Influencing the Choice and Amount of Finance Required

- What is the finance required for?
  - E.g. is it to finance long-term assets like a new factory) or a short-term increase in stocks?
- The cost of the finance
  - Bank finance incurs interest costs
  - Share capital also has a cost – the dividends (returns) required by shareholders
- The flexibility of the finance
  - What repayments might be required (and when)
- The business organisational structure
  - E.g. limited companies normally find it easier to raise finance than sole traders

Sources of Finance for a New (Start-up) Business

A new (or start-up) business normally finds it hard to raise finance. It is not surprising – the business is new and unproven and therefore much higher risk to potential finance-providers.

The main sources of finance used by new businesses tend to be:

Topic: Sources of Finance
3.4 Decision-making to Improve Financial Performance

Internal Sources	External Sources
Founder finance (various personal sources of the entrepreneur) Retained profits Friends & family	Business angels Loans & grants Crowdfunding Bank loan Bank overdraft

Founder finance is particularly popular and important for start-ups: this can involve some or all of the following:

- Cash and investments
- Redundancy payments
- Inheritances
- Personal credit cards
- Re-mortgaging
- Putting time into the business for free

Personal sources like the above provide some important benefits for a new business; for example:

- They are cheap (e.g. compared with a bank loan)
- The entrepreneur keeps more control over the business
- The more the founder puts in, the more others will invest (added confidence)
- Little red tape or delay
- Focuses the mind!

Sources of Finance for Established Businesses
A wider range of mainstream sources of finance is available for established businesses:

Internal Sources	External Sources
Retained profits Working capital Asset disposals	Share issues Bank loans and overdrafts Peer-to-peer lending Debentures Venture capital Supplier finance

Let's explore these in a little more detail, highlighting the key features of each and their respective benefits and drawbacks as a source of finance.

Topic: Sources of Finance

3.4 Decision-making to Improve Financial Performance

Retained Profits

By some distance the most important sources of finance for a profitable business.

Benefits of Retained Profits	Drawbacks of Retained Profits
• Cheap (though not free) • The "cost " of retained profits is the opportunity cost for shareholders of leaving profits in the business • Very flexible - management control how they are reinvested • Shareholders control the proportion retained • Do not dilute the ownership of the company - unlike the issue of new share capital	• A danger of hoarding cash • Shareholders may prefer dividends if the business is not achieving sufficiently high returns on investment • High profits and cash flows would suggest the business could afford debt (higher gearing)

Working Capital

The effective management of working capital is an important part of cash flow management. Key points to remember are:

- Cash inflow arise from reducing working capital
    - This is a one-off source of finance
    - However, the question is can it be sustained?
- Finance often wasted in excess stocks and trade debtors
- Look for very low inventory turnover ratio or high debtor days – for businesses that ought to be able to release cash tied up in working capital

Asset Disposals

- Potentially another one-off boost to finance
- Good examples: spare land, surplus equipment
- Note – not all businesses have spare assets
- Often occurs after acquisitions

Share Issues

You cover the detail of this when looking at shares and share prices. The key points to remember are:

Benefits of Share Issues	Drawbacks of Share Issues
Able to raise substantial funds if the business has good prospects	Can be costly and time-consuming (particularly flotations)
Broader base of shareholders	Existing shareholders' holdings may be diluted
Equity rather than debt = lower risk finance structure	Equity has a cost of capital that is higher than debt

Topic: Sources of Finance
3.4 Decision-making to Improve Financial Performance

Bank Loans and Bank Overdrafts

Bank loans are a common source of finance for established businesses. However banks have been criticised in recent years for making their lending criteria more demanding, which has resulted in less bank lending to some sectors:

Key points to note about bank loans:

- Medium or long-term finance (depending on the term of the loan)
  - Loan provided over fixed period
  - Rate of interest either fixed or variable
  - Timing and amount of repayments are set
- Good for financing investment in fixed assets
- Generally at a lower rate of interest that a bank overdraft
- However, bank loans don't provide much flexibility

Bank overdrafts are the classic source of short-term finance, widely used by businesses of all sizes.

Key points to remember about bank overdrafts:

- An overdraft is really a **loan facility –** the bank lets the business "owe it money" when the bank balance goes below zero, in return for charging a high rate of interest
- A **flexible** source of finance, in the sense that it is only used when needed
- Bank overdrafts are excellent for helping a business handle seasonal fluctuations in cash flow or when the business runs into short-term cash flow problems (e.g. a major customer fails to pay on time).

The relative benefits and drawbacks of bank finance are:

Bank Overdraft	**Bank Loan**
Advantages	
Relatively easy to arrange	Greater certainty of funding, provided terms of loan complied with
Flexible – use as cash flow requires	Lower interest rate than a bank overdraft
Interest – only paid on the amount borrowed under the facility	Appropriate method of financing fixed assets
Not secured on assets of business	
Disadvantages	
Can be withdrawn at short notice	Requires security (collateral)
Interest charge varies with changes in interest rate	Interest paid on full amount outstanding
Higher interest rate than a bank loan	Harder to arrange

Debentures

A debenture is a form of bond or long-term loan issued by the company, usually with a fixed rate of interest.

Topic: Sources of Finance

3.4 Decision-making to Improve Financial Performance

An increasing number of larger businesses have raised finance using debentures in recent years in preference to taking on bank debt.

Key points to remember about debentures are:

- Long-term: often 10-20 years
- Issued by the company (not a bank)
- Fixed rate of interest
- Usually secured against the assets of the company (provides some protection for debenture holders)
- Can be traded

Venture Capital (also known as Private Equity)

For the right business, venture capital is a highly useful source of external equity finance.

- Specialist investors in private companies
- Often back management buy-outs (MBOs)
- They manage investment funds designed to achieve high rates of returns
- Tend to focus on larger investments (>£1m) than business angels
- Will seek a large share of the share capital (equity) + representation on the Board
- Look to sell ("exit") their investment in the medium-term (e.g. 5-7 years)

Advantages of Venture Capital	Disadvantages of Venture Capital
Can raise substantial amounts	Venture capitalist requires a high rate of return
Business benefits from specialist investor support	Investment often supported by a high level of bank debt in business
Brings better discipline to business management & strategy	Not a long-term investment – venture capitalist will aim to sell within 5-7 years
Helps original business owners realise their investment	Loss of control – venture capitalist may take a majority share in company

Supplier Finance

As we have seen in our study of working capital management, the availability of trade credit from suppliers can be a significant source of short-term finance.

- Suppliers provide goods and services in advance of payment = trade creditors
- As a business expands, the amount owed to suppliers at any one time also grows
- If a business has a strong relationship with its suppliers, then it may be able to obtain better (i.e. longer) payment terms

Topic: Cash Flow Forecasting and Management

3.4 Decision-making to Improve Financial Performance

What You Need to Know
Constructing & analysing a cash flow forecast
Methods of improving cash flow

Introduction

Cash flow is hugely important in business:

- Cash flow is a dynamic and unpredictable part of life for most businesses (particularly start-ups and small businesses)
- Cash flow problems are the main reason why a business fails
- Regular and reliable cash flow forecasting can address many of the problems

As a result, cash flow forecasting is also a very important part of financial management:

- Cash is king – it is the lifeblood of a business
- If a business runs out of cash it will almost certainly fail
- Few businesses have unlimited finance – cash is limited, so it needs to be managed carefully

It follows that a carefully -prepared cash flow forecast can provide a variety of benefits:

- Advanced warning of cash shortages
- Make sure that the business can afford to pay suppliers and employees
- Spot problems with customer payments
- As an important part of financial control
- Provide reassurance to investors and lenders that the business is being managed properly

Constructing the Cash Flow Forecast

The cash flow forecast starts by making sure all cash inflows and outflows into a business are identified:

Main Cash Inflows	**Main Cash Outflows**
Cash sales	Payments to suppliers
Receipts from trade debtors	Wages and salaries
Sale of fixed assets	Payments for fixed assets
Interest on bank balances	Tax on profits
Grants	Interest on loans & overdrafts
Loans from bank	Dividends paid to shareholders
Share capital invested	Repayment of loans

The key to cash flow management is having **good information.** A good cash flow forecast:

- Is updated regularly
- Makes sensible assumptions
- Allows for unexpected changes

Topic: Cash Flow Forecasting and Management
3.4 Decision-making to Improve Financial Performance

An example of a cash flow forecast is provided below:

	Jan	Feb	Mar	Total
CASH INFLOWS				
Investment	10,000			10,000
Sales	2,500	10,000	15,000	27,500
Total inflows	**12,500**	**10,000**	**15,000**	**37,500**
CASH OUTFLOWS				
Raw materials	4,000	5,000	5,000	14,000
Wages & salaries	3,500	4,000	4,000	11,500
Marketing	2,500	1,000	2,000	5,500
Set-up costs	3,000	1,000	0	4,000
Other costs	2,000	1,000	1,000	4,000
Total outflows	**15,000**	**12,000**	**12,000**	**39,000**
NET CASH FLOW	**-2,500**	**-2,000**	**3,000**	**-1,500**
Opening balance	0	-2,500	-4,500	
Closing balance	-2,500	-4,500	-1,500	

The key points to remember about constructing a cash flow forecast are:

- A forecast is normally produced by month
- Net cash flow is the difference each month between cash inflows and cash outflows
- Opening balance is the amount the business starts with each month
- Closing balance = opening balance + net cash flow
- Negative closing balance suggests business needs bank overdraft or additional financing

Common Issues with Cash Flow Forecasts
Like all forecasting (e.g. sales forecasts and budgets) forecasting is inherently uncertain since it involves making estimates and assumptions. Real-life never turns out exactly how you expect! Common issues with cash flow forecasts include:

- **Sales prove lower than expected**
    - Easy to be over-optimistic about sales potential
    - Market research may have gaps
- **Customers do not pay up on time**
    - A notorious problem for businesses, particularly small ones
- **Costs prove higher than expected**
    - Perhaps because purchase prices turn out higher
    - Maybe also because the business is inefficient
    - A common problem for a start-up
    - Unexpected costs always arise – often significant

Topic: Cash Flow Forecasting and Management

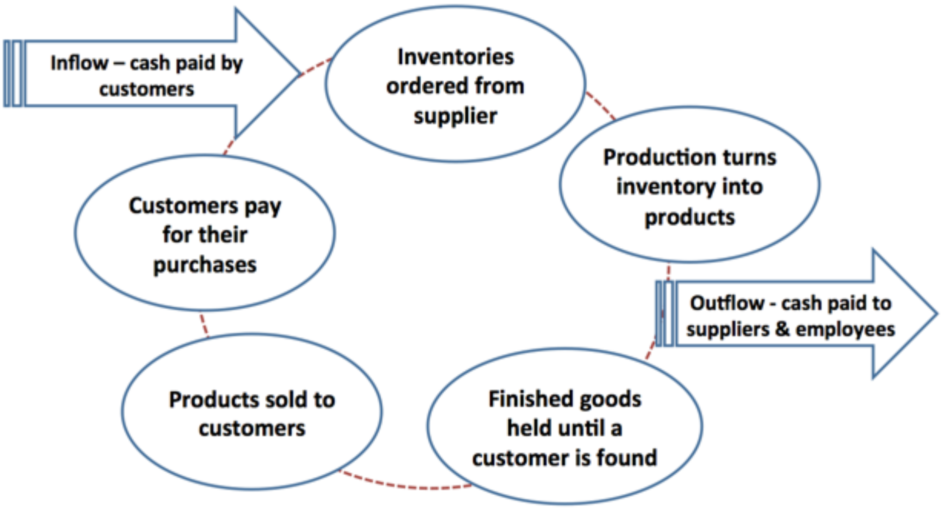
3.4 Decision-making to Improve Financial Performance

Managing Cash Flow

Producing cash flow forecasts is just one part of effective cash flow management.

Cash flow management is a crucial day-to-day activity for every business, in particular to avoid cash flow problems.

As cash flows around a business (see the diagram below) it is quite common for cash flow problems to arise.



The most common cash flow problems are summarised below:

Cause of Cash Flow Problem	Comments
Low profits or (worse) losses	• The main underlying cause of cash flow problems, particularly over the long-term • Profit is the most important source of finance • Lack of profit is the cause of business failure
Too much production capacity	• Spending too much on fixed assets • Made worse if short-term finance is used (e.g. bank overdraft) • Fixed assets are hard to turn back into cash in the short-term
Excess inventories held	• Excess stocks tie up cash • Increased risk that stocks become obsolete • But... • There needs to be enough stock to meet demand • Bulk buying may mean lower purchase prices
Allowing customers too much credit & too long to pay	• Customers who buy on credit are called "**trade debtors**" • Offer credit = good way of building sales • But... • Late payment is a common problem • Worse still, the debt may go "bad"
Overtrading – growing the business too fast	• Where a business expands too quickly, putting pressure on short-term finance • Classic example – retail chains

Topic: Cash Flow Forecasting and Management
3.4 Decision-making to Improve Financial Performance

Cause of Cash Flow Problem	Comments
	– Keen to open new outlets – Have to pay rent in advance, pay for shop-fitting, pay for stocks – Large outlay before sales begin in new store • Businesses that rely on long-term contracts also at high risk of overtrading
Seasonal demand	• Where there are predictable changes in demand & cash flow • Production or purchasing usually in advance of seasonal peak in demand = cash outflows before inflows • This can be managed – cash flow forecast should allow for seasonal changes

The key to managing cash flow problems lies in:

- Regular and reliable cash flow forecasting
- Managing working capital
- Having sufficient and suitable sources of finance

You look at sources of finance as a separate topic and we've already looked at cash flow forecasting. So let's now look at **managing working capital.**

Managing Working Capital
Effective management of working capital involves focusing on:

Debtors	Amounts owed by customers
Creditors	Amounts owed to suppliers
Inventories (or stocks)	Cash tied up in raw materials, work in progress and finished goods

Improving Cash Flow from Debtors

Key points to remember are:

Effective Credit control
- Policies on how much credit to give and repayment terms and conditions
- Measures to control doubtful debtors
- Credit checking

Offer cash discounts for prompt payment
Improve record keeping – e.g. accurate and timely invoicing
Potentially use debt factoring

What is debt factoring?
- The selling of debtors (money owned to the business) to a third party
- This generates cash
- It guarantees the firm a percentage of money owed to it
- But will reduce income and profit margin made on sales
- Cost involved in factoring can be high

Topic: Cash Flow Forecasting and Management

3.4 Decision-making to Improve Financial Performance

Improving Cash Flow from Creditors

Key points to remember are:

- Trade credit - amounts owed to suppliers for goods supplied on credit and not yet paid for
- Delayed payment means that a business retains cash longer
- But - have to be careful not to damage firm's credit reputation and rating
- Trade creditors are seen (wrongly) as a "free" source of capital
- Some firms habitually delay payment to creditors in order to enhance their cash flow - a short-sighted policy and raises ethical issues

Improving Cash Flow from Inventory (Stocks)

Key points to remember are:

- Inventory refers to goods purchased and awaiting use or produced and awaiting sale
- Inventories take the form of raw materials, work-in-progress and finished goods
- Stockholding is costly and therefore it is sound business to:
    - keep smaller balances (just in time stocks)
    - computerise ordering to improve efficiency
    - improve stock control
- This will cut down the spending on stock but may leave the business vulnerable to stock outs

Key Terms

Cash flow forecast	An analysis of estimated cash inflows and cash outflows over a future period and the resulting impact on cash balances
Working capital	The cash tied up by a business in inventories held and amounts owed by customers, less amounts owed to creditors
Credit control	The management of amounts owed on credit by the customers of a business

Topic: Setting Human Resource (HR) Objectives
3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
What is Human Resource Management (HRM)
HR objectives
Value of setting HR objectives
Internal and external influences on HR objectives & decisions
Hard and soft HRM approaches

Introduction to HRM / HR
Human resource management (HRM) is defined by the CIPD as "the design, implementation and maintenance of strategies to manage people for optimum business performance".

HRM has become significantly more important in modern business:

- Most businesses now provide **services** rather than produce goods – people are the critical resource to deliver the required **quality and customer service** level
- **Competitiveness** requires a business to be efficient and productive – this is difficult unless the workforce is well motivated, has the right skills and is effectively organised
- The move towards fewer layers of management hierarchy (flatter organisational structures) has placed greater emphasis on delegation and communication

HRM is a catch all term that covers a wide variety of tasks involving the management of people in a business. For example it includes:

- Workforce planning
- Recruitment & selection
- Training
- Talent development
- Employee engagement & involvement
- Managing diversity
- Developing corporate culture

HR Objectives
An HR objective is a specific goal or target of relating to the management and performance of human resources in a business.

HR objectives can add significant value to the operation of a business: they

- Connect HR activities & decision-making with overall business objectives
- Link HR with customers service and quality – two key components of competitiveness
- Help create effective working environment for a key stakeholder group - employees

Topic: Setting Human Resource (HR) Objectives

3.6 Decision Making to Improve Human Resource Performance

Common HR objectives are summarised below:

Objective	HR Actions
Ensure human resources are employed cost-effectively	Pay rates should be competitive but not excessive Achieve acceptable staff utilisation Minimise staff turnover Measure returns on investment in training
Make effective use of workforce potential	Ensure jobs have suitable, achievable workloads Avoid too many under-utilised or over-stretched staff Make best use of employees skills
Match the workforce to the business needs	Planning to ensure business has the right number of staff in the right locations with the right skills Effective recruitment to match workforce needs Training programmes to cover skills gaps or respond to changes in technology, processes & market Get the right number and mix of staff at each location where the business operates in multiple sites and countries
Maintain good employer / employee relations	Avoid unnecessary and costly industrial disputes Timely and honest communication with employees and their representatives Sensitive handling or potential problems with employees (e.g. dismissal, redundancy, major changes in the business) Comply with all relevant employment legislation
High employee engagement and involvement	Involving employees in job design and other work-related improvements Provide an effective outlet for the employee "voice" - communication
Operate effective talent development	Link talent development programmes with strategies for recruitment and retention Implement effective internal recruitment processes
Manage diversity well	Effective equality management and processes Full compliance with diversity legislation

Internal and External Influences on HR Objectives

The main internal influences on the setting of HR objectives are:

Topic: Setting Human Resource (HR) Objectives

3.6 Decision Making to Improve Human Resource Performance

Corporate objectives	E.g. an objective of cost reduction is likely to require HR to implement redundancies, job reallocations etc.
Operational strategies	E.g. introduction of new IT or other systems and processes may require new staff training, fewer staff
Marketing strategies	E.g. new product development and entry into a new market may require changes to organisational structure and recruitment of a new sales team
Financial strategies	E.g. a decision to reduce costs by outsourcing training would result in changes to training programmes

The key external influences on HR objectives can be summarised as follows:

Market changes	E.g. a loss of market share to a competitor may require a change in management or job losses to improve competitiveness
Economic changes	E.g. the recession of 2009/10 placed great pressure on HR departments to reduce staff costs and improve productivity
Technological changes	E.g. the rapid growth of social networking may require changes to the way the business communicates with employees and customers
Social changes	E.g. the growing number of single-person households is increasing demand from employees for flexible working options
Political & legal changes	E.g. EU legislation on areas such as maximum working time and other employment rights impacts directly on workforce planning and remuneration

Soft and Hard HRM

In terms of approaches to how management view human resources, a popular distinction is made between "soft" and "hard" HRM:

SOFT HRM	• Treats employees as the most important resource in the business and a source of competitive advantage • Employees are treated as individuals and their needs are planned accordingly
HARD HRM	• Treats employees simply as a resource of the business. • Strong link with corporate business planning – what resources do we need, how do we get them and how much will they cost

Topic: Setting Human Resource (HR) Objectives

3.6 Decision Making to Improve Human Resource Performance

The key features of Soft and Hard HRM approaches can be summarised as follows:

SOFT HRM	HARD HRM
Focus: Concentrate on the needs of employees – their roles, rewards, motivation etc.	***Focus:*** Identify workforce needs of the business and recruit & manage accordingly (hiring, moving and firing)
Key features: • Strategic focus on longer-term workforce planning • Strong and regular two-way communication • Competitive pay structure, with suitable performance-related rewards (e.g. profit share, share options) • Employees are empowered and encouraged to seek delegation and take responsibility • Appraisal systems focused on identifying and addressing training and other employee development needs • Flatter organisational structures • Suits democratic leadership style	***Key features:*** • Short-term changes in employee numbers (recruitment, redundancy) • Minimal communication, from the top down • Pay – enough to recruit and retain enough staff (e.g. minimum wage) • Little empowerment or delegation • Appraisal systems focused on making judgements (good and bad) about staff • Taller organisational structures • Suits autocratic leadership style
Is it the best approach? • Seen as an approach that rewards employee performance and motivates staff more effectively. • However, be too "soft" and when all the employee benefits are added up, the cost of the workforce may leave a business at a competitive disadvantage.	***Is it the best approach?*** • Might result in a more cost-effective workforce where decision-making is quicker and focused on senior managers. • But a genuinely "hard" approach might expect to suffer from higher absenteeism and staff turnover and less successful recruitment.

Key Terms

Human resource management	The strategies and activities involved in the management of human resources in a business
Soft HRM	An approach to HRM that sees people as the most important asset in a business
Hard HRM	An approach to HRM that aims to make the most efficient use of people in a business

Topic: Analysing HR Performance

3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
Labour turnover and retention rates
Labour productivity & unit labour costs
Absenteeism
Employee costs as a percentage of turnover

Introduction

In this topic we look at three important measures of HR performance:

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

Employee Retention

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

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

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

Labour Turnover

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

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

Let's look at an example of the calculation:

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

Labour turnover =

$$\frac{\textbf{Number of employees leaving (15)}}{\textbf{Average number employed (80)}} \quad \textbf{X 100}$$

$$\textbf{= 18.75\%}$$

Topic: Analysing HR Performance

3.6 Decision Making to Improve Human Resource Performance

A wide variety of factors can influence labour turnover:

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

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

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

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

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

Labour Productivity

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

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

Topic: Analysing HR Performance
3.6 Decision Making to Improve Human Resource Performance

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

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

Key factors that influence the level of labour productivity include:

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

Labour productivity is calculated using the following formula:

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

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

An example of the calculation is:

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

Labour productivity is therefore:

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

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

Potential approaches to improving labour productivity include:

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

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

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

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

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

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

Absenteeism can be calculated using this formula:

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

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

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

The key to tackling absenteeism is for management to:

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

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

Topic: Analysing HR Performance

3.6 Decision Making to Improve Human Resource Performance

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

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

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

Here is some summary guidance on interpreting the two ratios:

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

Key Terms

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

Topic: Organisational Design
3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
Organisational structure • Hierarchy • Spans of Control • Delegation & authority
Job design and organisational design • Job enlargement & job rotation • Job enrichment • Empowerment

Introduction to Organisational Structure
The organisational structure shows how employees and management are organised in a business.

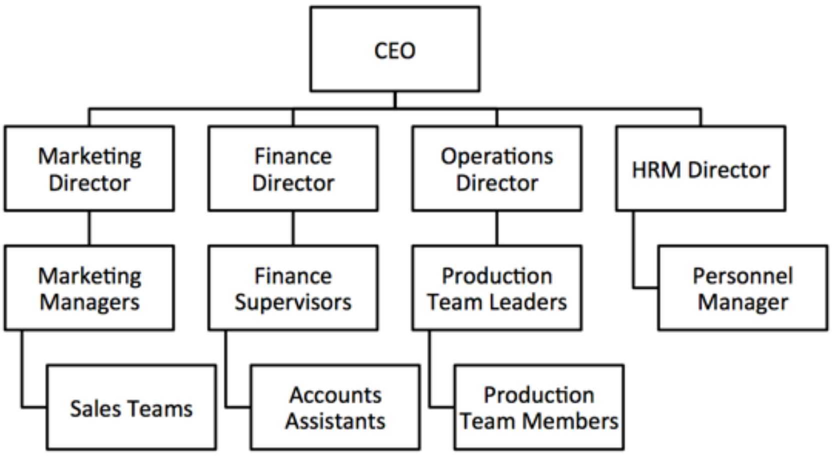
The organisational structure is vitally important because it determines:

- **Authority** and **responsibility** – who is responsible for whom and who is in charge?
- Individual job roles and titles
- The people to whom others are accountable
- The formal routes through which communication flows in the business

The simplest way to show how a business is organised is to look at an organisation chart. This shows the management hierarchy in a business. It works from the top to bottom and also illustrates:

- Span of Control
- Line management
- Chain of command

An example organisation chart is shown below:



Topic: Organisational Design

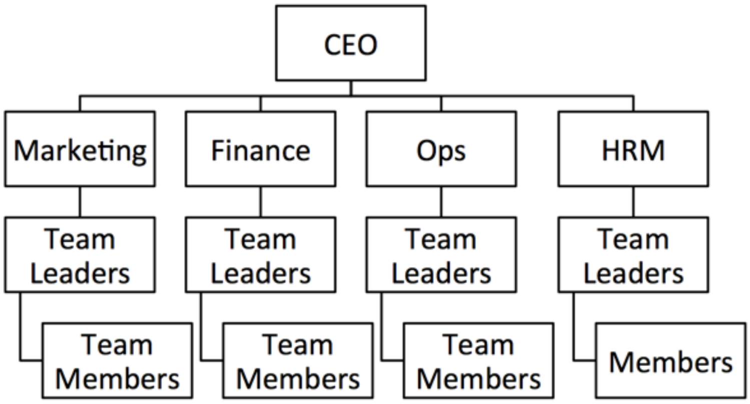
3.6 Decision Making to Improve Human Resource Performance

Hierarchy

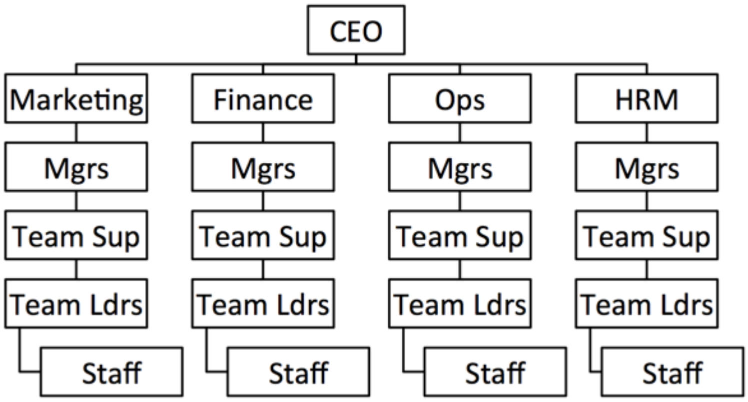
The levels of hierarchy refer to the number of layers within an organisation.

Traditional organisations were tall with many layers of hierarchy and were often authoritarian in nature.

The organisation chart above shows a business with four levels of hierarchy – from the Managing Director at the top, to assistants and team members at the bottom.

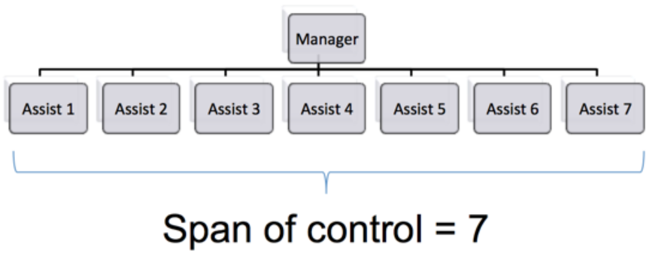


Below is another organisation chart, which shows a taller hierarchy.



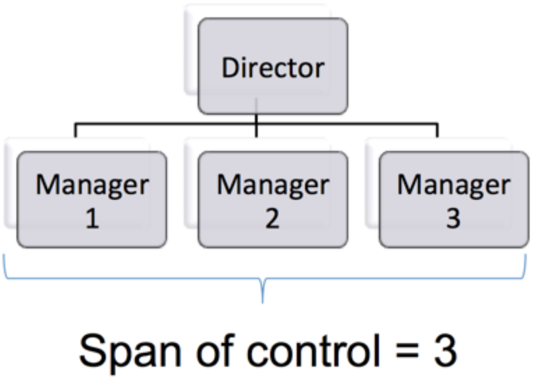
Span of Control

The span of control is the number of subordinates for whom a manager is directly responsible. The two diagrams below illustrate two different spans of control:



A span of control of 7 would be considered to be quite wide. Contrast this with a span of 3 below, which would be considered "narrow"

Topic: Organisational Design
3.6 Decision Making to Improve Human Resource Performance



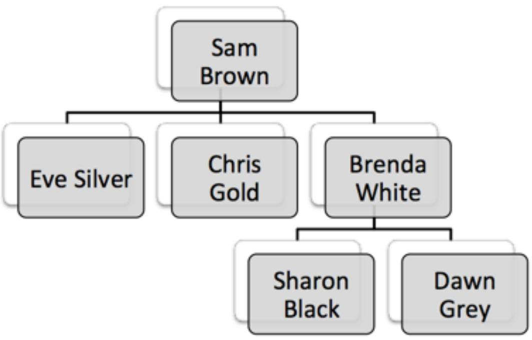
Is there an ideal span of control? The answer is generally no – a suitable span of control will depend on factors such as the:

- Experience and personality of the manager
- Nature of the business. If being a line manager requires a great deal of close supervision, then a narrower span might be appropriate
- Skills and attitudes of the employees. Highly skilled, professional employees might flourish in a business adopting wide spans of control
- Tradition and culture of the organisation. A business with a tradition of democratic management and empowered workers may operate wider spans of control

Should spans of control be wide or narrow?

Narrow Span of Control	**Wide Span of Control**
Allows for closer supervision of employees	Gives subordinates the chance for more independence
More layers in the hierarchy may be required	More appropriate if labour costs are significant – reduce number of managers
Helps more effective communication	

Chain of Command
The chain of command describes the lines of authority within a business. In the simple organisation chart below Sam is responsible for Eve, Chris and Brenda. Further down the chain, Brenda is responsible for Sharon and Dawn.



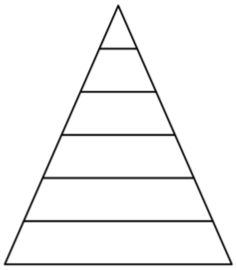
Topic: Organisational Design

3.6 Decision Making to Improve Human Resource Performance

What is the Most Effective Hierarchy?

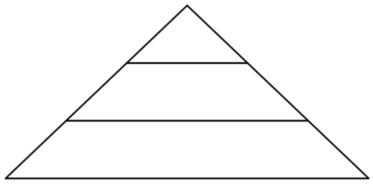
Although it is a generalisation, there are traditionally two categories of organisational structure based around the number of layers in the hierarchy and span of control: tall and flat

Tall structure



- Key features – many layers of hierarchy + narrow spans of control
- Allows tighter control (less delegation)
- More opportunities for promotion
- Takes longer for communication to pass through the layers
- More layers = more staff = higher costs

Flat structure



- Key features – few layers of hierarchy + wide spans of control
- Less direct control + more delegation
- Fewer opportunities for promotion, but staff given greater responsibility
- Vertical communication is improved
- Fewer layers = less staff = lower costs

Delegation

Be careful not to confuse delayering with a similar-sounding term: delegation. **Delegation** is the assignment to others of the authority for particular functions, tasks, and decisions. The advantages and disadvantages of encouraging greater delegation include:

Advantages of Delegation	Disadvantages of Delegation
Reduces management stress and workload Allows senior management to focus on key tasks Subordinates are empowered and motivated Better decisions or use of resources (potentially) Good method of on-the-job training	Cannot / should not delegate responsibility Depends on quality / experience of subordinates Harder in a smaller firm May increase workload and stress of subordinates

Job Empowerment

Job (or employee) empowerment is about giving employees the power to do their job. The concept is closely linked to motivation and customer service. Put simply, employees need to feel that their actions count. Empowerment is a catch-all term that covers:

- Giving authority to make decisions to front-line staff (e.g. hotel receptionist, call centre assistant)
- Encouraging employee feedback
- Showing more trust in employees

Topic: Organisational Design

3.6 Decision Making to Improve Human Resource Performance

Job Design

We also look at job design when considering motivation in practice (in particular looking at Hackman & Oldham's model). The key points to remember at this stage are:

- Job design is all about the tasks and responsibilities that are grouped into a specific job
- Job design can have a significant influence on labour productivity – through the link with motivation
- Boring, repetitive jobs can often lead to poor quality and low productivity

Changing the Organisational Structure

Organisational structures are dynamic – they change! Indeed a business that doesn't regularly assess how effective its organisational structure may find itself becoming uncompetitive.

- **Why change the structure?**
  - Growth of the business means a more formal structure is appropriate
  - Reduce costs and complexity (key)
  - Employee motivation needs boosting
  - Customer service and/or quality improvements
- **Challenges of changing the structure**
  - Manager and employee resistance
  - Disruption and de-motivation = potential problems with staff retention
  - Costs (e.g. redundancies)
  - Negative impact on customer service or quality

Delayering

Delayering involves removing layers of management from the hierarchy of the organisation. The potential benefits and drawbacks of delayering an organisational structure include:

Benefits of Delayering	Drawbacks of Delayering
Lower management costs Faster decision making Shorter communication paths Stimulating employee innovation	Wider spans of control – too wide? Potential loss of management expertise

Authority and Organisational Design – Who Makes the Decisions?

Decision-making in an organisation is about a**uthority.** A key question is whether authority should rest with senior management at the centre of a business (**centralised**), or whether it should be delegated further down the hierarchy, away from the centre (**decentralised**).

Centralised Decision-Making

Businesses with a centralised structure keep decision-making firmly at the top of the hierarchy (amongst the most senior management). The main benefits and drawbacks of a centralised approach include:

Topic: Organisational Design
3.6 Decision Making to Improve Human Resource Performance

Advantages of Centralisation	Disadvantages of Centralisation
Easier to implement common policies and practices for the whole business	More bureaucratic – often extra layers in the hierarchy
Prevents other parts of the business from becoming too independent	Local or junior managers are likely to much closer to customer needs
Easier to co-ordinate and control from the centre – e.g. with budgets	Lack of authority down the hierarchy may reduce manager motivation
Economies of scale and overhead savings easier to achieve	Customer service does misses flexibility and speed of local decision-making
Quicker decision-making (usually) – easier to show strong leadership	

Decentralised Decision-Making
In a decentralised organisational structure, decision-making is spread out to include more junior managers in the hierarchy, as well as individual business units or trading locations. The main benefits and drawbacks of a decentralised approach include:

Advantages of Decentralisation	Disadvantages of Decentralisation
Decisions are made closer to the customer	Decision-making is not necessarily "strategic"
Better able to respond to local circumstances	Harder to ensure consistent practices and policies at each location
Improved level of customer service	May be some diseconomies of scale – e.g. duplication of roles
Consistent with aiming for a flatter hierarchy	Who provides strong leadership when needed (e.g. in a crisis)?
Good way of training and developing junior management	Harder to achieve tight financial control – risk of cost-overruns
Should improve staff motivation	

Key Terms

Hierarchy	The structure and number of layers of management and supervision in an organisation
Span of control	The number of employees who are directly supervised by a manager
Delegation	Where responsibility for carrying out a task or role is passed onto someone else in the business.
Empowerment	Delegating power to employees so that they can make their own decisions
Delayering	The process of removing one or more layers from the organisational structure
Centralisation	An organisational structure where authority rests with senior management at the centre of the business
Decentralisation	An organisational structure where authority is delegated further down the hierarchy, away from the centre

Topic: Managing the Human Resource Flow

3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
Recruitment
Training & development
Redeployment
Redundancy & dismissal

Introduction: How Work is Changing

The important context for this topic s that the world of work is changing fast, which has significant implications for how businesses manage their human resource requirements;

- The way we work is changing rapidly:
  - Increase in part-time working
  - Increases in numbers of single-parent families
  - More women seeking work
  - Ageing population
  - Greater emphasis on flexible working hours
  - Technology allows employees to communicate more effectively whilst apart
  - People rarely stay in the same job for life
- Businesses need to understand and respond to these changes if they are to recruit staff of the right standard – and keep them!

The Growth of Part-time and Flexible Working

Increasing numbers of people in the UK are working part-time and/or on flexible working arrangements:

- **Advantages of this trend for businesses**
  - Cheaper to employ as entitled to less benefits
  - More flexible workforce (easier to reduce labour hours when sales fall or add hours when demand increases)
  - Wide range of potential recruits (e.g. working mothers who want to restrict the number of hours they work)
- **Disadvantages of this trend for businesses**
  - Employees feel less loyal to business and therefore less motivated
  - Harder for managers to control and coordinate workforce

Recruitment

The main methods of recruitment can be categorised into internal and external approaches, as listed below.

Methods of Internal Recruitment	**Methods of External Recruitment**
• Jobs given to staff already employed by business • Involves promotion and reorganisation	• Job centres • Job advertisements • Recruitment agencies (offline and online) • Headhunting • Personal recommendation

Topic: Managing the Human Resource Flow
3.6 Decision Making to Improve Human Resource Performance

The main benefits and drawbacks of internal and external recruitment are summarised below:

Benefits of Internal Recruitment	Drawbacks of Internal Recruitment
• Cheaper and quicker to recruit • People already familiar with business and how it operates • Provides opportunities for promotion with in business	• Business already knows strengths and weaknesses of candidates • Limits number of potential applicants • No new ideas can be introduced from outside • May cause resentment amongst candidates not appointed • Creates another vacancy which needs to be filled

Benefits of External Recruitment	Drawbacks of External Recruitment
• Outside people bring in new ideas • Larger pool of workers from which to find best candidate • People have a wider range of experience	• Longer process • More expensive process due to advertisements and interviews required • Selection process may not be effective enough to reveal best candidate

Training & Development
Training costs can be significant in any business. Most employers are prepared to incur these costs because they expect their business to benefit from employees' development and progress.

Training is needed within a business for a variety of reasons. Common training needs include:

- Supporting new employees (induction training)
- To improve productivity
- To increase marketing effectiveness
- Supporting high standards of customer service and production quality
- Introduction of new technology, systems or other change
- Addressing changes in legislation
- Support employee progression and promotion (internal recruitment)

If the training and development provided is effective, then the potential business benefits are significant: for example;

- Better productivity
- Higher quality
- More flexibility through better skills
- Less supervision required
- Improved motivation - through greater empowerment
- Better recruitment and employee retention
- Easier to implement change in the business

Effective training is also linked with a better-motivated workforce:

- Assuming training is effective: then…
- Employees feel more loyal to firm
- Shows that business is taking an interest in its workers
- Provide employees with greater promotional opportunities
- Enables employees to achieve more at work – perhaps gaining financially from this

Given the potential business benefits, it seems odd that many businesses neglect employee and management training. Why? Possible reasons include:

- They fear employees will be poached by competitors (who will then benefit from the training)
- A desire to minimise short-term costs
- They cannot make a justifiable investment case
- Training takes time to have the desired effect
- Sometimes the benefits of training are more intangible (e.g. morale) than tangible

On-the-Job Training

On-the-job training is where an employee receives training whilst remaining in the workplace. The main methods of on-the-job training are:

- **Demonstration / instruction** - showing the trainee how to do the job
- **Coaching** - a more intensive method of training that involves a close working relationship between an experienced employee and the trainee
- **Job rotation** - where the trainee is given several jobs in succession, to gain experience of a wide range of activities (e.g. a graduate management trainee might spend periods in several different departments)
- **Projects** - employees join a project team - which gives them exposure to other parts of the business and allow them to take part in new activities. Most successful project teams are "multi-disciplinary"

The key benefits and drawbacks of on-the-job training include:

Advantages	**Disadvantages**
Generally most cost-effective Employees are actually productive Opportunity to learn whilst doing Training alongside real colleagues	Quality depends on ability of trainer and time available Bad habits might be passed on Learning environment may not be conducive Potential disruption to production

Off-the-Job Training

Off-the-job training is training that takes place away from the workplace. Common examples are:

- Day or part-time attendance at college
- Professional development courses or conferences

- Online training / distance learning

The key benefits and drawbacks of off-the-job training include:

Advantages	Disadvantages
A wider range of skills or qualifications can be obtained Can learn from outside specialists or experts Employees can be more confident when starting job	More expensive – e.g. transport and accommodation Lost working time and potential output from employee New employees may still need some induction training Employees now have new skills/qualifications and may leave for better jobs

Redeployment and Redundancy
Two similar-sounding terms are linked, but different. Both relate to what happens when a business decides it needs to reduce or otherwise change the size of its workforce.

Redeployment involves moving employees to different jobs, departments or locations within the same business.

Redundancy arises when an employee is dismissed because the job / role no longer exists or is required.

It is normally the case that redeployment is preferable to redundancy, from both the employee and employer perspective. With redeployment:

- Maintains job security for employee
- Business retains skills & experience
- Labour resources are allocated more effectively
- Reduced costs of recruitment and selection

If there is no satisfactory redeployment option, alternatives to redundancy might also be possible. These include:

- A freeze on recruitment – with jobs lost through natural wastage (e.g. retirement)
- Short-time working or job-sharing
- Pay cuts or overtime bans to reduce wage costs

Key Terms

Redundancy	Where an employee is dismissed because the job / role no longer exists or is required
Redeployment	Moving employees to different jobs, departments or locations within the same business

Topic: Employee Motivation in Theory

3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
Main theories of employee motivation & their value • Taylor • Maslow • Herzberg
What is employee engagement?

Introduction to Motivation

Motivation is will to work. Motivation comes from enjoyment of work itself and/or from desire to achieve certain goals e.g. earn more money or achieve promotion.

There are two broad approaches available to motivate employees

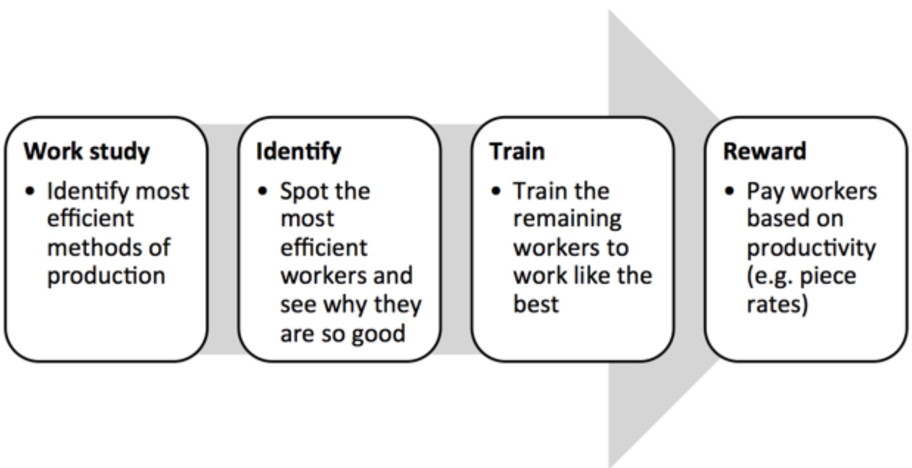
- Financial methods (e.g. salary, bonus)
- Non-financial methods (passing on responsibility or praise)

Theories of Motivation

Let's look in more detail at three classic theories of how to motivate employees:

Taylor (Scientific Management)

Taylor's "scientific" approach to management is summarised in the diagram below:



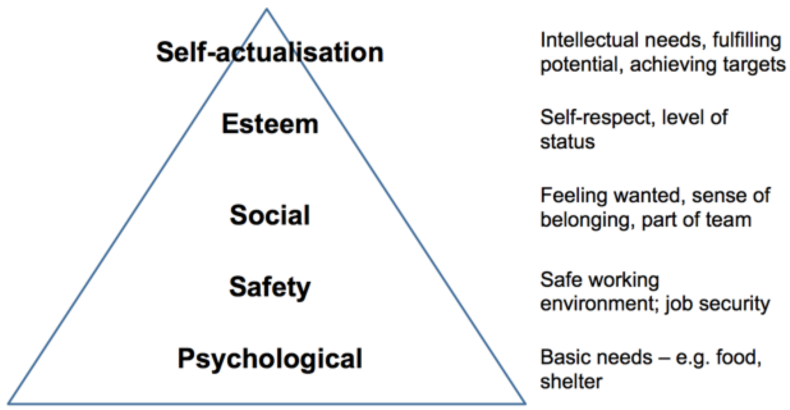
Topic: Employee Motivation in Theory

3.6 Decision Making to Improve Human Resource Performance

The key points to remember about Taylor are:

- Managers should maintain close control and supervision over their employees.
- Autocratic style of management- managers make all decisions themselves
- Consistent with Theory X (McGregor) approach to workers - believe workers are lazy and are only motivated by money
- Motivate workers using piece-rate payment (pay based on how much they produce)

Maslow (Hierarchy of Needs)



Maslow's famous hierarchy of needs suggested that:

- There are five levels of human needs which employees need to have fulfilled at work
- Only once a lower level of need has been fully met, would a worker be motivated by the opportunity of having the next need up in the hierarchy satisfied
- A business should therefore offer different incentives to workers in order to help them fulfill each need in turn and progress up the hierarchy

Herzberg (Two Factor Theory)

Herzberg suggested that there were two key factors in workplace motivation:

Motivators

- Factors that directly motivate people to work harder
- Giving responsibility, recognition for good work, opportunities for promotion

Hygiene (maintenance) factors

- Factors that can de-motivate if not present but do not actually motivate employees to work harder
- Pay, working conditions, job security

Herzberg argued that managers should:

- Motivate by using motivators plus ensuring hygiene factors are met
- Use job enrichment and empowerment (delegating more power to employees to make their own decisions).

Topic: Employee Motivation in Theory

3.6 Decision Making to Improve Human Resource Performance

Employee Engagement

Employee engagement is a relatively new concept in HRM although it is attracting significant attention. Employee engagement is a workplace approach designed to ensure that employees are committed to their organisation's goals and values, motivated to contribute to organisational success, and are able at the same time to enhance their own sense of well-being.

There are three main elements to employee engagement:

Intellectual Engagement	Thinking about the job & how to do it better
Affective Engagement	Feeling positive about doing a good job
Social Engagement	Takes opportunities to share work-related issues with others at work

Employee engagement is related to, but is not quite the same as employee motivation:

Employee Engagement	**Employee Motivation**
• Employee is positive about his /her work • Thinks hard about how to improve • Engaged with fellow employees	• Employee has a will to work • Due to work incentives and/or satisfaction from work itself

Key Terms

Motivation	The will to work
Employee engagement	Employees are deeply integrated into their work, including supporting the values of the organisation

Topic: Employee Motivation in Practice

3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
Financial methods of motivation
Job design and enrichment
Choosing appropriate methods of financial and non-financial reward systems

Introduction to Financial Motivation

Whilst financial rewards are an important and core reward from working, they are just one part of the source of motivation at work.

People work:

- To earn money
- For a sense of achievement or job satisfaction
- To belong to a group
- For a sense of security
- To obtain a feeling of self-worth

The motivational theorists recognised this, although they differed in terms of how important they thought financial rewards were in terms of motivation:

- Taylor was only theorist to emphasise pay, in particular piece-rate, as best way of motivating employees
- Mayo, Maslow and Herzberg all felt that non-financial rewards, such as team working, empowerment or job enrichment, acted as a better incentive for employees to work harder.

Main Financial Incentives and Rewards at Work

These can be summarised as follows:

Wages	Normally paid per hour worked and receive money at end of week
Salaries	Normally an annual salary which is paid at end of each month
Bonus system	Usually only paid when certain targets have been achieved
Commission	Some workers, often salesmen, are partly paid according to number of products they sell
Profit sharing	A system whereby employees receive a proportion of company's profits
Performance related pay	Paid to those employees who meet certain targets
Share options	Common incentive for senior managers who are given shares in company rather than a straightforward bonus or membership of a profit sharing scheme
Fringe benefits	Items an employee receives in addition to their normal wage or salary e.g. company car, private health insurance, free meals

Topic: Employee Motivation in Practice
3.6 Decision Making to Improve Human Resource Performance

Let's look in a little more detail at some of these financial rewards. The key points to remember about each are:

Wages and Salaries

Wages	• Paid by hour with pay packet normally received at end of each week • Often paid to lower skilled workers or to temporary staff • Any additional hours worked normally paid a higher rate on an overtime basis
Salaries	• Often set on an annual basis but payment is made at end of each month • Normally paid to managers or those higher up in a company • A set number of hours is not normally agreed but employment contract requires enough hours worked to get job done

Fringe Benefits

- Often also known as 'perks'
- Items an employee receives in addition to their normal wage or salary
- E.g. company car, private health insurance, free meals
- Often increases loyalty to company as these benefits are not always taxed or are taxed at a reduced rate
- More likely to recruit best people to the business

Overtime and Bonus Pay

- **Overtime**
  - Additional hours worked over and above normal working hours
  - E.g. at weekends or on bank holidays
  - Paid at a higher rate - often 1.5 or 2 times normal hourly wage
- **Bonus pay**
  - Given out when certain performance targets have been met
  - Normally applicable at manager level in a company
- **How bonuses are used**
  - By motivating employees to work harder in order to meet a realistic yet challenging target and therefore achieve a bonus payment
  - Would only be effective if bonus payments were a significant sum

Profit Sharing

- **What it is:**
  - A system whereby employees receive a proportion of business profits
- **Advantages**
  - Creates a direct link between pay and performance
  - Creates a sense of team spirit- helps remove 'them and us' barrier between managers and workers if all employees involved
  - May improve employee's loyalty to company

- Employees more likely to accept changes in working practices if can see that profits will increase overall

Performance-Related Pay (PRP)

- Increasingly popular method of paying people
- Paid to those employees who meet certain targets
- **Advantages**
  - Senior managers can easily monitor and assess individual employee performance during appraisal process
  - Setting of targets for employees can ensure they are all closely focused to company objectives
- **Disadvantages**
  - Discourages a team based approach- can create unhealthy rivalry between managers
  - Can be difficult to accurately measure performance of some workers e.g. in service sector firms
  - Incentives may not be larger enough to motivate employees

Piece-rate Payments

- Relatively unusual and old-fashioned way of payment
- Pay per item produced in a certain period of time
- **Advantages**
  - Requires low levels of manager supervision
  - Encourages high speed production
  - Provides good incentive for workers who are mainly motivated by pay
- **Disadvantages**
  - Workers are focused on quantity not quality
  - It is repetitive for workers and can be de-motivating
  - Workers are only used to one set method of production and may resistant change

Commission

- A popular and widely-used financial incentive usually linked to achievement of sales
- Typical set-up
  - % commission for £value of sale achieved
  - Basis commission rate set at low rate
  - Higher rate offered once sales targets are achieved
- Main advantage – clear link between sales and remuneration
- Main disadvantages – sales may be influence by factors outside of employee control (e.g. mature product, customer service)

Main Non-Financial Incentives and Rewards at Work
These can be summarised as follows:

Empowerment	Delegating power to employees so they can make their own

	decisions
Praise	Recognition for good work
Promotion	Promoting employees to a position of higher responsibility
Job enrichment	Giving employees more challenging and interesting tasks
Job enlargement	Giving employees more tasks of a similar level of complexity
Better communication	Employees have a chance to give feedback and advice to managers
Working environment	Providing a safe, clean, comfortable environment to work in
Team working	Offers employees an opportunity to meet their social needs and often accompanied by empowerment for team

Looking in a little more detail at two of the above:

- **Job enrichment**
  - Involves giving workers more interesting and challenging tasks
  - Seen as more motivating as it gives workers chance to further themselves
  - Herzberg in particular recommended this approach
- **Job enlargement**
  - Involves giving workers more tasks to do of a similar nature or complexity
  - Job rotation is a part of this

Getting the Mix Right Between Financial and Non-Financial Rewards

- Most businesses employ a mix of financial & non-financial rewards
- The "market" largely determines the base financial rewards paid for most jobs & skills
- Offering employees some flexibility in choosing which rewards they get often works well
- Ultimately, financial rewards are closely influenced by what a business can afford

The Role of Job Design in Motivation (Hackman & Oldham)
What role does the job (or tasks) that employees are asked to do have on their motivation at work? One theory that tries to address this is Hackman & Oldham's job characteristics model.

Hackman & Oldham's job characteristics model is based on the belief that the task itself is key to employee motivation. Specifically, a boring and monotonous job stifles motivation to perform well, whereas a challenging job enhances motivation. Variety, autonomy and decision authority are three ways of adding challenge to a job. Job enrichment and job rotation are the two ways of adding variety and challenge.

Their model argues that it is possible to design jobs that add to employee motivation.

Topic: Employee Motivation in Practice

3.6 Decision Making to Improve Human Resource Performance

Hackman & Oldham suggested that there are five job characteristics that can be studied to help predict job satisfaction:

Skill variety	How many different skills and talents does the job require of a person. Are they asked to do a lot of different things, or is it a monotonous, repetitive job?
Task identity	Is there a clearly defined beginning, middle and end to a given task? Does a worker know what he or she is supposed to do, and when he or she is successfully completed the task?
Task significance	Does the job have "a substantial impact? Will it matter to people, either within the organization or to society? Is this job/given task meaningful?
Autonomy	How much freedom does an individual have to accomplish his or her tasks? This freedom includes the ability to schedule work as well as figuring out how to get the tasks done.
Job feedback	Is an employee kept in the loop about their performance? Are they being told when they are doing well and when they are not?

Key Terms

Job design	The contents of a job in terms of its duties and responsibilities
Job enrichment	A job design technique that is a variation on the concept of job enlargement. Job enrichment adds new sources of job satisfaction by increasing the level of responsibility of the employee.

Topic: Employer-Employee Relations

3.6 Decision Making to Improve Human Resource Performance

What You Need to Know
Role of trade unions in employee representation
Benefits of good industrial relations
Impact of industrial disputes
Alternatives to industrial disputes

Introduction to Employee Representation

Employee representation arises when employees are part of a formal structure for involving them in the decision-making process of a business.

Employment law in the UK requires employers to involve employees in the following:

- Proposed redundancy programmes
- When employees are transferred from one employer to another (e.g. the sale of the business)
- On changes to pension arrangements
- Proposed changes to working time arrangements

It also makes good business sense to involve employees in a range of other decision-making processes. A formal system of employee representation helps:

- Make employees' views known to management
- Strengthen both management's and employees' understanding of workplace issues and other matters affecting the business
- Create an atmosphere of mutual trust between employees and management and therefore improve workplace relations

Overall, the key benefits and drawbacks of employee representation (from the business' perspective) can be summarised as follows:

Advantages	**Disadvantages**
Increased empowerment and motivation of the workforce	Time-consuming – potentially slows decision-making
Employees become more committed to the objectives and strategy of the business	Conflicts between employer and employee interests may be a block to essential change
Better decision-making because employee experience and insights taken into account	Managers may feel their authority is being undermined
Lower risk of industrial disputes	

The Role of Trade Unions

A trade union is an organised association of workers in a trade, group of trades, or profession, formed to protect and further their rights and interests. The traditional role of trade unions is to:

- Protect and improve the real incomes of their members
- Provide or improve job security

- Protect workers against unfair dismissal and other issues relating to employment legislation
- Lobby for better working conditions
- Offer a range of other work-related services including support for people claiming compensation for injuries sustained in a job

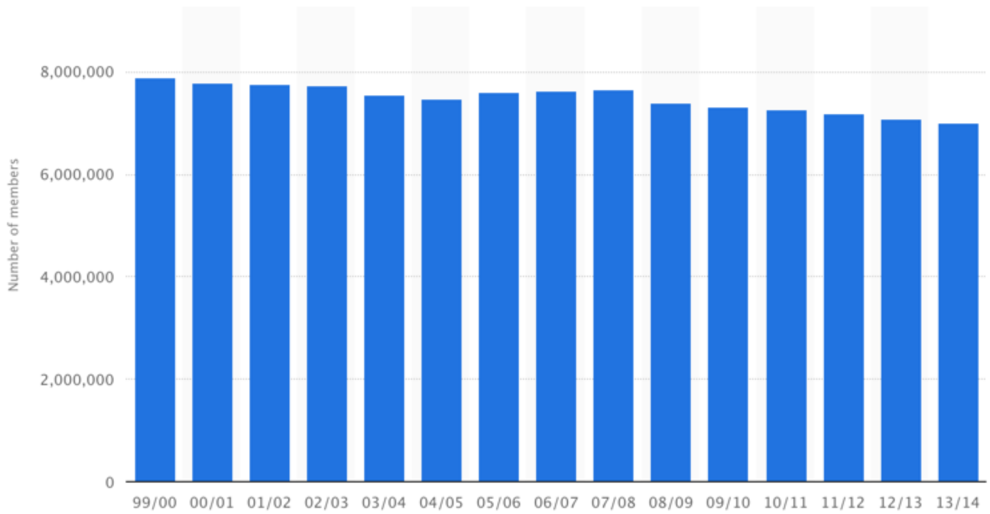
The two key functions of a trade union are therefore to:

Represent	Represent & protect interest of employees
Negotiate	Negotiate on behalf of employees with employer

Although the employer – trade union relationship is often viewed as being confrontational, there are some sound business reasons to pursue a good working relationship between the two:

- Negotiating with trade unions (ideally a single union) saves time and cost rather than dealing with all employees individually
- Unions are part of the communication process between the business and employees
- Employee morale and motivation may be improved if they know that their interests are being protected by a union
- The trade union can be a supportive partner in helping a business undergo significant change

The Decline of Trade Union Membership
A significant feature of the UK labour market in recent years has been the slow, but steady decline in employee membership of trade unions, as illustrated by the chart below:



The key reasons for declining trade union membership include:

- Decline in employment in manufacturing (where union membership is traditionally high)

- Increased employment in the service sector (e.g. retail) where unions are less well established
- Growth in the number of small firms which tend not to recognise (or need) trade unions
- Significant growth in flexible working (part-time, temporary, seasonal) – where employees see less need for union protection
- Improved employee involvement in the workplace – so less perceived need for collective bargaining

Industrial Action

Industrial action arises when workers do something that is intended to force an employer to agree to something, especially by stopping work. The most common methods of industrial action are:

Method	Description
Work-to-rule	Employees follow the strict conditions of their employment contract – no voluntary overtime, no participation in supporting activities. Staff still get their basic pay.
Overtime ban	Employees refuse to work overtime. Can have a significant effect on production capacity during period of peak demand, but ineffective as a bargaining tool during quieter periods!
Go-slow	Employees work at the slowest or least-productive pace that is allowable under their employment contracts
Strike	The action of last-resort; fraught with danger for both employer and employee and strictly policed by legislation on industrial action.

In most cases of industrial action, **the effect is lose-lose**: i.e. both employees and employers suffer in the short-term. Some examples of this are provided below.

Damage for the Business	Damage for the Employee
Lost sales and profits from the lost output	Lost pay
Damage to customer satisfaction	Potential loss of jobs if the action results in action to cut costs
An internal distraction for management and the business (worse if competitors are not affected)	Possible loss of customer and public support (depending on the reasons for the action)
Damaged relationship with staff may adversely affect motivation, productivity etc.	Risk that illegal action will result in legal proceedings

It therefore makes sense for employees and employers to avoid industrial disputes where possible. Good communication is the key: for example;

- Regular consultations with a trade union - pick up problems before they escalate
- A staff forum or joint working group to pass on information and collect ideas from workers and consult with workers
- An employee consultative body to discuss major issues as they arise
- Team and group meetings and feedback sessions

Topic: Employer-Employee Relations

3.6 Decision Making to Improve Human Resource Performance

Works Councils

A works council is a formal a group of employees representing a workforce in discussions with their employers. EU legislation make works councils mandatory for firms that operate in two or more EU countries and have more than 1,000 employees. The typical agenda for a works council includes:

- Business objectives and performance
- Workforce planning issues (e.g. recruitment, staffing levels)
- Employee welfare issues (working conditions, health & safety)
- Training and development programmes
- Compliance with legislation (e.g. discrimination)

Settling Industrial Disputes

The three main methods of settling industrial disputes are outlined below:

Method	Key Points
Conciliation	• Used when an employee is making, or could make, a specific complaint against their employer to an employment tribunal • Conciliator has no authority to seek evidence or call witnesses, or make decisions or awards • Conciliator discusses the issues with both parties in order to help them reach a better understanding of each other's position • Conciliator encourages the parties in dispute to come to an agreement between themselves, and so avoid the stress and expense of contesting the issue at an Employment Tribunal
Arbitration	• An alternative to a court of law • Held in private rather than in public (court case) • Arbitration involves an impartial outsider being asked to make a decision on a dispute • Arbitrator makes a firm decision on a case based on the evidence presented by the parties • Arbitration is voluntary, so both sides must agree to go to arbitration; they should also agree in advance that they will abide by the arbitrator's decision • Often used in disputes between employers and trade unions over collective bargaining issues (e.g. pay awards)
Mediation	• Involves an independent, impartial person helping two or more individuals or groups reach a solution that's acceptable to everyone • Aim is to restore and maintain the employment relationship wherever possible – not apportion blame • Best used early on in an industrial dispute • Agreements are not legally binding, but usually carried out

Key Terms

Employee representation	The formal or informal methods of involving employees in decision-making within an organisation
Industrial action	When workers do something that is intended to force an employer to agree to something, especially by stopping work.